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NONPROFIT ORGANIZATION LAW AND CHARITABLE GIVING

Presentation to the Nonprofit Organizations Standing Committee  
of the State Bar of California Business Law Section  
September 14, 2017

## **ENDOWMENT LAW**

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### **I. What is an endowment?**

**A. *In Common Usage.*** The term *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."<sup>1</sup>

**B. *In New Accounting Rules.*** The Financial Accounting Standards Board (FASB) issued new guidance in 2016<sup>2</sup> that defines *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 *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 *Funds Functioning as Endowment*.

The FASB guidance says that *quasi-endowment fund*, *board-designed endowment fund*, or *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.

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<sup>1</sup> See National Council of Nonprofits, <https://www.councilofnonprofits.org/tools-resources/endowments> (visited Jul. 28, 2017).

<sup>2</sup> Financial Accounting Standards Board, Accounting Standards Update No. 2016-14 (August 2016), "Not-for-Profit Entities (Topic 958)." The new rules are effective for financial statements issued for fiscal years beginning after Dec. 15, 2017.

C. **Legal Definition.** The Uniform Prudent Management of Institutional Funds Act, Cal. Probate Code §18501 *et seq.*, defines *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.<sup>3</sup>

## 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.<sup>4</sup> 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.<sup>5</sup> 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?

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<sup>3</sup> Cal. Probate Code §18502(b).

<sup>4</sup> See, e.g., *Queen of Angels Hospital v. Younger*, 66 Cal.App.3d 359 (1977); *In re Estate of Othmer*, 710 N.Y.S.2<sup>nd</sup> 848 (2000); *Dodge v. Anna Jaques Hosp.*, 301 Mass. 431, 436, 17 N.E.2d 308 (1938); Restatement (3<sup>rd</sup>) Trusts §28 (2003) (comment a).

<sup>5</sup> See, e.g., *College of Osteopathic Physicians and Surgeons*, 61 Cal.2d 750 (1964).

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.<sup>6</sup> 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.

### 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,<sup>7</sup> because of the exclusion of any

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<sup>6</sup> See *University of Southern California v. Bryson*, 103 CA 39 (1929), 1 Witkin, Summary of California Law (10<sup>th</sup> Ed., 2005) §253.

<sup>7</sup> 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").

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*,<sup>8</sup> but its 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 of 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.

#### **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:

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<sup>8</sup> 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).

- (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.