

## Mendrygal Law, PLLC – Client Alert

During economic downturns, charities and donors often inquire regarding a charity's power to invade or borrow from its endowment. Charities may be interested in increasing endowment spending, seeking release of spending restrictions, making loans from an endowment, or pledging endowment assets as security for loans. Although it is true that endowments are typically established to support the related charity, myriad restrictions apply to their use, including restrictions created by donors and Boards, and those required under state law. Borrowing from an endowment or pledging endowment assets is subject to restriction and regulation as well—often to the surprise of charities and their Boards.

What is an Endowment. The first question is whether the endowment at issue is, in fact, considered an endowment for legal purposes. Board-designated or “quasi” endowments (i.e. funds set aside or designated only by a Board of Directors or similar governing body) are not treated as endowments for legal purposes. An endowment for legal purposes is generally created only when a donor takes action—making a gift designated as an endowment or with spending restrictions or making a gift in response to a charity's solicitation for endowment funding.

Donor Intent. Any discussion about endowments necessarily raises the issue of donor intent. Donor-intent controversy is regularly in the public eye due to lawsuits and media stories in which institutions are accused of disregarding or misconstruing a donor's intentions. Conflicts related to donor intent can have significant implications for a charity from a legal and financial perspective, and—perhaps even more importantly—can have disastrous implications for both donor and public relations.

Most state laws governing endowments are default provisions that are “subject to the intent of the donor expressed in the gift instrument”. To the extent a gift instrument (i.e., a pledge or gift agreement) conflicts with UPMIFA (discussed below), the instrument will typically control.

Donor Consent. UPMIFA generally permits a charity to seek donor consent to changes in the use of a donation, including the release or modification of a restriction created by the donor. Where donors are alive and agreeable, this is often the preferred approach when considering invading an endowment. Oftentimes, even where charities have determined a legal basis exists to spend or borrow from an endowment, they nevertheless seek approval from major donors.

UPMIFA. UPMIFA or the “Uniform Prudent Management of Institutional Funds Act” provides standards for the investment, management, and spending of charitable funds, including endowments. It is important to understand that UPMIFA is based in state law, and the specific rules applicable to an endowment will vary based on the applicable law and how that state's legislature interpreted and implemented UPMIFA. A google search for “UPMIFA spending rules” may well result in inaccurate information. This alert is based on UPMIFA as adopted in Texas.

UPMIFA applies to most endowment funds—or, more specifically, to funds that are “not wholly expendable on a current basis”—irrespective of whether they are referred to as “endowments”. UPMIFA sets forth rules governing endowment management and spending, which include both the “appropriation

power” discussed below and, in some states including Texas, presumptions of imprudence where endowment spending exceeds a certain percentage of endowment value.

We are often asked by clients whether an endowment permits “total return” spending. While some endowments use this specific term, most often the answer lies in the UPMIFA appropriation power mentioned above. Subject to donor intent expressed in a gift instrument, a charity “may appropriate for expenditure ... so much of an endowment fund as the institution determines is prudent.” Essentially, this allows the Board of a charity to broadly invade an endowment in many instances. In making this determination, a Board must consider the uses, benefits, purposes, and duration of the endowment fund and must consider specific factors laid out in UPMIFA. As with all Board decisions, any action should be well documented in a written resolution or meeting minutes.

Interestingly, the language required to “opt out” of this appropriation power must be very specific—simply referring to a fund as an “endowment” or “income only” will generally not prevent a charity from invading an endowment.

“Underwater” Endowments. Another common question is whether an endowment may make distributions when the current asset value is less than the value of accumulated gifts—or the endowment is “underwater.” Although UPMIFA prioritizes the preservation of purchasing power of an endowment, spending from an “underwater” endowment is generally permitted where the charity acts in good faith and satisfies relevant standards.

Endowment Loans or Pledges. Unless specifically authorized by a donor or the endowment’s organizational documents, loans from endowments (or pledging endowment funds as collateral) are typically only permissible in circumstances where the charity could otherwise spend the endowment.

Other Mechanisms to Release Restrictions. In addition to seeking donor consent, other mechanisms are available to release or modify restrictions. Some gift instruments include procedures to this effect and court modification is always a possibility, although costly and time consuming. For certain endowment funds that are relatively small and old (subject to state-specific thresholds), a charity may be able to modify or release a restriction unilaterally, with notice to the state Attorney General. Again, the specifics of these options vary widely from state to state.

Impact of Organizational Documents. A common question involves the tension between purposes delineated in an endowment’s organizational documents (i.e., the Article of Incorporation or Certificate of Formation or the Bylaws) and the information communicated to donors. While organizational documents in place at the time of a contribution unquestionably control, there is a valid question—one that is often asked by state regulators—whether this aligns with the intent of a donor who may not have been fully aware of the content of the documents. Many endowments’ documents explicitly authorize an emergency invasion power, subject to particular approvals and parameters—typically with a goal of preventing an organization from going under during a time of unexpected financial strain.

Record-Keeping. Although an issue to be considered in the normal course of business, the discussion above emphasizes the importance of detailed and thorough record-keeping by endowments. A thorough documentation process should enable a charity to properly characterize endowment assets and fully understand the restrictions in place and the related financial reporting requirements.

If you have any questions related to the above discussion, please do not hesitate to contact one of the following attorneys or visit [www.mendrygallaw.com](http://www.mendrygallaw.com) for more information about our practice.

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**Mendrygal Law, PLLC is a boutique law firm devoted exclusively to guiding nonprofits through the complexities of the legal and regulatory requirements for tax-exempt organizations.**

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