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Nonprofits Are In a Bind As The Markets and Madoff Sink Endowments Underwater

In these difficult economic times, charitable organizations face many challenges, including those emanating from steep drops in their endowments as a result of losses in their equities and bonds. The shocking alleged fraud involving Bernard L. Madoff Investment Securities, which has impacted an indeterminate number of charities, underscores the recent trend where endowment funds of a growing number of nonprofit organizations are, or will become, "underwater." Even if your organization has managed to avoid losses from Madoff, it is likely that your endowment is affected by the overall economic downturn, which has cast a very wide net.

An endowment is an individual established fund consisting of cash, securities or other assets, which provides for the maintenance of a not-for-profit organization and that, under the terms of the applicable gift instrument, is "not wholly expendable by the corporation on a current basis." The term "underwater endowment" refers to an endowment whose market value has decreased below its historic dollar value. "Historic dollar value" is the sum of (1) the fair market value of an endowment fund at the time of creation, (2) the fair market value of any later gifts made to the endowment fund, and (3) any additions of endowment fund appreciation to historic dollar value that the donor directs the institutional board to make upon the creation of the fund.

For New York nonprofit corporations, the Uniform Management of Institutional Funds Act (UMIFA) and the New York Not-for-Profit Corporation Law (N-PCL) govern when, and to what extent, a nonprofit may spend the appreciation generated from endowment funds. New York law permits a "total return" approach to investing endowments, providing that the governing board of the nonprofit may invest in any real or personal property it deems advisable, whether or not such investments produce a current return. UMIFA expressly authorizes a charity's governing board to delegate investment decisions either to a committee of the board, or to outside investment advisors.

Organizations with endowments traditionally tended to invest largely in fixed-income bonds, preferred stock, or the safest blue chip common stocks. More recently, many charities have invested more aggressively and have turned to equities as well as riskier alternative investments such as hedge funds, private equity, venture capital, commodities, and distressed debt. Many endowment funds, including those that may have been invested prudently, appear to be suffering severe losses.

Absent an explicit donor restriction to the contrary, if the value of the assets in your endowment has appreciated over historic dollar value, the board of directors may appropriate for expenditure the net appreciation realized (with respect to all assets) and unrealized (with respect to marketable assets) as the board deems prudent. A board cannot appropriate net appreciation if the value of an endowment is at or below historic dollar value.

Many New York charities may have inadvertently made expenditures from endowment funds based on anticipated income and appreciation, but now find that their endowments are effectively underwater. When an endowment is underwater, the institution faces severe potential limitations on future expenditures. Moreover, if a charity has inadvertently made expenditures from principal in a manner which is inconsistent with a donor imposed restriction, prompt remedial action might be appropriate. This could include seeking permission from the donor to lift the restriction. Where such permission cannot be obtained (if, for example, the donor is deceased, or a living donor declines to provide the requested permission), the charity might examine whether to seek relief from the restriction under the doctrine of cy pres (which could require a court order on notice to the Attorney General).

If you are concerned about your organization's ability to utilize endowment funds, or if your endowment has lost value this year (as it most likely has), we recommend that you immediately consult with your legal and accounting advisors as to the appropriate options and course of action.

Tax Exempt Organizations Group

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