Lathrop GPM

Leveraging Institutional Capital Assets to Meet the Moment

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Hoping to alleviate the immense damage to vulnerable communities inflicted by COVID-19 and racial inequities that have drawn the spotlight over the past year, foundations and other charitable institutions are digging deeper and exploring new ways to increase the scope and impact of their grantmaking. This article outlines the key options to which grantmakers are turning. These options include issuing social bonds or tax-exempt bonds, borrowing through other credit facilities, pursuing internal borrowing, redesignating unrestricted assets, increasing endowment payouts, tapping purpose-restricted funds, and issuing guarantees.

Social Bonds

The Ford Foundation made headlines last summer when it announced a "once-in-a-century" undertaking by issuing $1 billion of corporate bonds with 30-year and 50-year terms and carrying a 2.451% and 2.815% interest rate, respectively. The bonds, designated as "social bonds," are unsecured general obligations of the foundation.

Several other foundations joined the Ford Foundation in using this strategy, including the Doris Duke Charitable Foundation, the MacArthur Foundation, the W. K. Kellogg Foundation, and the Andrew W. Mellon Foundation. And then, in October, The Bush Foundation issued $100 million of its own social bonds.

Social bonds are simply a form of corporate debt issued by an institution for sale in the public market. These are taxable bonds and, from a tax perspective, indistinguishable from traditional corporate bonds. In other words, interest paid on the bonds is taxable to the bondholders (that is, the investors). While the interest rate on such taxable debt is generally higher than tax-exempt debt, taxable debt is free from the regulatory restrictions applicable to tax-exempt debt, making taxable bonds more flexible and appealing for this type of financing. And, in times of very low interest rates, the difference in interest rates between taxable and tax-exempt debt may be immaterial.

Social bonds, however, are distinguishable from other forms of corporate debt in that the proceeds from their issuance will be used for certain social or environmental purposes, allowing investors to classify the bonds as socially responsible investments within their own investment guidelines. To qualify, the issuing foundation

must agree to restrict the use of the bond proceeds to identified social benefits or environmental initiatives. Typically, the issuing foundation describes how it will use the bond proceeds in the offering documents for the bonds, with the proposed use being validated by a second-party opinion that evaluates this framework against the Social Bond Principles adopted by the International Capital Markets Association (see, for example, the materials posted on the Ford Foundation website).

Issuing social bonds allows foundations to take advantage of the strength of their balance sheets and the current low interest rate environment to bolster their grantmaking activities at little additional cost. The expectation is that investment returns on their endowments will be more than sufficient to pay both the interest and debt service on the bonds as well as normal payout and operating expenses. Along these lines, the Ford Foundation stated that "the annual debt service will be in addition to the annual budget and will have virtually no impact on our grantmaking budget."

Social bond offerings usually are unsecured, but corporate bonds can be structured as either unsecured general obligation bonds or as bonds secured by specific assets of the borrower. Where secured, the lender has the right to take and sell the collateral if the borrower defaults on its obligations. Collateralizing social bonds introduces additional levels of complexity to the structuring of the bond obligations, such as the following:

- For an institution with a donor-restricted endowment, the ability to pledge endowment assets as collateral is limited. Because these assets are permanently restricted, they cannot be pledged as collateral in the traditional sense. Comments in the Uniform Prudent Investment of Institutional Funds Act (UPMIFA) suggest that endowment assets may be pledged as collateral, but the lender's ability to access that collateral is no greater than the borrower's — in other words, if the institution were to default on its debt, the lender would only be entitled to receive the annual earnings from, and not the principal of, the collateral. An alternative structure leading to a similar result might entail the institution's pledge as collateral of its annual draw from the endowment (not unlike an operating business pledging its accounts receivables) rather than of the endowment principal itself.
- Non-endowment assets with purpose restrictions could be used as collateral where the borrowed funds are also used for the purposes for which the collateral was given. For example, a scholarship fund could be used as collateral to borrow funds that are then used to fund an even greater number of scholarships than the underlying fund balance could support.
- Unrestricted funds and board-restricted funds could be pledged for any borrowing that serves an institution's charitable purposes, provided that the amount of debt is considered a prudent exercise of the governing's board's business judgment.

Tax-Exempt Bonds

Qualified 501(c)(3) bonds may be useful for financing infrastructure and other facility needs. These bonds are issued by a municipality and then the bond proceeds are lent to a 501(c)(3) borrower. The advantage of these bonds is that interest earnings on them are not generally taxable to the bondholders (the investors), which typically means their interest rates are lower. (This may be less true today with interest rates in general being so low.)

The tradeoff for the opportunity for lower interest rates is that there are significant limitations on how the bond proceeds may be used. For example, they must be used for hard assets — a property, real estate, buildings, equipment — owned by a 501(c)(3) organization and located within the issuing municipality's boundaries. It may be possible for a grant-making institution to use qualified 501(c)(3) bonds to create a loan or grant fund to support facility and equipment needs of grantees located in the municipality issuing the bonds, but this tool would only be useful in limited circumstances.

Other Credit Facilities

An institution could obtain credit facilities — term loans and revolving lines of credit — from a lending institution or a syndicate of lending institutions to support additional spending. As with social bonds, the debt could be unsecured or secured by appropriate assets of the institution. The business model would be similar in concept to social bonds, but instead of offering the debt for sale to investors in the open market, this would be a private transaction between the institution and a single lender or small syndicate of lenders. The advantage of this approach is that it may have lower transaction costs than a public bond offering.

Internal Borrowing

Alternatively, instead of investing with third parties, an institution might consider "investing" with itself by borrowing from its own investment pool and paying itself an appropriate interest rate. Unlike corporate bonds or credit facilities, this approach does not provide a revenue stream to pay off the debt because the investment pool has been reduced rather than invested. But this approach would have lower transaction costs than using corporate bonds or traditional credit facilities.

If funds in the investment pool are permanently endowed, this strategy would need to be consistent with and incorporated into the organization's investment policy in a manner that complies with UPMIFA.

Unrestricted and Board-Designated Funds

Funds that are not donor-restricted as endowment funds or for a specific purpose may be used to advance the institution's charitable purposes. Often, the Board has designated such funds for specific purposes, such as a Board-designated endowment, operating reserves, or Board-designated special purpose funds. It is permissible to redeploy such funds to meet current needs. Of course, it is the Board that must make this

decision, and when it does, it must be guided by its fiduciary duty to act in the best interest of the institution and its mission. In other words, the Board must balance both the short-term and long-term demands of its mission.

Endowment Funds

An institution cannot make grants or loans from the principal of an endowment fund, but a prudent portion of such funds can be appropriated for such uses. In times of tremendous need, an institution could undertake a critical evaluation of its spending policy that may support greater-than-normal spending percentages.

Under UPMIFA, an endowment fund is not wholly expendable on a current basis, and the institution may only appropriate for expenditure that amount of its endowment funds that it determines to be prudent. But the institution is allowed to determine what it deems to be prudent, which may vary over time.

In deciding whether to appropriate endowment funds, an institution must act in good faith, taking such care as an ordinarily prudent person in a like position would exercise under similar circumstances, and must consider the following factors:

- the duration and preservation of the endowment fund;
- the purposes of the institution and the endowment fund;
- general economic conditions;
- the possible effect of inflation or deflation;
- the expected total return from income and the appreciation of investments;
- other resources of the institution; and
- the investment policy of the institution.

Especially in the current strong investment earnings environment, an institution seeking to alleviate tremendous community needs could consider these factors and determine that a greater-than-normal spending policy in 2021 is, in fact, prudent.

Non-Endowment Purpose Restricted Funds

Where an institution holds funds that are restricted as to purpose but are not true endowment funds, the institution's determination as to whether it is prudent to increase the spending percentage of such funds is subject only to the business judgment rule.

Guarantees

Instead of doing its own borrowing, an institution with a strong balance sheet could leverage its assets for the benefit of other 501(c)(3) beneficiaries by guaranteeing their debt. A guaranty is a promise to pay the

debt of another party if certain events occur. For the guarantor, a guaranty may be carried as a liability on its financial statements, but no funds are actually paid out unless and until the guaranty is tapped. An institution issuing guarantees would need to plan carefully for this possibility to ensure it has adequate funds available to pay under the guaranty if and when it is called upon to do so.

As an example, say a foundation wants to support a new nonprofit organization that proposes to construct and operate a health care clinic in an underserved community. Because the clinic organization is new, it has no track record to demonstrate its ability to pay its debt obligations, which may make it difficult to find a lender — whether a traditional bank, a 501(c)(3) bond issuer or investors on the public market — who is willing to lend to it. By providing a guaranty, the foundation essentially promises the new clinic organization's lender that if the new clinic organization is unable to pay its debt obligations when they are due, the foundation will step in and pay the debt. While a lender may also take the clinic's real estate as collateral, it would generally view a guaranty from a financially strong foundation more favorably because the guaranty would assure cash payments to the lender and allow the lender to avoid the expense and uncertainty of a mortgage foreclosure. The use of a guaranty to reduce the lender's risk would thus enable the new clinic organization to access debt financing, and likely at a more favorable rate than it otherwise could.

Making the Decision

There are numerous options, then, for well-capitalized institutions to leverage their resources to meet the moment and address both the dual crises of COVID-19 and the demand for racial equity as well as the longstanding challenges that they have been addressing and must continue to address.

These options are intended to be out of the ordinary course of operations, which means they must be supported by the board of directors of the institution. The board must be guided by its fiduciary duty to act in the best interest of the institution and its mission. To meet its duty of care, the board must carefully consider all the options, and consider both short-term needs and long-term sustainability, always putting the institution's mission first. Having a robust decision-making process and ensuring that the board receives adequate information and takes the time to carefully consider the options, will help the institution both make good decisions and, if need be, defend them from second-guessing in the future.

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