Getting Serious About Building Endowment: Straight Talk for Charities and the Professionals That Serve Them

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Ten years ago, an endowment signaled an embarrassment of riches. Organizations that held endowments were considered overfunded and were chastised for holding funds rather than spending those dollars on critical current needs. As a result, boards were often ambivalent about an endowment, torn between the need to justify its existence and spending the assets to meet current needs. Now endowments are a sign of a fiscally responsible, well-prepared and forward-looking nonprofit, ready to weather economic downturns and ensure a long-term survival.

Endowments have never been more important than today. Gift income is down. Government grants are down. Corporate and foundation grants are down. Stock gifts are down. Those nonprofits that cannot count on an endowment resource in difficult times may be forced to cut staff and programs, or even cease to exist.

Building a strong endowment is a proactive, not reactive, process. The organization must have clear goals, spending policies, asset building strategies and an investment management process that reflects those objectives. This session is designed to guide both the nonprofit and professional advisor through that process.

I. How Well Do You Know Your Endowment's Vital Statistics? – A Quiz for Nonprofit Managers and Development Staff

In large profits and small, decisions about endowment structure and management are often relegated to the CFO or financial office. Development staff, volunteers and professional advisors may not know the details of management or performance. However, donors are asking questions and expect answers. Given the dramatic movement in the securities' markets and the abundance of information on performance available through financial publications and newsletter, these questions will increase.

Take this quick quiz to determine if you are prepared to talk with donors about your endowment:

1. Does your organization have an endowment?
2. What is the market value of your endowment?
3. What is the current asset allocation of your endowment?
4. How has that asset allocation changed over the last year with the dramatic changes in the stock market?
5. What was the total return on your endowment last year? (And, what is total return?) What was the total return over the last five years?
6. How do your total returns compare to the blended index return?
7. What is the spending policy for your endowment?
8. Are there any restrictions on terms a donor can impose on endowment gifts?
9. Are there any restrictions on the type of assets that can be contributed to your endowment?
10. Who makes decisions about distributions from your endowment?

Think through the answers you would give a donor if asked. Mark the questions you can answer, and then check the scoring results at the top of the next page:

Number of Questions You Can Answer	Scoring
9-10	Well prepared genius – your donors will be impressed
5-8	Moderately prepared – you will survive the call
3-4	Not good enough – prepare to be humbled
0-2	Do you really work there?

II. The Role of Endowment

A. Defining Endowment

The term "endowment" is broadly used throughout this discussion to describe funds set aside for the long-term benefit of the nonprofit (rather than for current operations). While operating funds are generally invested in cash equivalents and short-term bonds to maximize current income, endowment funds are invested in equities and longer-term bonds to achieve growth and an increasing stream of income.

1. The Need to Define Endowment

One of the difficulties in having a discussion about endowment is that each nonprofit defines the concept in its own way. This leads to confusion when comparing practices among institutions or trying to establish a baseline for moving forward. Some institutions define the concept using a statutory legal definition and include only those funds legally restricted as endowment. Others have not attempted to define the term at all and have funds scattered among a variety of accounts, each with its own investment structure, comprising the endowment. The first step in creating a successful endowment is to define it. This definition must include a description of the types of funds considered as "endowed", the type of funds committed to endowment, the spending policy, investment goals and purpose.

2. The Need to Make a Commitment to Endowment

Nonprofits are well advised to adopt a board resolution to allocate deferred planned gifts – bequests, beneficiary designations of insurance and retirement plans, remainders from charitable remainder trusts, and other unexpected gifts – to endowment rather than the operating budget. These gifts cannot be budgeted since they accrue at the death of the donor (which does not occur with the predictability suggested by the annuity tables) and create fluctuations in the operating revenue that may be difficult to cover in subsequent years. In addition, the long-term benefit of those gifts is lost if immediately expended. Discipline allows the board to commit the funds to endowment, and then request principal distributions when emergencies or special situations arise. A sample board resolution is attached at Appendix A.

3. Forms of Endowment

There are three types of endowments: true endowments; quasi-endowments; and term endowments.

a. True Endowment

A true endowment consists of funds permanently set aside (document or legally restricted) to generate income for the nonprofit. Principal may not be spent. Income may be narrowly defined as the dividends, interest, and rental income from the endowed assets, or more broadly to include realized or unrealized capital gain, depending on state law and the governing document for the funds. When a donor limits the use of endowed funds, the endowment gift is considered restricted. When the donor leaves spending discretion to the nonprofit, the gift is considered unrestricted. Most endowments consist of a pool of unrestricted funds as well as many small groups of restricted funds pooled for investment purposes.

> **EXAMPLE 1**: Jerry Jones left a bequest of $250,000 to Northwestern University to provide scholarships for Chicago students attending Northwestern with grade point averages of 3.8 or better on a 4.0 scale. His will specifically provided that the corpus of the gift was to be preserved and that income only was to be used for scholarships.

b. Quasi-endowment

While a permanent endowment has restrictions on the use of principal, a quasi-endowment does not. Quasi-endowed funds are funds committed to long-term use (endowment) generally by board resolution. Board-restricted funds may include unrestricted bequests or planned gifts received by the nonprofit, surplus funds available at year-end (that are not needed for operating reserves), or funds resulting from the sale of an asset. Since the donor did not restrict the funds, the board can remove its self-imposed restriction and make the principal available for use. Normally, the board will establish procedures to govern distribution of income and withdrawal of principal.

> **EXAMPLE 2:** Jerry Jones left a bequest of $250,000 to Northwestern University. Although he had contributed to the scholarship program throughout his life, he placed no restrictions on the use of the bequest gift. The board of the University, after discussion, decided to allocate the funds for scholarship purposes to reflect Mr. Jones' lifelong interests.

c. Term Endowment

A term endowment is a gift in which the principal is restricted for a specific period of time. For example, a donor may create a gift for ten years to benefit a particular university program, or to fund a need for a limited period of time. Alternatively, a donor may contribute funds to amortize a bond issue and tie the term to the life of the bonds. After the expiration of the time, the board may use the principal or allocate it to a quasi-endowment.

4. Pooled Endowments

Nonprofits pool endowed funds to achieve efficiency in investing the assets. Pooling endowed assets requires special accounting – either by use of an internal spreadsheet or other software – to segregate and track income from restricted funds or term-endowments. Tracking can be difficult when the endowment has hundreds of sub-accounts and income restrictions vary from fund to fund. Therefore, most nonprofits establish minimums for restricted funds and term endowments such as $50,000 to $100,000.

Sometimes pooling is not permitted because the donor specifies the funds are to be invested separately. In this case, the funds are managed as a separate account. Nonprofits are now doing a better job of communicating endowment objectives and restrictions to donors to avoid gift restrictions hindering long-term management and performance. Those left with older funds with restrictions may obtain some relief under the Uniform Management of Institutional Funds Act, discussed later.

B. Who Needs an Endowment?

Planned giving programs and endowments are closely related. The primary goal of most planned giving programs is to raise funds for the organization's endowment to ensure its long-term viability. Therefore, the first question to ask is: "Does the nonprofit organization need an endowment?".

There is no purely objective test that leads an organization to decide to establish an endowment. The following questions may help a board remain focused on objective, rather than emotional, issues in making the decision. Positive answers to any of these questions may lead the organization to consider the creation of an endowment:

- *Does the organization serve a purpose or need that is likely to exist on a long-term basis?*
- *Do cyclical economic variances impact the receipt of annual or special event gifts?*
- *Does the organization face increasing operating costs?*
- *Does the organization currently have new programs related to its purpose that cannot be operated because they lack funding?*

- *Does the organization anticipate future needs for programs that may not be met for lack of funding?*
- *Does the organization face increasing competition for annual gifts?*
- *Is the organization dependent upon government or private grants for its organizational expenses? .*
- *Has the organization lost major annual gifts through attrition of its donors?*

C. The Case Statement For Endowment

Once the charity has resolved the need for endowment, the points supporting the decision should be reduced to a compelling case statement for donor support. The case statement should mesh the mission and purposes of the organization with the need for long-term support. The statement should be a clear, concise, compelling argument for the donor's role in the charity's future and should appear on all of the nonprofit materials related to building endowment.

D. Getting an Endowment Commitment from the Board

Nonprofits often create endowments by accident rather than by design. An accidental endowment results from a gift – usually a planned gift – left to the organization by a donor for a specific purpose. The donor's objectives may be to create an income stream to replace his annual gift to the organization, to start or endow a scholarship, or to provide start-up funds for a new program. When the charity receives the restricted funds and sets them apart to comply with the donor's directives, an endowment is born.

Planned endowments result from a board action to establish a fund and resolution to build it. It may be funded first through a transfer of surplus operating funds or matured planned gifts. The board's goals may be to ensure future funding for the organization or to encourage donors to make endowed gifts. Endowments may also be intentionally created as part of a capital campaign. Capital campaigns that involve new buildings, a new campus, or even new programs require additional operational dollars for maintenance of facilities and programs. An endowment may be the only way to ensure that additional income is available to meet operating needs. Often, this endowment funding is built into the campaign goals.

1. Overcoming the Most Common Myths

Nonprofit boards may have concerns about building endowments and the deterrent that a big endowment may have on fundraising efforts. These concerns should be raised and answered before the board makes a decision on how to proceed.

- **The Organization Will Appear Rich**

Often boards are reluctant to create an endowment for fear that foundations and the public will not support the organization if it appears "rich" with endowed dollars. The concern of appearing too wealthy is real. The nonprofit must communicate the role of the endowment as it relates to the purpose that is served by the organization. Individual donors are more likely to commit their personal dollars to the organization's future if an endowment exists to protect those dollars.

- **Donors Will Restrict the Use of Funds**

Boards may also be concerned about restrictions placed on endowed dollars when the gift is made. When funds are restricted for a specific use, the charity must have the ability to segregate and account for the funds to ensure that the income and principal are spent in the manner directed. If the restrictions on fund use are so narrow that the charity is unable to spend the money for the purpose intended, the cost of accounting may exceed the value of the funds to the charity's operations.

EXAMPLE 3: In 1963, an Episcopal Church received a gift of $100,000 to be used exclusively to place flowers on the altar of the church for services and special events held at the church. Through careful investment management, this fund has now grown to over $1,000,000. The church uses the fund to keep magnificent flower arrangements on display throughout the year, but is unable to use all the income generated. The gift specifically prohibited use of the funds for other purposes.

One of the great appeals of a planned gift or an endowed gift is that it allows the donor to effectively control the money long beyond a normal lifetime. Many restricted gifts blend the donor's goals with specific areas of need for the charity. However, when donors want to place too many rules and restrictions on their gifts, this can create problems for an organization, and can sometimes prevent the use of the funds in any effective way. The key to success is flexibility in planning. There is almost always a way to work with a donor to design a fund for a designated purpose that is not so restrictive as to render it useless. When the gift is too restrictive, or is designated for a purpose that is counter to the purposes of the organization, the nonprofit should decline the gift.[1]

- **Donors Will Fund the Endowment and Discontinue Annual Giving**

The most common objection to creating an endowment is the concern that donors who make planned gifts or endowed gifts will discontinue or decrease their annual contributions. A corollary to this concern is the fear that solicitation for endowed gifts will compromise the nonprofit's ability to raise annual and special event gifts. In other words, the nonprofit staff and board are concerned that the donor will not respond to more than one "ask" in a year.

These concerns stems from a lack of understanding of the process of making a planned gift. *Annual and special event gifts* are made from the donor's current income stream. The decision to make an annual or special event contribution is made quickly and based on current facts, such as available income, other financial obligations, and personal interest. *Major and capital campaign gifts* are also generally made from a donor's income. In many cases, the gifts are "planned" as the appropriate asset and tax incentives are considered to maximize the benefits of the transaction. These decisions, involving one- to five-year commitments, are also based on facts currently available to the donor.

Planned gifts, however, are made from a donor's assets, not income. A donation of assets, rather than income, removes the objection that cash flow is limited, but it raises other issues. The donor may be hesitant to make a gift of assets until she is assured that her future needs such as health care, housing, and sustenance can be met. Donors must be educated on how to plan for future needs and how to integrate the benefits of planned giving into their overall estate plan. For example, converting low income, highly appreciated assets into a higher income stream through a charitable remainder trust or charitable gift annuity may help to address a donor's retirement income needs.

A review of an organization's donor records may reflect that there are many annual donors who have not made a planned gift, primarily because no one asked. However, it is rare to find a planned gift donor who is not also a regular donor to the annual campaign.

- **Solicitation for Endowment Will Interfere with the Capital Campaign**

Capital campaigns are a periodic form of fundraising necessary to finance buildings, new programs, and general expansion. Boards may fear that building an endowment will interfere with the ability to raise capital funds or will create the impression that capital funds are not needed. On the contrary, planned gifts can increase the success of a capital campaign. Many development officers believe that a capital campaign is a good place from which to launch a planned giving program. Why? Planned giving encourages donors to consider options and assets that allow a donor to make a significant gift even though he lacks the cash to do so.

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[1] See the sample endowment agreement at Appendix B containing language permitting flexibility in use of the funds over time.

Planned giving implies a long-term relationship. A donor who contributes a major gift to a capital campaign may also make a planned gift to protect that "investment." A donor will generally make a major gift only after personal contact with the organization and after the donor becomes involved enough to understand and believe in its mission. This donor is also likely to understand the importance of ongoing funding to sustain that mission.

- **An Endowment Program Requires Too Much Work**

Boards are often overcome with the details of program implementation and planned gift options. They may conclude that an endowment program requires too much education and too much money, and that there is insufficient staff to meet with donors and work through planning issues. This baffling argument, heard from time to time, reflects a focus on the day-to-day operations of the organization, without a perspective for long-term goals.

Endowment and planned giving programs do have a cost. An organization cannot simply declare that it is ready to receive planned gifts and then expect money to pour into the organization. Effective planned giving requires education of the staff, the board, and the donor base. It requires ongoing attention to detail. It requires relationships with donors. It requires cultivation of those relationships. These efforts take time and people, which do not come without cost.

- **Endowment Giving Is Limited to a Small Segment of the Donor Base**

Boards sometimes define planned gift donors narrowly, ascribing potential to only the elderly and wealthy. Naturally, if potential gifts are limited to such a small segment of the donor base, the board may feel that committing staff and resources to the process is not warranted. The myth that only the old and wealthy make good planned gift donors is pervasive. Success stories abound about individuals who left modest sums representing their entire wealth to charity. Share these stories with the board to help them overcome this perception.

TABLE 1 MAJOR ENDOWMENT CONCERNS: MYTHS AND REALITIES

Endowment Myth	Endowment Reality
The charity will appear too rich.	The charity must position the endowment as a resource for the future and a reflection of the fiscal responsibility of the organization's board.
Restricted gifts are too difficult to manage.	Donors like to know how the funds will be spent and often restrict the spending purposes. Work with donors to make the gifts as flexible for the long-term use of the organization as possible.
Raising funds for endowed purposes will diminish funds for annual gifts and special events.	The charity must position annual giving and endowment building as two separate opportunities. Making a gift to endowment is a way to ensure the charity will receive an annual gift after the donor is gone.
Planned giving will diminish the potential of a capital campaign.	To the contrary, planned gifts are a way to augment or protect the investment the donor has made in the capital campaign. In fact, the emphasis on planning may allow donors to make larger gifts to the capital campaign than otherwise possible.
Endowment management takes too much time and effort. Planned giving (to build endowment) requires too much education, staff training, and staff time.	Grumbling about time and effort required to manage an endowment reflects too great a focus on the administrative details of running a charity, and too little focus on the long-term goals of the

	organization. Successful planned giving programs require a commitment of time and money. However, the benefits to the charity far outweigh the costs.
Planned giving requires a lot of work for focus on a narrow segment of the donor base; it is not worth the effort.	This is a matter of perspective. First, planned gift donors range in age from 30 to 90. Second, planned gifts usually range in size from $1,000 to over $1,000,000. And third, the donors with the most potential to make planned gifts are ongoing contributors to the charity at any dollar level. Organizations with mature donor bases should have success with planned giving.

2. Getting the Board Gift

Once you have educated the board on the issues, and perfected the case statement for endowment, it is time to solicit gifts. Begin with the board. Tell the group collectively that you plan to visit with each of them individually to discuss the endowment and how they can participate. These visits can be used to initiate a planned giving program for those charities that do not have them, or to get the board involved in the planned giving program if the participation is low. The visits will not only produce new gifts to the endowment (through planned gifts) but will be the best way to help the board member truly understand the purpose, role and possibilities for the endowment.

E. The Perfect Profile for Success

Not every charity is ready for an endowment. It's difficult to make a case for long-term support of the organization if the charity is struggling to keep its doors open on a day-to-day basis. It must also be prepared to manage and account for the fund entrusted to it.

The nonprofit considering an endowment should look at its history and identify factors that may serve as indicators for success or as barriers to donors who will be asked to contribute. Indicators of success might include the following:

1. An organization that has been in existence for at least 8-10 years.
2. A history of strong program growth over the period of existence.
3. A solid fundraising program that has grown over the period of existence. Key elements should include a growing annual fund program, a solid base of repeat donors, major gifts and a readiness or entry into planned giving.
4. Stable nonprofit staff, again showing growth commensurate with its program and fundraising growth.
5. A financial officer or other staff member responsible for managing or providing oversight of the endowment.
6. Commitment by the board of directors to build endowment.

While there may be many other indicators of success, these are the baseline needs showing the organization is operating effectively and is ready to expand its fundraising to the next level and build a base of financial support for future operations.

Factors that may herald problems include the following:

1. A new organization, just struggling to get started.
2. Turnover on staff, or lack of adequate staff.
3. No fundraising program, or erratic fundraising, solely government-based funding, or heavy dependence on a few corporate or foundation funders.
4. Ambivalence of the board of directors about the need for endowment.

III. Structuring the Endowment

Once the nonprofit decides that it needs an endowment, it must determine the form of that endowment. The alternatives vary in the degree of protection afforded to the assets, access available to the board, complexity of the endowment form, and costs of administration.

A. Consolidating the Assets

Consolidating the endowed assets in a single location is critically important to the long-term success of the endowment. When endowment assets are scattered in a variety of brokerage houses, banks, checking accounts, or certificates of deposit, it is difficult effectively manage costs and maintain consistency in spending and investment management policies. The chief financial officer may also have difficulty in generating a single report detailing fund earnings, funds available for expenditure, and historical information on use of funds and to report to donors. Consolidation allows the nonprofit to focus on performance, purpose, and long-term goals.

Consolidation may also enhance investment performance. Larger, consolidated balances may enable investment strategies that are not possible for smaller pools of funds. For example, the charity may be able to pursue individual equities and bonds rather than mutual funds. Combining funds should also reduce the cost ratio of management of the funds. Most fiduciaries and investment management firms provide break points in the fee percentage as the assets increase in value.

B. The Endowment Form

There are three basic alternatives for the endowment form: a segregated fund held by the charity, a designated fund held by the community foundation or other umbrella organization, and a supporting foundation. The choice of form depends on the goals of the nonprofit in creating the endowment, the size of the endowed funds, and the resources available to manage the endowment.

1. A Segregated Fund Held by the Charity

One of the simplest ways to create an endowment is to have the board of the charity pass a resolution setting aside specific funds in quasi-endowment form in a segregated account. This discrete account can be established at a brokerage firm, a trust company, or at a bank in a checking account labeled “endowment.” The nonprofit can accomplish this transfer without the creation of a separate legal entity, without the application for a new tax identification number, and without the creation of a separate board.

While this alternative is the simplest, it is the most vulnerable to changing boards and attitudes since it can be dissolved as quickly as it was created. Therefore, the board should spend some time in developing written guidelines that specify how the endowed funds will be used. Ideally, the rules should make the invasion of the fund for purposes other than those originally intended as difficult as possible by enumerating the purposes for which the funds can be spent, and establishing a board process for approval and distribution of fund assets. The board should also create a method of reporting expenditures and growth of the endowed funds to the board.

> **A CAUTIONARY TALE:** A symphony in a mid-sized city had amassed an endowment of about $6 million. While this endowment was small, it represented a critically needed source of revenue for its musicians and programs. The endowment was set aside by the board in a fund held in the symphony’s name under the control of the board of directors. As the symphony began to have cash flow problems, it took money from the endowment to meet operating needs. The board, a group consisting of a cross section of symphony patrons, failed to note the trend as the endowment was raided each year to meet operating funds. As the symphony continued to borrow money to meet budget and programs, it secured its debt with

> the endowed assets. Ultimately, the symphony was forced to declare bankruptcy and shut its doors. A new symphony organization emerged several years later. This symphony began by launching a campaign for a $10 million endowment, but ensured that the funds were committed to an irrevocable trust that severely restricted principal spending, and forbid the pledging of assets for symphony debt.

Some protection for the funds is added by creating an informal group of board members, or even board and non-board members, who have the responsibility of managing the funds, making recommendations on distributions, and otherwise safeguarding the assets. This allows the charity to get new individuals involved in the management of the charity and provides a separation of powers that makes it more difficult to raid the funds than if the finance or program committee had control of decisions on the endowment.

Note to professional advisors: As the charity's advisor, you should help the nonprofit select the form that best suits its needs, its budget, and its weaknesses. Selection of one form does not preclude the later adoption or movement to another form of endowment. Some endowments begin as an in-charity fund, move to a designated fund at a community foundation, and then move to a supporting foundation once the assets have reached a size that justify the additional administrative expense.

2. A Designated Fund Held by the Community Foundation or Other Umbrella Organization

A designated fund is a restricted fund held for the benefit of a specific organization or purpose by another organization such as a community foundation. It is not a true endowment, since the governing fund agreement generally allows a distribution of income or principal. The fund is restricted, however, in the organizations to which the distributions can be made. A designated fund inside another charity is generally created by executing a fund agreement between the charity contributing funds and the charity receiving the funds that restricts the use of the assets for the contributing charity's benefit.[2] The fund document should specify the purposes for which distributions may be made, and the method of requesting and approving the distributions. It should also allow the charity to request a full distribution of funds when it is ready to fund a supporting foundation. The ability to withdraw funds is important, especially if the charity is using the designated fund as a way to build funds to a mass needed to create a separate foundation. For example, the charity may want to allow the funds to grow to a size of $1 million, and then move the funds to a supporting foundation. Since the funds belong to the receiving entity once transferred, the contributing charity must anticipate the eventual transfer event and make some provision in the agreement to move the funds (with the approval of nonprofit holding the funds).

Community foundations are often used to house and manage small endowments. The funds actually belong to the community foundation and contribution to the endowment are made payable or transferable to the community foundation for the benefit of the XYZ Charity Endowed Fund. The document usually requires that the Foundation Distribution Committee approve all distributions. This requirement adds a layer of protection to ensure that the funds are not used for inappropriate purposes. In essence, the community foundation serves as an incubator for the endowment and provides the benefits of oversight by a board of community leaders, pooled investment management, and a barrier to the distribution of funds.

A designated fund is attractive because it does not require the creation of a separate legal entity, the cost of creating the fund agreement is minimal, and the extra layers of management provide protection from unwarranted or unwise use of funds. Although creating a designated fund inside a community foundation or inside the charity's national umbrella organization has the advantage of putting a bit more distance between the funds and those who may want to spend the principal, it generally requires the charity to give up ownership of the funds. This approach provides more asset protection than a segregated fund inside the charity but is less flexible than a supporting foundation.

3. A Supporting Foundation

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[2] These documents are available from the charity that houses the funds.

Creating a supporting foundation (a foundation that qualifies as a public charity because its sole purpose is to support an organization that meets the criteria of Internal Revenue Code Section 501(c)(3)) is the most complicated and expensive endowment alternative. The appeal of a supporting foundation is that it provides the greatest protection of the assets and flexibility for the endowed funds.[3]

a. Defining a Supporting Foundation

A supporting foundation is a form of public charity (as opposed to a private foundation) that receives its charitable status because it is "operated, supervised or controlled by," "supervised or controlled in connection with," or "operated in connection with" the charity it is organized exclusively to support.[4] The foundation's articles of incorporation must restrict the distribution of funds to the one or more charities it supports. For example, a supporting foundation may be established to support The University of Alabama but must direct that distributions be made to, for the benefit of, or to further the mission of the University. Or a supporting foundation may be established to support the American Red Cross and all of its affiliates and be used to support the Red Cross and its mission. While the supporting foundation can be limited to making distributions to a narrower range of purposes or interests of the charity, it cannot distribute funds for purposes broader than the charity it supports.

A supporting foundation must do more than make payments to or for the charity it supports; it must also meet one of three structural tests.

- *The supporting foundation must be operated, supervised or controlled by the primary charity.* This relationship looks much like a parent and subsidiary. The majority of the controlled supporting foundation's board must be either filled by officers of the organization it supports or is appointed by that charity.[5]
- *The foundation must be supervised or controlled in connection with the primary charity.* This test is met if the individuals controlling and managing the primary charity are the same individuals controlling and managing the supporting foundation.[6]
- *The foundation must be operated in connection with the charity.* This test is both the most flexible and the most complicated to prove. It requires that the supporting foundation is responsive to and significantly involved in the operation of the supported charity.[7] This nexus is proved by meeting the responsiveness test *and* the integral part test.[8] The responsiveness test is met if the officers, directors, or trustees are elected or appointed by the officers or directors of the supported charity, if the supporting and supported charities share officers, directors, or trustees, or if there is a "close and continuous working relationship" between the officers, directors, or trustees of the two organizations. Alternatively, the responsiveness test can be met when the supporting foundation is organized as a trust, the supported organization is a named beneficiary of the trust, and the supported organization has the power to compel an accounting of the trust.[9]
- The integral part test can be satisfied if the supporting charity performs functions or activities that the supported organization otherwise perform itself. Alternatively, the integral part test is met if the charity pays all of its income to the supported organization and that income is a large enough percentage of the total receipts of the charity so that the charity is attentive to the supporting foundation. The difficulty in meeting this test is establishing that attentiveness.[10]

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[3] See IRC § 509(a)(3) and the accompanying regulations for a full description of a supporting foundation.
[4] IRC § 509(a)(3)(B); Regs. §§ 1.509(a)-4(a)(3), -4(f)(2).
[5] Regs. §§ 1.509(a)-4(f)(4), -4(g)(1)(i).
[6] Regs. §§ 1.509(a)-4(f)(4), -4(h)(1).
[7] Reg. § 1.509-4(f)(4).
[8] Reg. § 1.509(a)-4(i)(1)(i).
[9] Reg. § 1.509(a)-4(i)(2).
[10] The regulations provide examples of attentiveness at § 1.509(a)-4(i)(3)(iii)(c).

In other words, a supporting foundation must have a close working relationship with the supported charity, and must be responsive or attentive to it.

b. Creating a Supporting Foundation

A supporting foundation is created either by incorporation under the nonprofit corporation laws of the state in which the charity is located or by trust document. The corporate form requires Articles of Incorporation and By-Laws that are then filed with the court, and generally the Attorney General of the state. The trust form requires an irrevocable trust document. Both forms must comply with state law governing nonprofit corporations or trusts and with IRS requirements for a supporting foundation under IRC §509(a)(3).

The foundation is a separate entity for tax purposes. A Form 1023 seeking status as a supporting foundation must be filed within 15 months of creation of the foundation. The organization will generally be granted tax-exempt status from the date of creation, provided the application for exemption is filed within the time period allowed and is ultimately accepted by the Internal Revenue Service.[11] If the foundation is required to change its activities or substantially change its organizing documents to qualify, the IRS may assign a later effective date.[12] The new foundation is governed by a board of directors, or by trustees, who are separate, but related, to the governing charity. This separate group of fiduciaries provides the greatest protection against unauthorized use or depletion of the funds of the foundation.

A supporting foundation is more expensive to create and to operate than a segregated or designated fund. Costs include start-up costs as well as the ongoing expenses of separate bookkeeping, investment management, solicitation of gifts, recording of gifts, audits, and tax filings. Therefore, foundations should be not created with plans to bring the foundation asset base to a size of $1,000,000 or more in a short time span.

C. Designated Gifts

Designated gifts are a necessary part of the overall endowment structure. As shown in many surveys – most recently in the NCPG 2000 Donor Survey, one of the most compelling reasons for making a planned gift is knowing the purpose for which the funds will be used. This does not mean that all planned gifts are endowed, but it does mean that donors enjoy specifying the fund use and charities should expect that many gifts would arrive with restrictions. Allowing designated gifts, however, does not mean that donors can contribute gifts of any size with restrictions.

1. The Issues

The nonprofit should adopt gift policies that provide clear guidance on the most common issues related to designated gifts.

a. Size

The charity should set a minimum size for an endowment that is accounted for separately. Separate accounting includes annual valuation of the account and tracking annual distributions of income and/or principal. Since the requirements for separate accounting are expensive (whether handled in-house or by a third party), the minimum size should be set at a fairly high level such as $50,000, or preferably $100,000. Smaller accounts can be recognized by name in the annual report, but should be combined with a pool of accounts with a similar purpose.

b. Limited Purpose

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[11] Internal Revenue Service Publication 557, "Tax-Exempt Status for Your Organization," <www.irs.gov>, p. 4.
[12] *Id.*

There are many cautionary tales about donors who made gifts for narrow purposes, only to have that purpose change or diminish over time. These include the donor who restricted her gift to fund homes for unwed mothers (which no longer exist because social norms have changed) or the donor who restricted his gift to the church for flowers (and the fund has grown to a point that the fund produces more income than can be used for that purpose) or the donor who restricted his gift to the university to the creation of a business school (and the gift was turned down). It is impossible to anticipate every donor's objectives and to rule out the inappropriate ones. Therefore, most nonprofit gift policies simply state that the nonprofit will not accept any gift that is counter or not in keeping with its long-term mission, or any gift that is too difficult to administer.

The better solution, however, is to have a conversation with the donor before the gift is set in stone and ask the donor to consider broadening the objectives and purposes of the gift and to sign an endowment agreement that gives the nonprofit flexibility to apply the gift to other like purposes if the original purposes is no longer needed or appropriate.

c. Accounting Cost

The final consideration in designated gifts is the cost to account for the gift. If the donor has specified, for example, that 80% of the accounting income (interest and dividends) is to be expended for the named purposes and 20% of the accounting income is to be reinvested for growth of the fund, the charity must determine if it can manage that accounting task and the cost of making those calculations. Obviously, if the fund holds $100,000 or more, the costs will represent only a small percentage of the fund. If instead the fund is only $5,000, the costs may represent 2%, 3% or more of the fund. The accounting costs may easily exceed the amount of income to be distributed. While this observation is driven by common sense, practical matters are illusive when planning a gift the donor is excited about. To avoid problems, the nonprofit should think through these issues in advance and set and publicize clear guidelines to donors.

2. The Solutions

How do you encourage your donors to design gifts that fit your guidelines? Incorporate the information in your marketing and discussions, and take proactive steps to make the process comfortable and rewarding to donors.

a. The Pre-emptive Strike – Broad Areas of Need

One of the easiest way to allow donors to select endowment purposes that are most appealing to them, while maintaining flexibility at the charity's level is to create 4 to 6 areas of need within the endowment. For example, the endowment at the Alabama School for the Deaf and Blind is divided into seven major areas:

- Presidential Endowment for Excellence
- Academic Program Endowment
- Student Life Endowment
- Learning Resources Endowment
- Institute Outreach Endowment
- Human Resources Endowment
- The Marianna Greene Henry Special Equestrian Center Endowment

This approach has the advantage of organizing the various endowed funds so that funds available, and needs for additional funds, can be clearly identified. In addition, this allows the charity to publish these six areas of need in their annual report and endowment brochures, encouraging donors to select the area of need that is most appealing, and thus eliminating the need to create a new fund use.

b. Combining Smaller Accounts

Once these categories are established, smaller accounts can be combined under the appropriate category. This is not as simply as it sounds, of course. Some funds may be restricted, and the charity may need to get the restrictions released. And families should be contacted to seek permission (or inform, as appropriate) for the change. Accounts over the designated limit can remain on their own, but would also be organized under the appropriate endowment group.

c. Annual Reporting Recognition

A final step in this process is to publish the fund names from donors, under the various endowment categories, in the annual report or in a special foundation or endowment report. All those donors that established $1,000, $5,000 or $25,000 funds that were combined with other smaller accounts can still be recognized annually even those the fund balances are not separately accounted for. This gives the donors and their families important recognition, preserves the name of the fund, and also emphasizes the key endowment areas to donors.

C. Endowments for National and Regional Charities

National charities may have special reasons to create a pooled endowment. Those that operate with affiliates and chapters across the country may find that each entity is operating with a different set of rules and regulations and experiencing varied results. Most national organizations play a key support role for those organizations, and providing structure and management for the local endowment is one way to add lasting value for the organization as a whole and to its local offices.

1. The Form of the Roll-Up

A national endowment is a pooled fund that holds assets for local offices, invests them, and provides accounting and statement reporting to donors. The roll-up can be structured in one of two ways: the local office can transfer ownership of the funds to the local office (generally not very appealing to the affiliate) or the national office can manage the funds for local offices in an agency arrangement. If an agency arrangement is used, the national charity may need to obtain a no-action letter from the state securities commissioner since it will be providing investment managements services for affiliates and related entities. (Every national nonprofit is organized in a slightly different way. Some file consolidated returns while others operate as separate nonprofits licensed to use the national name.) The no action letter simply states that the charity can manage assets for its related entities with similar mission without being licensed to manage investment funds. The charity's legal counsel should manage this process.

2. The Goals of "Roll-Up" Endowments

The goal of the roll-up is four fold: to provide a service to the affiliate, most of which are not staffed to handle investment management; ensure uniform management of endowment assets across the country; reduce the costs of management; and enhance reporting and stewardship to donors. The service must be easy to use, consistent in its product, and allow convenient access to funds if it is to be effective and attractive to affiliates.

3. The Occasional Pitfalls

If the national roll-up is not well organized, easy to use, and cost effective, the local offices will find many reasons not to use it. The most common reasons for this reluctance include the board's desire to control the funds and the feeling that investing the funds locally will create a fundraising advantage. These objections can be overcome if addressed directly. However, the national organization must work to market the national endowment concept to its local offices in order to succeed. Focus on the offices interested in moving funds. Once the other organizations observe how that process works, they will be more willing to consider the option for themselves. The process will also go more smoothly if the national organization establishes a clear set of policies and procedures for establishing funds, distributing funds, and making requests for unscheduled distributions.

IV. Managing the Endowment

Raising the funds for endowment is only part of the process. The most difficult and long-term aspect of endowment is proper management.

A. The Endowment Agreement

The endowment agreement sets out the terms of the gift and defines its purposes and limitations. While many gifts come to the charity without an agreement (for example, through a will), those gifts made during life or even gifts given at death but planned during life can be governed by an endowment agreement. There are two key benefits to the agreement: the charity and the donor can reach agreement on the goals of the gift, and the charity can build in a mechanism for change, if needed.

1. The Importance of Shared Expectations with Donors

Donors are often driven to make endowed gifts because of specific visions they have on the use of the funds. Some donors are able to express these goals in a very articulate fashion, while others are vague. There's almost a benefit to the charity entering the discussion with the donor. It's a great opportunity to know more about the donor's goals and objectives, and to reshape those goals if they are too narrow or will be too difficult to accomplish. It is also possible that the donor may have goals that are not in keeping with the charity's mission. If so, the discussion allows the charity to direct the gift to other purposes, or to turn it down if necessary.

2. Creating Flexibility

One of the greatest challenges faced by nonprofits are the restrictions donors place on use of funds. Restricting a gift to conform to the donor's personal attitudes on investment management or use of funds is almost irresistible but often hampers the charity's ability to maximize use of the funds. The advisor's role is to integrate the donor's concerns or goals into a gift design that will last in perpetuity and support the charity's mission. Consider these two examples.

> **EXAMPLE 4:** A donor in the 1940s made a major contribution to a community foundation to provide support for homes for unwed mothers. In the 1940s, there were numerous such homes designed to shelter unwed mothers during pregnancy and avoid the shame of having the community learn of their situation. In the year 2001, there are few such homes since society's attitudes toward unwed mothers are more accommodating. Counseling and help is provided to those in need, but it is largely through agencies that work with the women in their own homes.
>
> **EXAMPLE 5:** A donor made a bequest of $500,000 to the Botanical Society to maintain a specific building constructed by her father. Several years after her death, the Botanical Gardens was renovated; the named building was torn down and a garden installed on the spot. The Botanical Gardens must now go to court to have the restrictions removed and the funds allocated to maintenance of the new buildings.

Three ways that changes can be made in the original purpose of an endowed gift are:

1. Incorporating language in the endowment document that permits the board to make changes when the original purpose is no longer valid;
2. Donor approval of change under the Uniform Management of Institutional Funds Act; or
3. Court action.

The goal should be to balance the need to incorporate the donor's priorities with the need for flexibility.

a. Creating Flexibility in the Gift Document

The simplest way to provide flexibility in ongoing use of funds and yet preserve the donor's original intent, is to anticipate change in the governing document. The governing document may be an endowment agreement executed on delivery of the gift, language in a will or trust creating the gift, or simply a verbal acknowledgement recognized in writing on receipt of the gift. A sample endowment agreement with this flexibility is provided at Appendix B.

b. The Uniform Management of Institutional Funds Act

Sometimes the advisor is not involved in creating the gift arrangement, but is called in to fix a problem with an executed agreement that no longer fills the donor's intended purpose. State law may provide some help. The Uniform Management of Institutional Funds Act was approved and recommended for enactment in all states by the National Conference of Commissioners on Uniform State Laws at their annual conference in San Francisco, California held August 4-11, 1972.[13] The uniform law was offered to nonprofits as a way to address the inconsistencies in state laws governing the conduct of charitable organizations. Although most state laws addressed permissible investments for fiduciaries, they provided no similar set of guidelines for nonprofits. Charities, that for many years had invested in "safe" investment quality corporate bonds and government bonds, felt the pressure to participate in the long-term growth of the stock markets. Institutions that had formerly used a conservative formula of spending actual income generated by endowed funds, now wished to follow the trend of investing on a total return basis and spending a portion of the realized gain.[14]

Investing and spending on a total return basis is not possible when the governing document for the funds limits spending to actual income, or a portion of the income. The charity may also have difficulty when the donor agreement restricts spending to a particular purpose, especially when that purpose is no longer a party of the charity's function. Therefore, the Uniform Act also provided a remedy for making changes to donor agreements. The Uniform Act permits change when then donor consents to the change, and the governing board releases the restriction. If the donor is no longer alive, the charity must go to the court with jurisdiction requesting release. The Act does not allow a charity to change an endowed fund to an expendable fund and does not allow it to change the fund from a charitable purpose to a non-charitable use.

The language of the section of the Uniform Statute allowing a change to donor restrictions is set out below:

> *Section 7. [Release of Restrictions on Use or Investment]*
>
> *(a) With the written consent of the donor, the governing board may release, in whole or in part, a restriction imposed by the applicable gift instrument on the use or investment of an institutional fund.*
>
> *(b) If written consent of the donor cannot be obtained by reason of his death, disability, unavailability, or impossibility of identification, the governing board may apply in the name of the institution to the [appropriate] court for release of a restriction imposed by the applicable gift instrument on the use or investment of an institutional fund. The [Attorney General] shall be notified of the application and shall be given an opportunity to be heard. If the court finds that the restriction is obsolete, inappropriate, or impracticable, it may by order release the restriction in whole or in part. A release under this subsection may not change an endowment fund to a fund that is not an endowment fund.*
>
> *(c) A release under this section may not allow a fund to be used for purposes other than the educational, religious, charitable, or other eleemosynary purposes of the institution affected.*

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[13] A copy of all Uniform and Model Acts and other materials issued by the Conference can be obtained from National Conference of Commissioners On Uniform State Laws, 1155 East Sixtieth Street, Chicago, Illinois 60637; see <www.law.upenn.edu/bll/ulc/ulc_final.htm#umifa> for text.

[14] Insight into the origins of the Uniform Management of Institutional Funds Act can be found in the preface of the report.

(d) This section does not limit the application of the doctrine of cy pres.

Many states have adopted this language in whole or in part. Current adoption status is shown at Table 2.3. (Note: State laws are frequently changed. Always check the current applicable state statute.)

TABLE 2 STATUS OF STATE ADOPTION OF UNIFORM MANAGEMENT OF INSTITUTIONAL FUNDS ACT

States That Have Adopted UMIFA in Whole Or in Part

State	Code Section	State	Code Section
Alabama	§§16-61A-1 to 16-61A-8	Montana	§§72-30-101 to 72-30-207
Arkansas	§§28-69-601 to 28-69-611	Nebraska	§§58-601 to 58-609
California	Probate Code §§18500-18509	Nevada	§§164.500 to 164.630
Colorado	§§15-1-1101 to 15-1-1109	New Hampshire	No reference available.
Connecticut	§§45a-526 to 45a-535	New Jersey	§§15:18-15 to 15:18-24
Delaware	§§4701 to 4708	New Mexico	No reference available.
District of Columbia	§§32-401-32-409	New York	§§102,512, 514, 522
Florida	No reference available.	North Carolina	§§36B-1 to 36B-10
Georgia	§§44-15-1 to 44-15-9	North Dakota	§§15-67-01 to 15-67-09
Hawaii	§§517D-1 to 517D-11	Ohio	§§1715.51 to 1715.59
Idaho	§§33-5001 to 33-5008	Oklahoma	60 §§300.1 to 300.10
Illinois	760 ILCS 50/1 to 560 ILCS 50/10	Oregon	§§128.310 to 128.355
Indiana	IC 30-2-12 to IC 30-2-12-13	Rhode Island	§§18-12-1 to 18-12-9
Iowa	§§540A.1 to 540A.9	South Carolina	§§34-6-10 to 34-6-80
Kansas	§§58-3601 to 58-3610	Tennessee	§§25-10-101 to 25-10-109
Kentucky	§§273.510 to 273.590	Texas	No reference available.
Louisiana	§§9:2337.1 to 9.2337.8	Utah	§§13-29-1 to13-29-8
Maine	Title 13 §§4100 to 4110	Vermont	§§3401 to 3407
Maryland	§§15-401 to 15-409	Virginia	§§55-268.1 to 55-268.10
Massachusetts	Chapter 180A §§1 to 11	Washington	§§24.44.010 to 24.44.900
Michigan	§§451.1201 to 451.1210	West Virginia	§§44-6A-1 to 44-6A-8
Minnesota	§§309.62 to 309.71	Wisconsin	§§112.10 to 112.10(7)(b)
Mississippi	§§79-11-601 to 79-11-617	Wyoming	§§17-7-201 to 17-7-205
Missouri	§§402.010 to 402.225		

States That Have Not Adopted UMIFA

Alaska	Pennsylvania
Arizona	South Dakota

c. Court Action

When neither the donor agreement nor state law provides relief, court action may be the only remaining option. Filing a petition with the court is costly, time consuming, may provide only limited relief. (Courts are understandably reluctant to rewrite documents expressing a donor's intentions.) The action may involve the donor, the donor's family, the charity, and the state attorney general.

B. Determining How to Use the Funds

The nonprofit must establish a process for distributing endowed funds that ensures the funds will be used for the purposes intended, and lends thoughtful consideration to the charity's priorities and uses. Without a system or process, the funds may be automatically allocated to the nonprofit's annual budget, or may fall prey to special interests on the board or staff. This will breed inconsistency in the use of the funds, create ambivalence on the part of donors and staff about the function of the endowment, and may even lead to the depletion of the funds.

1. Setting a Spending Policy

The spending policy for the endowment governs the rate at which the funds are distributed from the endowment annually. A policy is important for several reasons. First, it creates discipline in spending. When times are bad, or special projects arise, the board may see the endowment as the easiest way to fill the gap. If so, the endowment will be quickly depleted. Second, it allows the charity to budget effectively. The spending policy should allow the nonprofit to determine the annual distribution and incorporate that figure in the appropriate places in its budget. Third, it provides the investment manager with critical information to guide asset allocation of the investments. The investment structure must be able to generate sufficient cash to accommodate the spending policy (or a combination of investment income and incoming cash).

The spending policy can be structured in any way that creates consistency and that makes sense. Two examples include:

- x% of the average market value at the end of the prior fiscal year.
- x% of the average of the last sixteen quarter-end market values (this formula or a version of it allows for consistency from year to year)

2. Making Requests from Endowment for Capital Projects

Occasionally, the nonprofit may need to withdraw or borrow funds from the endowment for capital projects. Create a process that requires a finance committee recommendation, an endorsement from the development committee, and a vote of the board. When the funds are held in a separate foundation, there is already a process required because there two entities and two boards (the nonprofit and the foundation). When the endowment is simply a separate fund of the nonprofit, this distinction is less clear and there is more need for process.

For the most part, it is best to finance capital projects by raising new funds, borrowing the funds from a conventional lender, or delaying the project. If the endowment is seen as an easy way to meet current capital needs, it will not survive long. Borrowing can be as expensive as withdrawal. First, the charity loses the growth and income from the funds that will impact the charity's budget in the coming year and the long-term growth of the endowment. Second, many organizations borrow the funds, wait several years, and then write off the debt, treating it as the principal distribution it was from the outset.

C. Accounting and Accountability

Charities that accept endowed funds must be able to account to donors, donors' families, and the public for the management and use of the funds committed to endowment. In addition, the charity must ensure that distributions are made in accordance with the terms laid down by the donor or the board. Some fund agreements may restrict distributions to accounting income, others may allow a total return/spending policy approach, and some may permit principal distributions for specific purposes. The use of the funds must also be tracked and document. When the distributions are restricted to specific purposes, the nonprofit has an obligation to follow through. Too often this accounting trail is murky, as endowment earnings are distributed to one account for distribution or are simply allocated to the annual budget.

1. Reporting to Stakeholders

Endowment reporting offers a great opportunity for stewardship. Donors who create funds during life often want information on how the fund is growing, and the lives or programs touched by the distributions. This is most easily accomplished with a fund statement that shows the donor's gift balance accompanied by a letter detailing the distributions made from the fund and the uses to which those funds were put. If the donor is no longer alive, this information can be sent to the donor's descendants, with a personal note about the donor's goals and objectives in creating the fund. Whether the report goes to the donor or the donor's family, it will remind them of the importance of the gift and may encourage them to make additional contributions. One annual report combines stewardship and fundraising.

2. Getting the Work Done

Tracking individual funds, allocating increases and decreases to reflect capital gains and losses, apportioning income and fees, and posting additions and distributions is not an easy task. The options for the charity are to staff the work in house or to hire an outside management firm.

a. Internal Management

Many charities handle accounting internally through Excel spreadsheets or other software. This accounting is easily handled in house when the endowment has a limited number of designated funds. It becomes more problematic when the number of accounts increases. The difficulties are ensuring accuracy and providing donor reporting. As stated earlier, the individual handling the accounting must separate income and principal, allocate investment gains and losses, accounting for contributions and distributions, and allocate fees proportionately (or to specific accounts as appropriate). This is even more difficult if there are multiple layers such as those shown below for a fictitious university:

Level One	All accounts rolled into master roll-up account.
Level Two	Accounts for each school and program – master account (for example, these accounts would contain the roll-up for all endowment accounts in the Medical School, the Dental School, the College, the Athletic Department, etc.)
Level Three	Divisional accounts within each school. For example, all scholarship accounts in the Medical School, all chairs and faculty support accounts in the Medical School, all facility maintenance accounts in the Medical School.
Level Four	The individual accounts.

In addition to the rigors of fund allocation, the annual accounting to donors is more difficult. Most internally produced balance sheets are not suitable for mailing. Therefore figures must be produced and integrated with the letter reporting results to the donor.

b. Third Party Management Firm

A number of third party vendors are equipped to do the accounting for endowment sub-accounts. Most banks and trust companies have divisions geared to nonprofit management, and there are specialty administrative firms with this capability. When hiring a firm to do this specialized accounting, know your goals (accounting, donor statement reporting, etc.) and know the number of levels of accounting you will require. Some firms cannot manage more than one or two sub-account levels, while others are more flexible.

D. Investment Management

The importance of competent investment managers is always more apparent in a bear market such as the one we have experienced recently. Few charities have the staff and expertise to manage financial assets with the care required by law. Nonprofit staffs, especially at smaller nonprofits, rarely include a Chief Financial Officer with experience in investment management or the understanding of the challenges posed by investment of planned gifts. For this reason, asset management is often relegated to the nonprofit board. Too often, decisions about the form and style of investment management are made without first discussing spending policy, long-term goals, or investment restrictions. Guide the board in developing policies that will put a consistent, objective process in place to select and monitor investment management.

1. Setting Goals

Begin the manager selection process by reviewing and clearly articulating goals for the investment of the endowment. For example:

- The goal of the investment process is to protect the assets and to increase the principal value to keep up with inflation.
- The goal of the investment process is to produce maximum annual income for the operation of the nonprofit. The second priority is to increase the underlying value without compromising the principal value of the fund.
- The goal of the investment process is to grow the endowment assets at a rate equal to 5% in excess of the inflation rate.

This instruction should be given to the investment manager (not determined by the investment manager) and strongly impacts the course of action taken by the manager.

2. Selecting Managers

Once the goals of the endowment are clear, select a manager or managers to invest the funds. The best way to approach the selection is through use of a Request for Proposal (RFP) that specifies the organization's requirements. Are you looking for investment management only or investment management and administrative management? Do you want a fixed income account and an equity account, or do you want a balanced fund manager? Do you have special reporting requirements such as quarterly reports that compare the results to specified indices, or annual comparison to other like managers? There are no right and wrong answers, but the charity should think through their oversight needs and reporting needs and incorporate those requirements in the RFP. See sample RFP in Appendix C.

Questions to raise in the interview process should include the following, at a minimum:

- How long has your firm been in the investment management business?
- What style(s) of management do you offer?
- What was the average asset allocation in your fund (if it is a balanced manager) over the last five years? How has that changed, if at all, over the last year?
- What benchmark is appropriate for measuring the performance of your funds?
- May we see your net and gross performance figures?
- May we see linked quarterly returns (compared to the appropriate index)?
- May we see a copy of the performance reports?
- How do you perform relative to your peers?

3. Reviewing Results

The charity's investment management policies should specify the frequency and method of reviewing investment performance and the investment manager. It is important for the nonprofit to establish a regular review in which the results are compared to benchmarks, asset allocation is compared to standards set in the policies, and spending policy is compared to total return. To the extent possible, the policies should provide direction on when and how changes are made in investment managers in the event that results do not meet expectations.

E. Reviving a Hopelessly-Hampered Endowment

Sometimes an endowment becomes hopelessly mired in detail and internal politics. This confusion is frequently a function of a lack of policies specifying when contributions are allocated to endowment, how distributions are made from the endowment and the endowment's investment process. In these cases, there's no way but up. The best advice is to stop and sort out the mess. Begin with the board and explain what must be done; get their commitment to the process and to building endowment. Adopt the necessary policies, and take the times to go through each account – one by one – to restore integrity in the accounting and reporting. If necessary, contact the donor to remove restrictions. If the donor is no longer alive, check state law to see if there is relief under the Uniform Management of Institutional Funds Act. If all else fails, go to the court to ask for assistance. If the funds are perpetual, the sooner you address it, the sooner you can move on.

V. Marketing the Endowment

Once the endowment is organized, well managed and effectively invested, consider it a powerful marketing tool. For years charities have shied away from mentioning or advertising endowment for fear of sending the message to donors that it had plenty of assets and does not need additional contributions. Marketed in the right way, however, it becomes a showcase for solid management techniques, and a beacon for donors who are considering planned gifts. The case statement for endowment should always accompany the message, so that donors understand the purpose of the fund, its role in the ongoing viability of the nonprofit, and the outstanding endowment needs.

A. Creating Visibility

Make the endowment visible in the organization's marketing materials and annual report. Consider these tips:

- Devote one or more pages in the annual report to the endowment, its performance, its funds, its distributions and how to contribute. If the funds are held in the foundation, be careful to distinguish the separate entity and its relationship to the charity. (List board members and stress the mission of the foundation – to support the mission of the nonprofit.)

- Create a separate endowment or foundation brochure. Provide the annual report on the foundation's activities, funds, and management and go into more detail on how a donor can create their own endowment for the organization. Include planned gift options offered by the charity.

- Provide information on the endowment or foundation on the website. Give the endowment its own page and include the information suggested for the annual report and separate brochure.

- Include endowment goals as a part of ongoing capital campaigns. Capital campaigns are a way of fundraising life that allows larger institutions to build buildings, expand programs, expand campuses, etc. Include endowment options tied to the primary campaign that will give donor options in gifting.

B. Creating Accountability

1. Reporting Funds

As suggested earlier, account to donors, or donors' families, on an annual basis. Send them a letter and reporting reflecting the impact of their endowed gift. Emphasize your appreciation for the gift and the effective management the organization has provided. Encourage additional contributions to the fund, or creation of a new fund for an area of personal interest.

2. Reporting Investment Results

Always address investment results in the report. Donors become especially curious about investment results in down years. Even in down years there can be good news if the nonprofit results have met or exceeded market results. Even if the investment results are not reported in the public documents, donors who have contributed funds to the endowment should be told and staff should be prepared to answer donors' questions with an emphasis on the strong points of the portfolio's performance. If the performance has been disastrous, then staff should be prepared to tell donors what the charity plans to do to position itself more positively moving forward.

C. The Importance of Stewardship

Endowment performance reporting provides the most tangible way to provide stewardship to endowment donors. Consider these donors similar to other types of donors with the potential to make additions to gifts or to create new funds. Annual reporting also provides a way to involve family members, either before or after the donor's death. Keeping in touch with family members through annual reporting allows the planned giving officer to develop a relationship with family members and to cultivate them as potential new donors.

VI. The Role of the Professional Advisor

Professional advisors may get involved in building the endowment in several ways.

- *Draftsman and advisor*. The professional may be called on to draft the endowment documents. This may require that she facilitate a discussion of the need for endowment and advise the board on the most appropriate form.
- *Investment manager*. The professional may have the opportunity to manage the charity's endowed assets. The investment manager must reach a consensus with the board on the endowment's spending policy and long-term goal for the funds. The manager must also anticipate and deal with designated gifts, restrictions on gifts, and any other factors that may limit the investment and performance of the funds. This can be a challenge when the charity has not undertaken an evaluative process of determining the need, purpose, and goal of its endowed funds.
- *Board member*. The professional may serve on the charity's board or professional advisory board and be called on to make a decision on the need for endowment and form of endowment. A board member must understand endowment issues from the perspective of a fiduciary.

Regardless of the role assumed by the advisor, she should understand the purpose of an endowment, its role in nonprofit fund development, and the different endowment forms.

APPENDIX A-1
SAMPLE BOARD RESOLUTION COMMITING FUNDS TO ENDOWMENT

THE XYZ CHARITY
CORPORATE RESOLUTION

WHEREAS, The XYZ Charity is a nonprofit corporation organized and existing under the laws of the State of ____________; and

WHEREAS, The XYZ Charity has made a commitment to the development of funds from public sources for the support of the programs and operation of The XYZ Charity in furtherance of its charitable mission; and

WHEREAS, The XYZ Charity conducts annual fundraising to generate funds required for operation; and

WHEREAS, The XYZ Charity desires to build an endowment to meet the future needs of the organization, and to provide resources for unexpected expenses, programs, or facility improvement;

THEREFORE BE IT RESOLVED that:

The XYZ Charity will:

1. Commit all proceeds of bequests, distributions from charitable remainder trusts, proceeds from retirement plan beneficiary designations, proceeds from life insurance beneficiary designations, proceeds from gift annuities (current and deferred), and other deferred gifts to the organization to the XYZ Endowment Pool [here substitute the name of the organization's foundation, the community foundation endowment fund for its benefit, or the segregated fund holding the organization's endowed funds], provided, however, that if such funds are transferred to XYZ with a use designated by the donor, such designation shall be honored.

2. Establish an annual spending policy for those funds, which may consist of income and some portion of the gains generated by the principal, to be used by XYZ in its operation or for the purposes designated by the donor.

3. Establish a procedure to distribute the principal of such funds, provided, however, that such distributions of principal shall be restricted to narrow situations of unexpected need and shall not generally be used for the operating budget of the foundation.

CERTIFICATE OF ADOPTION

We the undersigned do each hereby certify that the above and foregoing resolution was duly adopted on ______________ by The XYZ Charity at a regular meeting of the Board of Directors held on due notice and in compliance with its By-laws and Articles of Incorporation at which time a quorum was present and has not been modified or revoked.

____________________________________ ____________________
President, The XYZ Charity Date

____________________________________ ____________________
Secretary, The XYZ Charity Date

APPENDIX A-2
SAMPLE RESOLUTION ESTABLISHING ENDOWMENT
CORPORATE RESOLUTION

WHEREAS, The XYZ Charity is a nonprofit corporation organized and existing under the laws of the State of _______________; and

WHEREAS, The XYZ Charity has made a commitment to the development of funds from public sources for the support of the programs and operation of The XYZ Charity and other nonprofits in the community; and

WHEREAS, The XYZ Charity desires to expand the capacity of XYZ to meet future needs, unexpected fluctuations in income, and to fully discharge its mission; and

WHEREAS, The XYZ Charity recognizes the need to encourage donors to contribute funds to the future use and purposes of XYZ, and that to do so, XYZ must provide a method of managing and investing such funds; and

THEREFORE BE IT RESOLVED that:

1. The XYZ Charity will establish a permanent endowment to be called "The XYZ Permanent Endowment".

2. The XYZ Permanent Endowment will be held [here, indicate whether the fund will be a segregated account initially held at a bank, trust company, or brokerage, an endowment account at the community foundation, or a supporting foundation].

3. The board of XYZ, upon the recommendation of its development and investment committees, will establish policies for administration and investment management of the funds held in endowment.

4. The board of XYZ, upon the recommendation of its development and investment committees, will adopt an accounting process that allows segregation of funds for the purpose of reporting to donors and monitoring spending for designated purposes, but will permit assets to be consolidated for the purposes of investment management.

5. XYZ will ensure compliance with the disclosure requirements of The Philanthropy Protection Act of 1995.

CERTIFICATE OF ADOPTION

We the undersigned do each hereby certify that the above and foregoing resolution was duly adopted on _______________ by The XYZ Charity at a regular meeting of the Board of Directors held on due notice and in compliance with its By-laws and Articles of Incorporation at which time a quorum was present and has not been modified or revoked.

_______________________________________ _______________________
President, The XYZ Charity Date

_______________________________________ _______________________
Secretary, The XYZ Charity Date

APPENDIX B
SAMPLE ENDOWMENT AGREEMENT

THIS AGREEMENT made and entered into this ___ day of ____________, 2002, by and between ___________________, hereinafter referred to as the "Donor", and ABC Charity, Inc. (hereinafter referred to as "ABC Charity"), a nonprofit corporation organized and located in Alexandria, Virginia.

W I T N E S S E T H:

WHEREAS, the Donor has transferred and delivered to ABC Charity the cash or property set out on Schedule A of this document to be held, invested and reinvested by ABC Charity in the manner set forth herein; and

WHEREAS, ABC Charity has accepted the donation for the purposes and under the considerations hereinafter set forth;

NOW THEREFORE, in consideration of the premises and the mutual covenants hereinafter set forth, the parties do agree as follows:

1. The donation is transferred and delivered to ABC Charity for the purpose of establishing the ___________________ Fund (the "Endowment.") and is to become a part of ABC Charity and to be governed by the Articles of Incorporation for ABC Charity, and By-Laws of that organization, as amended from time to time.

2. The original contribution and any and all additional gifts subsequently transferred to ABC Charity either by the Donor or other interested contributors shall be held, invested and reinvested in the manner hereinafter set forth in paragraph 6.

3. The Donors request that an annual distribution be made from the fund for the purposes described in paragraph 4. The amount of this annual distribution may be set by the Board of Directors of ABC Charity in accordance with a general spending policy of ABC Charity. It is the intent of the donors that the fund distribute an amount or percentage of the average annual earnings of the trust, to include earned income, and realized gain, and that the corpus of the trust will remain and grow in perpetuity.

4. The purpose of the Endowment is to [here insert the purposes for which the funds can be spent and specific programs if appropriate.]

5. Should ABC Charity lose its tax-exempt status as an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986, as amended, (hereinafter the "Code") and as an organization that is not a private ABC Charity within the meaning of Section 509(a) of the Code, or otherwise cease to exist, the Board of Directors of ABC Charity shall distribute all assets remaining in the Endowment its 501(c)(3) tax-exempt successor in interest to that organization so long as that successor is not a private foundation within the meaning of Section 509(a) of the Code to be used for the purposes outlined in paragraph 4. Should the successor in interest lose its tax-exempt status described in Section 501(c)(3) of the Code and as an organization is not a private ABC Charity within the meaning of Section 509(a) of the Code or otherwise cease to exist, then all assets remaining in this fund shall be distributed outright to charitable organizations qualified as 501(c)(3) organizations under the Internal Revenue Code that has purposes as similar as possible to those purposes listed in paragraph 4.

Should the purpose for which this Endowment is established cease to exist or represent a need so that the Board of Directors are unable to find organizations in need of such funds, then the Board of Directors, by majority vote, have the power to redirect the funds held in this Endowment for a purpose or purposes as similar as possible to the original intent of the Donors.

6. ABC Charity hereby accepts the property contributed to the Endowment and will hereafter invest it in accordance with the investment policies and procedures of ABC Charity. ABC Charity in its sole discretion is authorized to sell, exchange, or otherwise dispose of any securities or other property held by it at any time hereunder and to deliver such instruments as may be required by either a transfer agent, exchange, or other entity effecting such transfer. These assets may be pooled with other like assets in order to facilitate an orderly and cost effective management of assets for the organization. In addition, assets held by ABC Charity may be transferred to a foundation created to support ABC Charity and its programs (upon a vote of its Board of Directors) if such transfer facilitates an order and cost effective management of assets. ABC Charity is authorized to use such methods as it deems necessary or advisable for the investment, sale, exchange, or transfer of any security held hereunder and to pay reasonable compensation and expenses in connection with the performance of said services. ABC Charity shall have the sole power to determine its investment policies and procedures and to decide any and all questions in connection therewith.

7. ABC Charity may hire agents to provide investment advice, administrative management, and tax preparation as are reasonable and necessary to carry out its duties. Fees and expenses for these services shall be charged first against the income of the Endowment, and then the fund principal on a pro-rata basis against all funds held in ABC Charity together with any necessary administrative costs of ABC Charity in managing these assets.

8. This Agreement shall be irrevocable and the Donor hereby expressly acknowledges that he/she shall have no right or power either alone or in conjunction with others and in whatever capacity to revoke or terminate this Agreement; provided, however, nothing herein contained shall be interpreted so as to prevent the Donor from making further contributions to this Endowment.

9. Common investment funds managed by ABC Charity are exempt from the registration requirements of the federal securities laws pursuant to the exemption for collective investment funds and similar funds maintained by charitable organizations under the Philanthropy Protection Act of 1995 (PL 104-62).

10. This constitutes the full and complete agreement by and between the parties and all oral agreements and/or discussions are merged herein and are null and void to the extent that they are in conflict herein. In no event shall this Agreement be treated or interpreted as creating a separate trust. No changes, alterations, additions, modifications, or qualifications shall be made or had in the terms, conditions, or provisions of any paragraph or item of this Agreement. Nor shall any amendment, modification or alteration be permitted that would result in this Endowment being treated as a separate trust or that would affect the status of ABC Charity as an organization described in Section 501(c)(3) of the and as an organization which is not a private ABC Charity within the meaning of Section 509(a) of the Code.

11. This Agreement is binding upon the parties hereto, their successors and assigns.

IN TESTIMONY WHEREOF WITNESS the signatures of the parties hereto the day and year first above written.

________________________________ "Donor" ______________ Date

ABC Charity

BY:______________________________ ______________
President, Board of Directors Date

APPENDIX C –1
REQUEST FOR PROPOSAL
INVESTMENT MANAGEMENT FOR ABC NONPROFIT

The ABC Nonprofit is seeking professional investment management for its endowed funds and planned gifts. The investment manager must have at least a five year investment management record, must have current assets under management of at least $500,000,000 and must have experience in the management of tax-exempt portfolios,

Specifications:

The ABC Nonprofit anticipates initial assets of $7,000,000 and annual asset growth at the rate of $2,000,000. Assets must be managed in accordance with written investment polices of the ABC Nonprofit which will be provided to the manager and are attached to this RFP. These policies require a mix of equity and fixed income management inside the portfolio.

Quarterly investment performance reports are required. These investment performance reports must be accompanied by a written summary of investment performance and a discussion of that performance in relation to the goals of the ABC Nonprofit. An annual meeting with ABC Nonprofit to review the investment performance in the account is also required.

Proposal Requirements:

Your proposal must be in writing and must include the following information:

- The name of your investment firm, its address and the name of the manager that will handle this account
- Information about the history of your company, including its principals, their background, and their employment history with the firm.
- Your equity and fixed income management philosophies.
- The index by which you measure your equity and fixed income results.
- Investment results for the following periods:
  - Year to date through June 30, 1998
  - One year for the fiscal year ending with June 30, 1998
  - Three years for fiscal years ending with June 30, 1998
  - Five years for fiscal years ending with June 30, 1998
  - Ten years for fiscal years ending with June, 1998
- Copies of sample investment performance reports.
- The proposed fee schedule for management of this account with estimate of first year cost based on the asset data set out above.
- Names of customers, with contact person and telephone number, who currently use this service
- Any additional information that you believe is relevant to your selection

Submission of Proposal:

Written proposals must be submitted to:
Mr. Iam N. Charge
ABC Nonprofit
1234 Administration Building
1001 South 20th Street
Anywhere, USA

The deadline for receipt of proposals is 5 p.m. on _________________.
Any questions about this proposal may be addressed to Mr. Charge at 205/123-4567.

APPENDIX C-2
REQUEST FOR PROPOSAL FOR FIDUCIARY SERVICES
CUSTODY, ADMINISTRATION, AND INVESTMENT MANAGEMENT

XYZ University is taking proposals for custody, administrative and investment management services from banks, trust companies and investment management firms to manage selected pools of endowment assets.

General Description of Assets

XYZ University is seeking proposals for management for the following types of endowed assets:

> **Charitable Remainder Trusts**: XYZ currently serves as Trustee of 75 Charitable Remainder Trusts totaling $20,000,000. This is an area of strong growth for the University.
>
> **Charitable Gift Annuities**: XYZ currently holds _________ charitable gift annuities totaling $ ___________________.
>
> **Pooled Income Fund**: XYZ current maintains a pooled income fund with ____ participants and total assets of $1,000,000. It is anticipated that this pooled income fund may be terminated and the participant interests converted to charitable gift annuities.

Management and administration of these assets is currently handled by XYZ staff.

Custody Services Required

1. The custodian must be able to provide current statements of position with current market value, records of account additions, records of account withdrawals and allocations of income, gain, fees and other expenses for each charitable remainder trust. These statements must be available on a quarterly (monthly?) basis.
2. The custodian must be able to provide a current statement of position with current market value, records of account additions, records of account withdrawals and allocations of income, gain, fees and other expenses for the pool of charitable gift annuity assets. In addition, the custodian must be able to provide individual annuity balances and transaction information on an annual basis and upon request.

Administrative Services Required

1. The administrator must be able to manage the trust in accordance with the terms of the trust document. This means that the administrator will be responsible for compliance with the terms of the document, including valuation of assets and distribution of non-charitable payments on the schedule established by document.
2. The administrator is responsible for all tax filings. This includes the preparation of the tax return for the charitable remainder trusts and the pooled income fund. Additionally, the administrator is responsible for the production of K-1s for the charitable remainder trusts and the pooled income fund on a timely basis, and for the production of 1099-Rs for the charitable gift annuities on an annual basis. The administrator will be provided with a copy of all prior year tax returns, together with any other information needed to file the initial year returns.

3. The administrator is responsible for all state regulatory filings for charitable gift annuities. The administrator will be provided with a list of the states in which charitable gift annuities have been issued, and the annuities associated with those states.

4. The administrator must be available to all beneficiaries of charitable remainder trusts, charitable gift annuities or the pooled income fund when necessary to answer questions or to resolve mailing or distribution issues.

Investment Management Services Required

1. The investment manager must be able to provide asset management for these assets. Management may be provided through individual securities or mutual funds, as appropriate.

2. The investment manager must be able to provide guidance on asset allocation bands to meet the objectives of the trust, charitable gift annuity or pooled income fund.

3. The investment manager must provide performance reports at least quarterly with at least one personal meeting with the University annually. The report should include the performance for the period (in a manner accepted in the industry) and compare that performance to benchmarks for the period selected by XYZ.

Information Requested

Please provide the following information in the Request For Proposal:

1. The name of your organization, and a brief history. Include information about the current assets under management. Specifically identify the assets under management for nonprofit organizations and any special services that you offer in this regard.
2. The name of the primary contact for the account, and the fiduciary structure for account management. For example, where custody, administration, tax and investment management services are provided by different areas of the company, describe the working relationship.
3. A sample of the reporting statement used for charitable remainder trusts.
4. A sample of the reporting statement used for charitable gift annuities.
5. A sample of the reporting statement used for pooled income funds.
6. The list of prospective investment management vehicles (either individual management or mutual fund management) that will be used in the investment management of these assets. Provide year to date, 1 year, 3 year, and 5 year return figures for the period ending June 30, 1999.
7. A brief synopsis about the chief investment manager for each of the funds listed in #6 above.
8. Information on support or special services offered by the fiduciary. These services may include expertise in timber valuation, management, and sale; oil, gas and mineral interest valuation, management, and sale; real estate valuation, management, and sale; special services for tangible personal property; special services for nonprofit clients; and any other services that might be applicable or helpful to XYZ University. Provide pricing for these services if in addition to quoted prices in this proposal.
9. Pricing for services based on the information provided in the initial description of account. Provide a pricing schedule for assets in addition to the assets currently held. This pricing should be comprehensive covering all services listed in this RFP. In the event you are pricing only a portion of these services (i.e., investment management only, custody only, administration only) please make that clear in your proposal. It is not likely that the services will be awarded on a piece-meal basis and such a proposal may affect your opportunity to obtain this business.
10. A list of any special fees, including transaction fees, receipt, delivery or any other fees that may be charged to an account in addition to the charges listed in #9.
11. A statement asserting that the fiduciary's accounting system is Y2K compliant.
12. A statement describing the company's business recovery plan. This statement should describe in general terms how the custodial records are safeguarded, and how those records are restored in the event of disaster.

The fiduciaries are asked to present these proposals in writing by 5 pm (EDT), ______, 2002.

If you have any questions about this RFP, please contact: