Nonprofit Corporations

Borrowing With Tax-Exempt Bonds

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in collaboration with Alexandra Davis

ORRICK

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Members of Orrick's **Nonprofit Corporation Finance Group** are shown on the contact list on the inside of the back cover of this booklet.

DISCLAIMER: Nothing contained in this booklet should be construed or relied upon as legal advice. Instead, this booklet is intended to serve as an introduction to the general subject of the use of tax-exempt bonds by nonprofit corporations, from which better informed requests for advice, legal and financial, can be formulated.

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CHAPTER ONE

Introduction

Nonprofit corporations have borrowed money using tax-exempt bonds for many years.

Recently, however, the tax-exempt bond market has experienced a substantial expansion in the types of nonprofits using such financing. Previously dominated by hospitals and universities, now virtually every type of eligible nonprofit corporation is borrowing on a tax-exempt basis, spurred by increasing demand for facilities, sector competition, better understanding of the benefits of tax-exempt financing and greater market acceptance of nonprofit corporation credits. For example, see the list in Chapter 3, "Eligible Nonprofit Corporations." Not only large, established institutions with substantial financial resources need apply, but also relatively small, even start-up, nonprofits without established credit may be financeable.

The purpose of this pamphlet is to provide nonprofits that might not have previously considered or fully understood tax-exempt financing with relevant information about their eligibility for, the benefits of, and the procedures associated with such financing.

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[1] Rankings for securities transactions of various types are performed annually by Securities Data Company, which has ranked Orrick number one in the country as bond counsel for tax-exempt bonds since prior to 1990. On average, Orrick handles more than 300 bond issues, aggregating more than $16 billion, a year.

CHAPTER TWO

Why Use Tax-Exempt Bonds?

A. Options

In financing capital projects, nonprofit corporations may have three choices:

- Pay-as-you-go, out of revenues, endowment or donations,
- Conventional taxable financing, from a bank, private placement or the public capital markets,
- Tax-exempt financing, by private placement or publicly offered bonds

Tax-exempt financing is virtually always the best option. This is because tax exempt financing offers the lowest cost of borrowing and usually the best terms.

B. Comparison to Taxable Debt

Better Rates. The public capital markets typically offer lower interest rates than private placements or bank financing (i.e., more competition produces lower rates). However, tax-exempt financing offers lower interest rates than taxable debt no matter how either type is sold. Because interest paid on tax-exempt debt is exempt from federal income tax (and usually income tax of the state in which issued as well), the investor requires less interest to produce the same after tax return as taxable debt would produce. The difference varies from time to time based on market factors but is usually 2 to 4 full percentage points less than comparable taxable debt.

For example, interest rates on 30 year bonds sold around July 1, 2001 were roughly as follows:

Ratings[2]	Tax-Exempt Bonds	Taxable Bonds
AAA	5.15%	8.5%
AA	5.2%	8.6%
A	5.3%	8.75%
BBB	5.9%	9.7%
UNRATED	6.5-7.5%	10.5-12%

Better Terms. Conventional taxable debt, whether in the form of a bank loan or negotiable securities, generally has much less flexible terms than tax-exempt debt. Tax-exempt debt generally may be issued on a long-term (e.g., 20-30 year) fixed interest rate basis, compared to most taxable debt which is usually issued with a shorter term at a variable interest rate indexed to prime, U.S. Treasuries or LIBOR. If preferred, tax-exempt debt also may be issued on a variable rate basis, based on one of the foregoing indices or a tax-exempt index such as that maintained by The Bond Market Association.

The financial covenants required in connection with tax-exempt financing are also usually less onerous and restrictive than those required in taxable debt financings. These covenants cover such matters as limitations on the ability of the borrower nonprofit corporation to incur additional debt or encumber property, required levels of liquid assets or asset to liability ratios, conditions on the acquisition or disposition of property and on mergers or consolidations. While the use of mortgage security on real property is common to both types of financing, it is less common in tax-exempt financing. The public capital market for tax-exempt financing is also willing to accept much smaller sizes (for example, $5 million or even less) than the capital market for taxable debt (which prefers $25 million or more).

[2] Ratings refer to independent appraisals of the credit quality of the bonds and the likelihood of their repayment performed by one or more of the credit rating agencies: Standard & Poor's Corporation, Moody's Investors Service or Fitch IBCA, Inc. The ratings are expressed as letter grades AAA, AA, A, BBB (expressed as Aaa, Aa, A and Baa by Moody's) from highest to lowest investment grate ratings, with +/- or numerical subcategories. Ratings are considered very important by the underwriters in marketing the bonds and by investors in determining what interest rates will induce them to purchase the bonds. Bonds may be sold with or without a rating, although usually at materially higher interest rates.

So tax-exempt financing offers the best interest rates and usually better terms and conditions than taxable financing. How about the option of pay-as-you-go, non-debt financing with revenues as received or donations, endowment or other accumulated funds?

C. Comparison to Available Funds and Donations

The availability of tax-exempt financing presents one of those rare circumstances in which it is better to borrow than to pay with accumulated funds, even if there are ample available funds.

One of the benefits of tax-exempt financing is lower interest rates. These rates are based on market rates for tax-exempt obligations, which can provide investors with the same after tax return as taxable obligations, but with lower interest rates because this interest is not subject to tax. Accumulated funds, including donations, of nonprofit corporations can normally be invested in taxable obligations bearing higher taxable rates (on which the nonprofit corporation does not, however, pay any tax). As a result, by spending proceeds of tax-exempt debt instead of accumulated funds, a nonprofit will normally have the opportunity to invest those accumulated funds, that it would otherwise have spent, in taxable obligations yielding more than it must pay in interest on the tax-exempt debt. This earnings advantage can be quite substantial.

For example, if a nonprofit that wishes to finance a $20 million project has $20 million of available funds which are or can be invested at 7%, but can also borrow with tax-exempt bonds at $5^{1/2}$%, the nonprofit will earn $350,000 a year more on its investments than it is paying on the bonds. Endowment funds often earn much more than 7%. Of course, there will be some costs associated with issuance of the bonds which will depend on the size and difficulty of the financing, but, except for relatively small financings, say $5 million or less, such costs are usually less than one years' worth of this earnings advantage.

This earnings advantage, based on the spread between taxable and tax-exempt interest rates, is sometimes called "arbitrage." The federal tax requirements for the tax-exemption of interest on bonds govern when such arbitrage is permitted. See further discussion below in Chapter 5,"Interplay Between Tax-Exempt Bonds, Fund Raising, Endowment Funds and Foundations."

CHAPTER THREE

Eligible Nonprofit Corporations

A. IRC Section 501(c)(3)

Generally, only state or local governmental entities are eligible actually to issue tax-exempt bonds (the "Issuer").[3] The nonprofit corporation borrows the proceeds of tax-exempt bonds issued by such an Issuer at the request of the nonprofit corporation. See Chapter 8 for a more complete description of the structure of a tax-exempt financing.

In order to be eligible to borrow using tax-exempt bonds, a nonprofit corporation must be a so-called "501(c)(3) corporation," meaning a nonprofit corporation that has received a determination letter from the Internal Revenue Service that it qualifies as an organization of the type described in Section 501(c)(3) of the Internal Revenue Code.[4] Section 501(c)(3) generally contemplates nonprofit corporations organized and operated for one or more of the following purposes: religious, charitable,

[3] One exception, a "63-20 corporation" that can itself issue tax-exempt bonds, is described below in footnote 4.

[4] Two other types of nonprofit corporations are eligible to use tax-exempt bonds: (1) an "instrumentality" of a governmental entity as described in IRS Revenue Ruling 57-128 (which involves a good deal more control by the governmental entity than is the case in most 501(c)(3) corporations) and (2) a so-called "63-20 corporation," which is a nonprofit corporation considered to be acting on behalf of a governmental entity in accordance with the requirements of Revenue Ruling 63-20 as updated by Revenue Procedure 82-26, including a requirement that any property financed by the 63-20 corporation vest in the governmental entity at the end of the term of the bonds. These types of nonprofit corporations are often established specifically to facilitate structuring of a tax-exempt financing and do not require a ruling or determination from the IRS (although some do also obtain a 501(c)(3) determination). A 63-20 corporation is the only type of nonprofit corporation that can itself issue tax-exempt bonds without having to apply to a public entity to do so.

scientific, testing for public safety, literary, educational or prevention of cruelty to children or animals.[5] These purposes are fairly broadly defined in the Code. There are approximately one million 501(c)(3) nonprofit corporations.

Examples of types of nonprofit corporations that are 501(c)(3) corporations and that have used tax-exempt financing are:

B. Private Nonprofit Educational Organizations

colleges and universities
auxiliary foundations, including for public college and universities
private elementary and high schools[6]
charter schools[7]
religiously affiliated schools[8]
research institutions, centers, etc.[9]

[5] There are various types of nonprofit corporations described in Section 501(c) of the Internal Revenue Code in addition to those described in 501(c)(3), such as certain types of civic, business, social and fraternal organizations. Generally, except as explained in footnote 4, only those described in Section 501(c)(3) and which receive an IRS determination letter to that effect are eligible for tax exempt financing as described in this pamphlet.

[6] Although college and universities have borrowed through tax-exempt bonds for decades, it was not until the early 1990s that private K-12 schools started tapping the tax-exempt market to raise capital. A typical example is the Sea Crest School, a private K-8 school in Half Moon Bay, California, that borrowed $4 million in a tax-exempt bond financing of new school facilities.

[7] Charter schools are a relatively recent phenomenon and only in the past year have a few begun to access the tax-exempt market, hampered by the short term of their charters in most states (3-5 years) compared to the 20 plus year term of the bonds and by uncertain cash flows in some states. However, the number of such financings is expected to increase rapidly as legal structures and market acceptance both improve.

[8] See Chapter 7, "Special Considerations for Religiously Affiliated Nonprofits" for a discussion of issues raised by religious affiliation.

[9] Some types of corporate and federal government sponsored research can raise special issues under the tax laws governing tax-exempt bonds that are beyond the scope of this pamphlet. See Treasury Regulation 1.141-3(d) and Revenue Procedure 97-14 and/or consult bond counsel as early as possible.

C. Cultural Organizations

museums[10]
libraries[11]
aquariums[12]
cultural venues[13]
historical preservation[14]
public broadcasting stations[15]

D. Recreational Organizations

local sports facilities
community centers
YMCAs

[10] An interesting example is the Asian Art Museum of San Francisco, which was able to borrow more than $100 million to rehabilitate and convert the historic San Francisco Public Library building into the Museum even though the Museum Foundation does not own the building or the collection or directly control the revenues.

[11] The New York Public Library used tax-exempt debt to refurbish its Main Reading Room and expand existing facilities.

[12] The Aquarium of the Pacific in Long Beach used tax-exempt and taxable bonds in 1995 to finance the Aquarium and tax-exempt bonds in 2001 to refinance it.

[13] A fascinating financing was accomplished by The American Center for Wine, Food and the Arts, a start-up nonprofit with few assets and no track record, which borrowed $70 million through tax-exempt bonds in 1999 to finance a unique venue in Napa, California, combining museum, educational, restaurant and meeting facilities focusing on wine, food and the arts.

[14] Various enhancements to Mount Vernon, including gift shop, restaurant and auditorium, were financed by the Mount Vernon Ladies Association of the Union, using $9.2 million in tax-exempt bonds.

[15] National Public Radio borrowed $10-12 million to renovate a building in Culver City, California, as a west coast production facility.

E. Charitable Organizations

charities
foundations[16]

F. Health Care Organizations

hospitals
clinics
multilevel care
assisted living
congregate care

G. Multifamily Rental Housing[17]

low-income housing corporations
lessening the burden of government corporations

[16] Headquarters facilities have been financed with tax-exempt bonds by a number of foundations, including The Howard Hughes Medical Institute, The Rockefeller Foundation and the Ewing Marion Kauffman Foundation.

[17] Refers to residential rental units (not used on a transient basis) with separate and complete living (including cooking) facilities. Unlike almost all of the other types of projects listed, residential rental housing is classified as an "exempt facility" under the tax code. This means that even a for-profit corporation can use tax-exempt bonds to finance such a project, if at least 20% of the units are occupied by individuals whose income is not more than 50% of area median gross income or at least 40% are occupied by individuals whose income is not more than 60% of area median gross income. A nonprofit corporation may not be subject to those strict income limitations, although similar restrictions may be contained in its articles or by-laws or application to the IRS for 501(c)(3) determination. Nonprofits also have the advantage over for-profits of not being subject to volume cap allocation, limitations on use of bond proceeds to acquire land or existing property, and certain other restrictions imposed by federal tax rules on for-profit borrowers.

H. Other (Including Public-Private Partnerships)[18]

student housing
hotels
toll roads
cruise terminals
parking facilities
anything else that can help to "lessen the burden of government"

[18] Many of the nonprofit corporations that fall into this "Other" category, as well as some in preceding categories, perform commercial activities that are traditionally conducted by for-profit corporations. If the particular activity is recognized as a burden of government, a nonprofit corporation that undertakes the activity may qualify for 501(c)(3) status because "lessening the burdens of government" is considered a charitable purpose. Obtaining a 501(c)(3) determination for such a corporation usually requires counsel experienced in showing (i) historic governmental involvement in the type of activity to be undertaken by the corporation and (ii) the various kinds of relationship between the corporation and the government whose burden is to be lessened that the IRS will find relevant.

CHAPTER FOUR

Eligible Uses of Tax-Exempt Bonds

There are five basic eligible categories of expenditures of the proceeds of tax-exempt debt: (1) capital expenditures, (2) refinancing prior debt, (3) reimbursing prior capital expenditures, (4) working capital and (5) financing costs, such as costs of issuing the bonds, capitalized interest and reserves. A single bond issue may combine more than one or even all of these purposes.

A. Capital Expenditure Projects

The most common use of any debt is the acquisition or construction of a project – land, buildings, equipment and/or related infrastructure. The primary limitation on the types of projects that can be financed is that they must be owned by the nonprofit corporation (or by a governmental entity) and not be used (i) in a manner that constitutes an unrelated trade or business under Section 513(a) of the Internal Revenue Code (which generally means that it be used in a manner consistent with the nonprofit purpose of the corporation) or (ii) in the trade or business of another person or entity (other than another 501(c)(3) corporation or governmental entity) (a "non-exempt person").

Nevertheless, the project or portions of it can be used by for-profit entities in their trade of business if:

1. The portion of the project so used can be allocable to moneys spent on the project from sources other than proceeds of tax-exempt bonds (such as accumulated funds, donations or the proceeds of taxable debt).

2. The portion of the project so used represents less than 5% of proceeds of the tax-exempt bonds (net of reserves), with any proceeds used to pay costs of issuance of the bonds counted against this 5% amount.

3. The use by a non-exempt person or entity is pursuant to an operating or management contract that meets the requirements of IRS Revenue Procedure 97-13, relating to term (not to exceed 15 years), compensation (mostly fixed with the percentage of compensation that can be variable depending on the term of the contract provided no portion can be based on net profit) and limitations on the number of persons affiliated with the operator or manager that may be on the board of directors of the nonprofit corporation. A more complete description of the requirements of Revenue Procedure 97-13 is contained in Chapter 6, "Private Developers/Operators."

B. Refinancing Prior Debt

Refinancing outstanding taxable debt, including bank loans and mortgages, is a very common use of tax-exempt bonds, particularly (but by no means exclusively) by first time users of tax-exempt debt. The primary limitation is only that the proceeds of the prior debt were used for capital projects that would qualify for financing with tax-exempt bonds as described in immediately preceding subsection A.

Tax-exempt bonds can also be used to refinance prior outstanding tax-exempt bonds, although, generally, only one so-called "advance refunding" is permitted. An advance refunding is defined as issuing the refunding bonds more than 90 days before redemption or other payment of the bonds to be refunded. This limitation does not apply to refunding prior outstanding tax-exempt debt that is paid or redeemed within 90 days of issuing the refunding bonds or to refunding prior outstanding taxable debt whatever the timing may be.

C. Reimbursing Prior Capital Expenditures

Under certain circumstances, capital expenditures that could qualify for financing with tax-exempt bonds but which are made prior to issuance of the bonds can be reimbursed with proceeds of the bonds when issued.

The tax rules generally prohibit reimbursement of expenditures made prior to issuance of the bonds based on a concern about where to draw the line. However, there are some exceptions:

1. If the prior expenditures were made with the proceeds of a bank loan or other type of borrowing which is still outstanding, then that prior debt may be refinanced as described in immediately preceding subsection B.

2. Certain preliminary "soft costs" such as architectural, engineering, surveying, soil testing and similar costs paid prior to commencement of acquisition, construction or rehabilitation of a project may be reimbursed up to 20% of the aggregate issue price of the bonds issued to finance the project. Land acquisition, site preparation and similar costs are not included in such "soft costs."

3. Any other capital expenditures (including costs of issuance) paid before the bonds are issued may be reimbursed if they are paid after, or not more than 60 days before, the nonprofit corporation or the issuer of the bonds expresses "official intent" to reimburse such expenditures by resolution, declaration or other action that meets the requirements of applicable tax regulations; provided that the reimbursement is made no later than 18 months after the later of the date the cost is paid or the date the project is placed in service (but in no event more than 3 years after the cost is paid). *One of the first steps in any serious consideration of a tax exempt financing for a capital project should be the adoption of an official intent reimbursement resolution*. Properly drafted, it can be fairly general, simple, and nonbinding. There is no cost or liability to not issuing the bonds or not using the proceeds for reimbursement. Bond counsel will normally provide such a resolution upon request without charge. See Chapter 9, "Steps to Issuing the Bonds" below.

Bond proceeds used to reimburse the nonprofit corporation as described in (1) or (2) above are considered "spent" and may generally be used for any purpose or invested at an arbitrage profit by the nonprofit corporation without restriction.

D. Working Capital

While use of tax-exempt bonds to finance working capital is not specifically prohibited, the tax rules governing the tax-exemption of interest on the bonds generally make such financings impractical, except in some cases for an amount not exceeding 5% of the bond proceeds (net of reserves) if used as working capital in connection with the project being financed with the balance of the bond issue.

E. Costs of Issuance, Capitalized Interest, Reserves

Costs of Issuance. Costs incurred in connection with issuing the bonds, such as underwriter's discount or fees, fees of bond counsel and other lawyers and consultants, rating agency fees, trustee's fees and the like, may be included in the bond issue, subject to a cap of 2% of the bond issue, which cap does not include the cost of any bond insurance or credit enhancement. This 2% cap is usually more than enough to cover costs of issuance, unless the bond issue is relatively small in size or unusually difficult and time consuming to complete.

Capitalized Interest. Interest payable on the bonds during the longer of three years or the period in which the project is to be constructed and for up to one year after completion of construction may be included (i.e., capitalized) in the bond issue. The capitalized interest is generally held by the bond trustee and used to pay interest on the bonds, with the result that the nonprofit corporation does not have to pay any debt service on the bonds during such period.

Reserves. It is common to have a debt service reserve fund held by the bond trustee and funded with bond proceeds equal to the lesser of 10% of the bond issue, 125% of average annual debt service on the bonds or (in the typical case) maximum annual debt service. The debt service reserve fund is used to pay debt service on the bonds if for any reason the nonprofit corporation fails to pay. Other reserves, such as operating reserves, may also be funded with bond proceeds, but usually only within the limitations on working capital set forth in subsection D above.

CHAPTER FIVE

Interplay Between Tax-Exempt Bonds, Fund Raising, Endowment Funds and Foundations

A nonprofit corporation may have a choice of financial resources to apply to a project, including:

(1) proceeds of tax-exempt bonds,

(2) donations and pledges,

(3) endowment, quasi-endowment, or other accumulated funds, or

(4) third party guarantees or other financial support, often from a foundation with which the nonprofit has close ties.

As pointed out above in Chapter 2, "Why Use Tax-Exempt Bonds," to the extent that tax-exempt bond proceeds can be used instead of other funds that can be invested in taxable obligations, it is possible to earn more on the investments than the interest paid on the bonds. This earnings advantage, based on the spread between tax-exempt and taxable interest rates, is sometimes referred to as arbitrage.

The federal tax requirements governing the tax-exemption of interest on bonds prohibit certain types of arbitrage. One type of arbitrage that is prohibited is that which results from using the proceeds of tax-exempt bonds to "replace" moneys that have been raised or set aside, and restricted or earmarked, specifically to finance the same project to which the tax-exempt bond proceeds would be applied.[19] However,

[19] The "replacement" issue occurs when the moneys raised or set aside for a project are freed up by the bond issue. No issue is presented to the extent that the project is financed with such moneys in combination with tax-exempt bond proceeds.

so long as the donations were not restricted to use on acquiring or constructing the project or other funds that may have been accumulated were not specifically and formally earmarked for the project, then use of tax-exempt bonds instead of such donations or accumulated funds generally would be permissible. For this reason, in situations that may involve this choice, it is advisable to consult bond counsel as early as possible regarding these issues and any related fund raising program. It is usually easier to raise funds for a project than for endowment, and bond counsel can offer advice about how to phrase fund raising campaign literature and pledge documentation (including in some cases how to recast pledges already received) in a manner designed not to interfere with the fund raising objective but at the same time to preserve the maximum opportunity for tax-exempt financing and for permissible arbitrage.

In order to improve the security and possibly the ratings of the bonds (and thereby lower the interest rate), the nonprofit corporation is often asked to pledge a portion of its endowment or other funds or to covenant to maintain available fund balances at a particular level. If the pledge creates too great assurance that the pledged moneys will be available to pay debt service on the bonds even if the nonprofit encounters financial difficulty, or if the fund balance required to be maintained exceeds the amount reasonable for the purpose for which maintained or is tested more frequently than semi-annually, the nexus between such funds and the bonds may be considered so close that applicable tax regulations will require the yield on investments of such funds to be restricted to the yield on the bonds, thereby eliminating some of the benefit of tax-exempt bonds. It does not matter whether the pledge or covenant is to the bondholders or to a guarantor of the bonds. However, it is usually possible to structure a pledge or fund balance requirement in a manner that provides reasonable security without tripping over the yield restriction line.

Foundations and other third parties may provide a variety of forms of financial support to a nonprofit corporation's project, such as, cash contribution, collateral or guaranty. So far as optimizing the benefits of the tax-exempt financing is concerned, the best structural choice will turn on similar issues to those discussed above as well as on the particulars of any legal relationship between the foundation and the nonprofit corporation. Increasingly, the choice is some form of guaranty. Of course, a foundation may itself be the nonprofit corporation borrower of tax-exempt bond proceeds either for the benefit of another nonprofit corporation or for its own facilities.[20]

The proper allocation of the resources mentioned at the beginning of this chapter is an important part of the "art" of structuring a financing that maximizes the benefit of the tax-exemption of interest on the bonds and the potential arbitrage earnings advantage described above. In situations where these opportunities apply, this will be one of the most important steps in formulating the transaction. While the variations in circumstances are too varied and the applicable tax rules often too complex and subtle to cover more thoroughly here, advice of highly qualified bond counsel with substantial experience with these types of financings is needed and should be accessed at the earliest possible stage. See Chapter 9, "Steps to Issuing Bonds" below.

[20] For example, the Rockefeller Foundation has used tax-exempt bond proceeds to finance new headquarters. The David and Lucile Packard Foundation has guaranteed bonds issued for the YMCA of Greater Santa Clara Valley and the Lucile Salter Packard Hospital at Stanford. The J. Paul Getty Trust used tax-exempt bonds to finance its museums in Los Angeles.

CHAPTER SIX

Private Developers/Operators

Private developers, operators and managers often play a role in tax-exempt financings by non-profit corporations. For example,

(1) the project may originate with a private developer, who in order to obtain tax-exempt bond financing for the project turns to an existing nonprofit corporation or causes a new nonprofit corporation to be created, or

(2) a nonprofit may choose not to operate all or part of a project and instead contract with a private operator or manager to do so.

Situation (1) may arise in connection with what are sometimes referred to as "public/private partnerships." The public entity may wish for legal or other reasons to interpose a nonprofit corporation between it and the private developer. Situation (1) may also arise in connection with a project that started out to be purely private but shifted to tax-exempt financing because either conventional financing was not available on acceptable terms or the overall economics of tax-exempt financing for all or part of the project turned out to be more favorable to the developer. Situation (1) often gives rise to nonprofit corporations for purposes not traditionally associated with nonprofits but which can be viewed as lessening the burdens of government and therefore qualify. See Chapter 3, "Eligible Nonprofit Corporations."

In situation (1), the developer generally cannot own the project financed with tax-exempt bonds,[21] but may receive a development fee, a construction management fee

[21] Certain types of projects (such as low-income multifamily rental housing projects that satisfy certain separate tax requirements) may be financed by a private developer as the borrower, owner and operator; however, that is outside of the scope of this pamphlet. Projects that qualify for tax-exempt financing in part because the borrower is a nonprofit corporation generally must be owned by the nonprofit corporation, but may be developed and/or operated by a private developer and/or operator.

and the like so long as such fees are commercially reasonable, and may (or an affiliated or related company may) operate and/or manage the project.[22]

The tax rules governing private operators or managers (hereafter, for convenience, referred to as "managers") are the same, whether for situation (1) or situation (2). These rules are set out in Revenue Procedure 97-13 and restrict the term of the management contract, the compensation of the manager and the corporate relationship between the manager and the nonprofit corporation, generally as follows:

(1) The term (including any renewal options exercisable unilaterally by the manager) may not exceed 15 years or such shorter term as may be required on account of the type of compensation provided (as explained immediately hereafter).

(2) Compensation must generally fall into one of the following categories:

(a) At least 95% of the compensation is based on a periodic fixed fee, and the contract term does not exceed the lesser of 15 years or 80% of the reasonably expected useful life of the managed facility. A periodic fixed fee means a stated dollar amount for a specified period (but may automatically increase according to a specified objective external standard like CPI which is not linked to output or efficiency of a facility). A one-time, fixed incentive payment or productivity reward based on gross revenue or expense targets is allowed to be paid to the manager without affecting the fixed fee payment requirement.

(b) At least 80% of the compensation is based on a periodic fixed fee, and the contract term does not exceed the lesser of 10 years or 80% of the reasonably expected useful life of the managed facility. A one-time, fixed incentive payment or productivity reward based on gross revenue or expense targets is allowed to be paid to the manager without affecting the fixed fee payment requirement.

[22] In certain circumstances it may also be desirable or necessary for the developer or operator to take back or purchase a portion of the bonds, usually subordinated to the bonds sold to investors. In such cases, such bonds must be considered to be true debt (and expected to be paid) and not be disguised equity.

(c) 50% of the compensation is based on a periodic fixed fee, or 100% is based on a capitation (per person) fee or a combination of the two, and the contract term does not exceed 5 years (subject to a right of cancellation by the nonprofit corporation for any reason without penalty after 3 years).

(d) 100% of the compensation is based on a per-unit fee, or a combination of a per-unit fee and a periodic fixed fee, and the contract term does not exceed 3 years (subject to a right of cancellation by the nonprofit for any reason without penalty after 2 years). Per-unit fee means a stated dollar amount for each specified unit of service (such as each car parked by the manager of a parking garage) and may automatically increase according to a specific objective external standard like CPI that its not linked to output or efficiency of a facility.

For each category, no part of compensation may be based on net profits, although the portion of compensation not required to be a periodic fixed fee may be based on a percentage of gross revenues or a percentage of expenses (but not both) or based on a per unit fee or (under certain circumstances) a capitation fee.

(3) In order to prevent the manager from having a relationship with the nonprofit corporation that could substantially limit the nonprofit's ability to exercise its rights under the management contract, the manager cannot control (for example, appoint) more than 20% of the members of the board of the nonprofit and no board member of the nonprofit corporation may be the chief executive officer of the manager or its governing board (or vice versa).

CHAPTER SEVEN

Special Considerations for Religiously Affiliated Nonprofits

The act of loaning money, whether from the proceeds of tax-exempt bonds or not, by a governmental entity to a religiously affiliated nonprofit corporation raises a special set of issues under the First Amendment of the U.S. Constitution relating to establishment of religion and under similar provisions in most state constitutions. The situation usually arises in connection with religiously affiliated schools and colleges.

Until recently the legal analysis applied in deciding whether the school or college was eligible for tax-exempt financing turned on whether the nonprofit corporation borrower/operator was "pervasively sectarian." If so, then the act of the governmental bond issuer in loaning funds to the nonprofit corporation was viewed as advancing religion or creating excessive governmental entanglement with religion which could violate the First Amendment prohibition on establishment of religion. Whether a nonprofit school or college was pervasively sectarian turned on whether it limited students, faculty or staff by religious background or required prayer or instruction in the tenets of a particular faith and on the nature of any administrative, governance or financial relationship with a church, synagogue, mosque or other religious organization.

However, in June 2000, the U.S. Supreme Court rendered a decision in Mitchell v. Helms, which is generally regarded to have substantially changed this legal analysis. Although the case did not involve tax-exempt bonds or a governmental loan of any kind and the decision was based on a plurality of the Supreme Court Justices making its precise meaning somewhat difficult to decipher, the focus of the legal analysis is now generally regarded to have shifted away from the religiously affiliated organization to the nature of the governmental financing program and the facilities being financed with bond proceeds. In general, so long as the law or program under which the bonds are issued is neutral, secular and generally available without regard to religious affiliation and the portion of the project financed with bond proceeds is not used in sectarian worship or religious indoctrination, use of tax-exempt bonds for such purpose will not be considered barred by the First Amendment. If a portion of the facility will be used for religious worship or religious training, it can be carved out of the tax-exempt financing and financed with other sources.

This is a rapidly changing area of the law and judicial interpretation of establishment of religion clauses in some states' constitutions may be not consistent with Mitchell v. Helms or the foregoing analysis. For these and other reasons, the analysis may not always be as simple and straightforward as just suggested. However, it is quite clear that in many states a broader range of religiously affiliated schools are being financed with tax-exempt bonds than was previously thought possible. Bond counsel should be consulted on this issue as early as possible. See Chapter 9, "Steps to Issuing the Bonds."

CHAPTER EIGHT

Finance Structure and Documentation

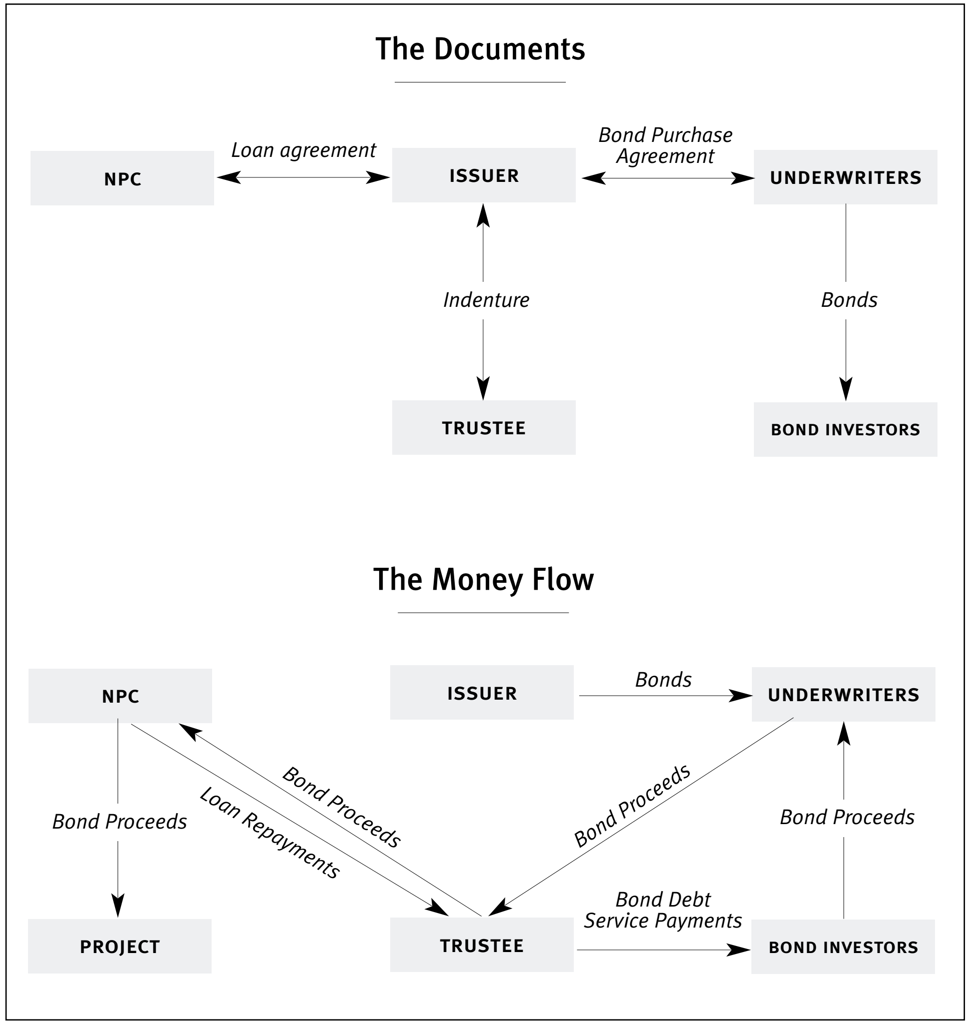
There are a number of variations in the structure of tax-exempt financings for nonprofit corporations. However, the following is illustrative of the basic model:

1. The Bonds are issued by a state or local governmental entity (the "Issuer") which, under applicable state law, has the power to issue bonds for nonprofit corporations for projects or purposes (the "Project") of the type purposed. The Bonds are issued pursuant to an indenture or trust agreement (the "Indenture") between the Issuer and a bank trustee (the "Trustee"). The Trustee holds the bond proceeds until requisitioned for the Project, plus the debt service reserve fund and the bond repayment fund.

2. The Bonds are sold by the Issuer to an underwriter or underwriters (the "Underwriters") pursuant to a bond purchase agreement (the "Bond Purchase Agreement") between the Issuer and the Underwriters, which is approved by the nonprofit corporation (the "NPC"), for resale to investors in the tax-exempt market using an official statement (the "Official Statement") describing the Bonds and other information that investors would want to know in deciding whether to buy the Bonds, which may include financial and operating information about the NPC.

3. The proceeds of the Bonds are loaned to the NPC pursuant to a loan agreement (the "Loan Agreement") between the NPC and the Issuer (which assigns most of its rights, including the right to receive repayments of the loan from the NPC, to the Trustee as security for the Bonds pursuant to the Indenture). The Loan Agreement sets out the terms of repayment of and security for the loan. There may or may not be a deed of trust on the Project or other property to further secure the loan. If so, it is also assigned to the Trustee.

4. The proceeds of the Bonds are used by the NPC to finance the Project, fund the debt service reserve fund and pay the costs of issuance of the Bonds.



A separate public entity is required to issue the Bonds, because with the exception referred to in footnote 3 above, only public entities are qualified under the Internal Revenue Code to issue bonds the interest on which is exempt from federal income tax. However, the NPC is the true party-in-interest and the true obligor of the Bonds. The Issuer functions as a conduit, passing the Bond proceeds collected from Bond investors by the Underwriters (net of the Underwriters spread or fee) to the NPC and the loan repayments received from the NPC back to the holders of the Bonds, in each case through the Trustee. The Issuer is not liable on the Bonds except to apply amounts received from the NPC pursuant to the Loan Agreement as provided in the Indenture. Having assigned its rights under the Loan Agreement (except the right to receive payment of any fee or indemnification) to the Trustee, the Issuer generally has no role or a very limited role after issuance of the Bonds. The Trustee takes over at that point to collect, maintain and disburse the moneys and enforce the rights assigned to it by the Issuer under the Loan Agreement.

The documents of primary interest to the NPC are the Loan Agreement and the portion of the Official Statement covering the NPC. The Loan Agreement will typically contain a number of representations about the NPC and a variety of covenants, usually including covenants pertaining to the following: the amount and times of amortization and repayment of the loan including option to prepay; a pledge and security interest of general or project revenues of the NPC; maintenance of corporate existence and mergers; rates and charges; limitations on encumbrances, indebtedness, acquisition and disposition of property; financial ratios (such as income to debt service and/or assets to liabilities); maintenance and operation of facilities; insurance; indemnification of the Issuer; events of default and remedies. These terms will vary considerably with the nature of the NPC and, possibly, the nature of the Project, but are generally less onerous than those found in an equivalent bank or other conventional loan agreement.

The Official Statement is the disclosure document used in most tax-exempt bond financings. It describes the Bonds and contains the information material to bond investors in deciding whether or not to purchase the Bonds. If the NPC is not newly created, has an operating history and repayment of the Bonds depends in some material way on its creditworthiness, then the official statement will include financial and operating information about the NPC that would be material to bond investors. It may involve some effort on the part of the NPC personnel to compile this information, and the NPC will be responsible for certifying that the portion of the Official Statement pertaining to it meets the federal securities laws standard of not containing any misstatement of material fact or omitting to state any material fact necessary to make the statements contained therein, in light of the circumstances under which made, not misleading.

In some cases, particularly if the NPC chooses to have the Bonds issued bearing a variable interest rate and subject to tender (in order to further reduce interest rates by having the Bonds priced like short-term instruments), the Bonds will be credit enhanced by a letter of credit or standby credit agreement issued by a bank. In that case, there will be an additional contract with the bank, containing additional covenants, and payment of the Bonds may then depend more on the bank issuing the letter of credit than the NPC, which may afford an opportunity, in effect, to replace information in the Official Statement about the NPC with information about the bank.

As discussed in Chapter 6, "Private Developers/Operators," the nonprofit corporation may enter into a development agreement with a private developer for the Project and/or an operation or management agreement with a private party to operate or manage all or part of the Project.

CHAPTER NINE

Steps to Issuing the Bonds

A. Steps

While there are lots of variations depending on the type of Issuer, the type of Project, applicable state law, policies and procedures of the Issuer and other factors, the following is illustrative of the basic steps in a typical tax-exempt bond issue for a nonprofit corporation ("NPC"):

1. **Consult bond counsel.** Bond Counsel is the law firm primarily responsible for rendering an opinion on the validity and tax exemption of the Bonds and for drafting the legal documents to be executed by the NPC and the Issuer in connection with the Bond issue (and in some cases for creating the NPC and obtaining the 501(c)(3) determination). While Bond Counsel typically represents the Issuer, and the NPC is represented by its own counsel, Bond Counsel's fees (like all other expenses of the transaction) are paid by the NPC and most (but not all) Issuers permit the NPC to choose or at least recommend Bond Counsel. It is important to have a Bond Counsel very experienced in similar nonprofit corporation bond financings and, given the tax driven nature of most such financings, particularly experienced in the complex tax laws that govern the tax-exemption of interest on the Bonds.

   To pause for a brief pitch: Orrick, Herrington & Sutcliffe LLP is the leading bond counsel firm in the country (ranked number one for more than a decade) with unmatched expertise and experience in the tax laws applicable to tax-exempt bonds generally and particularly their application to tax-exempt bonds for nonprofit corporations.

It is important to involve Bond Counsel early to determine whether the nonprofit corporation and the project it wishes to finance are eligible for tax-exempt financing and to help design the basic legal and structural conditions for such a financing. Most bond counsel will provide preliminary advice on these matters without charge in case the transaction proceeds no further.

2. **Engage the Underwriter.** The Underwriter is an investment banking firm that is responsible for marketing the Bonds – for helping to structure the financing, for helping to organize the NPC's financial information for inclusion in the Official Statement and for presentation to the rating agencies to obtain ratings on the Bonds and/or to bond insurers or credit providers, and for purchasing (i.e., underwriting) the Bonds for resale to investors. Its counsel is primarily responsible for preparing the Bond Purchase Contract and the Official Statement. Consulting the Underwriter early is crucial to determining whether it is possible to market Bonds for the NPC, at what expected rating and interest rates, and to work out the basic structure of the financing with Bond Counsel.

3. **Adopt reimbursement resolution.** See discussion in Chapter 4, "Eligible Uses of Tax–Exempt Bonds -- Reimbursing Prior Capital Expenditures." Bond counsel will normally provide this resolution on request without charge.

4. Determine with Bond Counsel and Underwriter what public entity will serve as the Issuer of the Bonds. In some states or in some situations, there may be several possible issuers with different policies, procedures, politics, governing laws and fees.

5. Bond Counsel prepares and circulates to the working group initial drafts of Indenture and Loan Agreement.

6. If applicable (see Chapter 8), the NPC works with the Underwriter and its counsel to prepare a draft of the portion of Official Statement that sets forth the relevant financial and operating information about the NPC and/or the Project.

7. Underwriter's counsel prepares and circulates to the working group initial drafts of Bond Purchase Contract and Preliminary Official Statement.

8. One or two rounds of meetings or conference calls to discuss the foregoing documents followed each time by circulation of revised drafts.

9. Draft documents are submitted to the rating agencies and/or bond insurers or bank credit enhancement providers.

10. Another round of document review to take into account any comments or requirements of the rating agencies, etc. followed by circulation of substantially final drafts.

11. Meeting of the governing board of the NPC to approve the Bond issue and authorize execution of the legal documents to which it is a party or signatory.

12. Hearing on and approval of the Bonds by the Issuer (or government entity in which the Project is located if not the Issuer) after at least 14 days published notice (usually combined with step 13).

13. Meeting of the governing board of the Issuer to adopt the bond resolution authorizing issuance of the Bonds and execution and delivery of the legal documents and distribution of the Official Statement.

14. The Underwriter mails the Preliminary Official Statement to potential purchasers of the Bonds (or posts it on the internet and e-mails notice of its availability).

15. Pricing of the Bonds (i.e., setting the interest rates to be borne by the Bonds) by the Underwriter (based on interest by investors) in consultation with the Issuer and the NPC.

16. Sale of the Bonds by execution of the Bond Purchase Contract between the Issuer and the Underwriter, approved by the NPC.

17. Preparation of a final Official Statement containing the final sale information for delivery to purchasers of the Bonds at or before receipt of their purchase confirmations.

18. Closing – delivery of the Bonds to the Underwriter in exchange for the purchase price, simultaneously with delivery of final executed copies of the legal documents, and various certificates, receipts and opinions.

B. Timetable

A typical Bond issue for a nonprofit corporation takes approximately 90-120 days from start to finish. For example, assume at least 30-40 days for steps 1-7 (i.e., structuring the issue and circulating first drafts of the basic legal documents), another 40-60 days for steps 8-13 (i.e., to finalize documentation and obtain approvals, ratings and, if applicable, credit enhancement), 7-10 days for steps 14-16 (i.e., for the Underwriter to market the bonds), followed in about two weeks with step 18 (the closing).

If the nonprofit corporation is to be created as part of the financing, creation of a nonprofit corporation and obtaining a 501(c)(3) determination from the IRS generally takes 120-180 days, which period can run concurrently with steps 1 through 10 above.

These timeframes are fairly representative but may in each case take a lot longer if circumstances require.

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