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Advisory

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PUBLIC FINANCE

After the Bond Closing Obligations of Non-Profit Borrowers

The borrower has survived the process of issuing tax-exempt bonds. It was well worth the effort, too. The interest rate is unbelievable. All the other participants on the deal have filed away their documents, not to be reopened for some time to come, if ever. Unfortunately, the borrower does not have the same luxury. In addition to the requirement to pay debt service on the bonds and ongoing issuer fees, the documents contain a host of other obligations, some spelled out in great detail and others in lawyer's shorthand.

While these obligations vary based on myriad factors (the most important of which is probably the credit quality of the borrower), they typically fall into certain distinct categories. This Advisory was developed to describe these various obligations in general terms. Each college, hospital and other non-profit borrower should have someone on its staff (or its counsel) review its own documents to determine its own specific obligations and to set up systems for monitoring compliance.

Reporting Obligations

The ongoing reporting obligations of a non-profit borrower are dictated both by the federal securities rules (Rule 15c2-12 under the Securities Exchange Act of 1934 in particular) and by contract with the issuer or trustee and any credit enhancer.

Financial reporting

These obligations to provide financial reporting are generally contained in the loan agreement (stating the contractual obligations with the issuer/trustee) and the continuing disclosure agreement (as required by Rule 15c2-12).

(The forms of these documents can vary. For example, some issuers may use a unitary loan and trust agreement and in some cases the continuing disclosure obligation may be contained within the loan agreement.)

Also, for credit-enhanced deals, financial reporting requirements may be contained in separate agreements with the liquidity provider, bond insurer, letter of credit bank or other credit enhancer (referred to collectively herein as “credit enhancers”), or in separate sections of the loan agreement added at their request.

Financial reporting requirements may consist of filing financial statements, but may also include calculation of liquidity ratios, debt service coverage and other financial tests. Colleges generally are only required to do annual financial reporting, whereas hospitals are increasingly required to do quarterly reporting. Some documents require annual filing of a certificate that no default has occurred (or a description of any default that has occurred) from the chief financial officer or the outside auditor.

Reporting on operations

The obligation to report on operations generally is contained in the continuing disclosure agreement, although some loan agreements also require this information. Like financial reporting, for credit-enhanced deals, these reporting obligations are sometimes contained in a separate agreement or a separate section of the loan agreement. For colleges, these may include the obligation to provide updated information

on applications, acceptances, matriculants, total enrollment, SAT/ACT data, and tuition and fees. For hospitals, these often include the obligation to provide updated information on utilization, including number of licensed beds, beds in service, admissions, patient days, average length of stay, occupancy percentage, outpatient visits, and sources of patient service revenue.

Material event reporting

In addition to the periodic reports on finances and operations, Rule 15c2-12 also requires reporting of certain so-called material events. Material event reporting requirements are generally contained in continuing disclosure agreements. These mandate prompt reporting (at a minimum) of any of the following events, if material to the bonds:

- Principal and interest payment delinquencies
- Non-payment related defaults
- Unscheduled draws on debt service reserves reflecting financial difficulties
- Unscheduled draws on credit enhancements reflecting financial difficulties
- Substitution of credit or liquidity providers, or their failure to perform
- Adverse tax opinions or events affecting the tax-exempt status of the security

- Modifications to rights of security holders
- Bond calls (the giving of notice of regularly scheduled mandatory sinking fund redemption is not deemed material for this purpose)
- Defeasances
- Release, substitution, or sale of property securing repayment of the securities
- Rating changes

Filing reports

Annual reports made pursuant to continuing disclosure agreements must be filed with certain nationally recognized municipal securities information repositories (NRM-SIRs) designated by the SEC and with the state information depository (SID) set up in the host state, if any (SID together with the NRM-SIRs: the “Repositories”). The material event notices are filed either with the Municipal Securities Rulemaking Board (MSRB) or the NRM-SIRs, and any SID. The documents can provide for the borrower to make the filings itself or for the borrower to provide them to a dissemination agent (often the trustee) who will in turn make the filings for the borrower. Often the loan agreement also will call for information to be filed by the borrower with the issuer and/or trustee, and by the borrower or the trustee with bondholders who

Practice Pointer

It should be noted that Rule 15c2-12 requires disclosure of a borrower's failure, even in a single instance, to comply with its continuing disclosure agreements in the past five years. In some cases of noncompliance, borrowers simply neglect to attend to these obligations, but in others, the borrower may have sent the information to a dissemination agent, and the agent may have failed to forward the information along to the Repositories in a timely manner. To avoid disclosure of noncompliance in the future (which is potentially embarrassing, at a minimum, and if unexplained or recurrent may preclude an underwriter from underwriting future bonds), a borrower should set up tickler systems to ensure that it complies with its reporting obligations in a timely manner, and should follow up with the dissemination agent to ensure that the dissemination agent makes timely filings.

provide their mailing address to the trustee for that purpose. Currently, municipal bond market participants are actively considering improvements in the filing system.

There is a suggested cover sheet to use when making your filings with the Repositories. It can be found online at the following address: http://www.bondmarkets.com/regulatory/Generic_Cover_Sheet_and_Instructions.pdf.

Financial and Other Covenants

Borrowers with very strong credit ratings often are not subject to financial covenants. However, many colleges and most hospitals and other non-profits are required to agree to certain financial covenants. These are contained in loan agreements and separate agreements with credit enhancers. The following is a list of some common covenants: (These covenants vary based on factors such as credit strength, type of borrower and presence or absence of credit enhancers.)

- Restrictions on ability to issue additional debt
- Requirement to maintain a particular debt service coverage
- Requirement to maintain a certain liquidity ratio
- Limitations on creations of liens, including limitations on the leasing of property
- Limitation on sale or other disposition of assets, including cash
- Maintenance of corporate existence

- Requirement to maintain tax-exemption of borrower and tax-exemption of the interest on the bonds

Failure to comply with these covenants may trigger an obligation to engage a management consultant or it may trigger an event of default under the bond documents with potentially severe consequences for a borrower. Borrowers should understand these covenants thoroughly and set up internal monitoring mechanisms.

Bond Tax Covenants

Borrowers generally covenant to maintain the federal tax-exempt status of the interest on the bonds. Discussed below are four key categories of issues that must be scrutinized to ensure that a borrower does not inadvertently run afoul of the complex federal tax law rules. Many of these rules are certainly traps for the unwary because they place structural limitations on what might otherwise be considered prudent business practices for a borrower.

1. Private Use Limitations

Under federal tax law, facilities that are acquired, improved or enhanced with the proceeds of tax-exempt bonds on the basis of ownership and use by a non-profit entity must comply with rules that are designed to limit the amount of private

benefit derived from such facilities. The purpose of this limitation is to prevent for-profit companies from indirectly benefiting (except for a *de minimis* amount) from this type of tax-exempt bond financing. These are referred to as the “private activity” rules. If these rules are violated, it can jeopardize the tax-exempt status of the interest on bonds retroactive to their date of original issuance.

Inappropriate private use of a bond-financed facility can arise from the following:

- a nonqualified management contract (*e.g.*, one in which the manager is compensated based on net profits or one in which the manager may not be terminated)
- a lease
- certain research agreements
- other similar priority rights or long-term use of property (greater than 180 days)

The rules regarding management contracts and sponsored research are described in more detail later in this Advisory.

At colleges, private business use issues often arise in connection with dormitories (*e.g.* summer rentals), dining halls or cafeterias, student centers, conference centers, research laboratories, stadiums,

theaters, bookstores, gift shops, parking garages, and athletic facilities. At hospitals, common types of private business include physician contracts, joint ventures with third parties, leases, food service arrangements, laboratories, gift shops, and parking garages.

Each private use arrangement must be reviewed carefully to confirm that it complies with the private activity rules. To determine whether private use complies with the applicable tax rules, there is a two-pronged test. The first prong limits the percentage of a bond-financed facility that can be used by private parties in their trade or business. For these purposes, the federal government is treated as a private party. In addition, use by another non-profit organization, if such use is not related to the borrower’s non-profit purpose, is also private use. The second prong limits the amount of revenues that can be generated by the private use. Both prongs must be violated in order to run afoul of the private activity rules.

Prong one provides that no more than 5% of the bond proceeds net of reserves (including investment earnings) may be used to finance property that is used by private parties. Use includes leases, management and service contracts, licenses and less formal arrangements which

permit physical use of the property. The amounts paid for costs of issuance of the bonds counts against this 5% limit.

Even if the facility has more than 5% private use, it still must fail the second prong (also known as the private payment test) in order to violate the private activity rule. This second prong provides that no more than 5% of the principal or interest on the bonds can be derived directly or indirectly by revenues generated by a privately used facility. In other words, use of bond proceeds to finance facilities used by a private party is problematic only to the extent that such privately used facility generates revenues for or otherwise secures the repayment of the bonds. Therefore, if a borrower allows a private party to use bond-financed space free of charge and the borrower does not generate revenue from such use, the private payment test may render such use harmless. In calculating the revenues from the facility, one can net out ordinary and necessary operating and maintenance costs borne by the borrower in connection with the privately used portion of the facility. However, if the borrower derives revenue from a privately used portion of a facility, such revenue may be considered a private payment even if the private party is not the direct source of the revenue.

Borrowers should keep track of the amount of private use that occurs in bond-financed facilities, and maintain detailed records. The private use rules are not intuitive and are often buried in lengthy tax certificates that are signed, but not always thoroughly digested, at the bond closing. If contracting and/or leasing activity is decentralized within a borrower, it may be advisable to conduct educational sessions with the applicable departments to ensure that these rules do not get violated inadvertently. Some borrowers may want to use systems which allow them to use, but not exceed, the 5% allowance.

Management Contracts

In certain cases, arrangements for management or other services results in the manager or service provider being treated as a private user. The private activity rules provide that all of the facts and circumstances determine whether a management or service contract for a bond-financed facility results in private use. The IRS has issued Revenue Procedure 97-13, which establishes safe harbors under which certain types of management arrangements are treated as not resulting in private use. Under the safe harbor, all compensation to the manager/servicer must be reasonable and there must be no compensation based on net profits. The

safe harbor includes specific provisions governing the maximum term of a contract, the portion of the compensation that may be variable (*e.g.*, based on a percentage of revenue) versus fixed and the contract's termination provisions. It is important for a borrower or its counsel to be knowledgeable about Revenue Procedure 97-13. For example, the standard contracts of well-known companies that enter into food service contracts with borrowers routinely are not compliant with the requirements of this Revenue Procedure, and physician contracts often have provisions that may be problematic.

Sponsored Research

In certain cases the private sponsor (including, for these purposes, the federal government) of certain research may be deemed a private user of the facility. Certain non-commercial basic research can be protected under the safe harbor guidelines for sponsored research. The applicable rules are contained in Revenue Procedure 97-14 and these rules should be consulted in connection with any sponsored research arrangements involving bond-financed property.

2. Investment Restrictions on Certain Funds

If the bonds issued on behalf of a borrower have, for example, a

bullet principal payment in the future, a prudent chief financial officer may very well decide to set aside certain amounts over the years so that there is sufficient money on hand to make the payment at maturity. In such circumstances, however, the funds set aside for such purpose may need to be yield restricted (*i.e.*, the funds must be invested at a rate no higher than the yield on the bonds). The tax rules refer to these as invested sinking funds or pledged funds. This rule applies to any set-aside funds that are expected by the borrower to be used directly or indirectly to pay principal of or interest on the bonds (other than the debt service fund established under the bond documents), and to any funds or investments pledged or otherwise restricted so that such funds or property are reasonably assured to be available to pay, directly or indirectly, principal or interest on the bonds (or to reimburse the credit enhancement provider) in the event the borrower encounters financial difficulties. This includes, for example, any cash collateral given to a letter of credit bank and board-designated funds solely available for debt service payments.

3. Investment of Funds

There are a number of tax rules applicable to the investment of

bond proceeds (*e.g.*, construction funds and debt service reserve funds). All investments must be purchased and sold at fair market value. Investments not of a type traded on an established securities market are presumed to be acquired or disposed of for a price that is not equal to their fair market value, although such presumption can be rebutted if certain bidding procedures are followed. There are safe harbors for investments in certificates of deposit, guaranteed investment contracts and investments purchased for a yield-restricted defeasance escrow. Generally, bond counsel will provide assistance in ensuring that these rules are followed at the time the bonds are initially issued. However, if investments are changed or reinvested after the bond issue closes, bond counsel will not be involved unless called upon by the borrower. Unless a borrower has internal expertise in the investment of bond proceeds, consultation with bond counsel or other parties with such expertise is prudent.

In certain scenarios, bond proceeds that are not subject to investment restrictions at closing may subsequently become subject to restriction. For example, if the bond proceeds in the construction or project fund are not expended within three years, the borrower may have to restrict the earnings

on that money to the yield on the bonds. If the borrower no longer intends to spend the money on project costs, the borrower typically is required to use the excess funds to redeem bonds on the first available call date.

Apart from the tax rules, most loan documents establish limits on what types of investments will be permitted for bond-related funds. These limitations on “permitted investments” are usually dictated by state law and credit concerns.

4. Rebate

In the loan agreement and/or in the tax certificate, the borrower typically agrees to make any necessary rebate payments to the Internal Revenue Service (IRS). “Rebate” refers to payments required to be made to the IRS equal to the “positive arbitrage” made on certain bond-related funds; *i.e.* earnings in excess of the bond yield as determined under IRS rules. Such rebatable earnings can arise in a construction fund, in a debt service reserve fund or in invested sinking funds. In general, these payments are due every five years, but there is also a payment due within 60 days of the final payment of the bonds. Many bond documents also require that rebate be calculated annually and that annual deposits be made to a Rebate Fund held by the trustee.

Avoidance of Insider Trading by Trustees, Officers or Employees

It is illegal to buy or sell securities (including tax-exempt bonds) while in the possession of material, non-public information (so-called “inside information”). Material information is any information that a reasonable investor would consider important in deciding to buy, hold or sell securities. If a person has material, non-public information relating to the borrower (positive or negative), he or she should not buy or sell the borrower’s bonds or engage in any other action to take advantage of that information. If someone discloses the information to others with whom they have a relationship (*e.g.*, family member or friend) and that person trades on such information, the person who disclosed the information may be liable as a so-called “tipper” and the person who traded on the information may be liable as a so-called “tippee.” Failure to follow these rules can result in significant personal liability, including civil penalties, criminal fines and/or jail. This is true even when the profit earned is negligible.

Given these risks, board members and management should be cautious if they buy or sell the borrower’s bonds. It is recommended

that they consult with the borrower's compliance officer (if there is one) and/or an attorney prior to buying or selling. Trustees or management personnel who buy bonds of the non-profit they serve should assume that they may be restricted in selling their bonds during certain periods, and that accordingly such holdings may not be liquid.

Investor Relations

Appropriately handled, insider trading rules do not prevent borrowers from providing information to the market. In fact, there are strong reasons why borrowers should maintain open lines of communication with its bondholders and the market generally. Borrowers that cooperate with information requests likely will find that it enhances the marketability of their bonds in the future. In addition, a history of positive investor relations pays dividends for a borrower if and when it ever needs waivers, bondholder amendments or consents in the future. The National Federation of Municipal Analysts (NFMA) has urged, among other things, that borrowers designate a person to handle inquiries from investors and potential investors in a uniform and centralized fashion, and that borrowers make themselves available via dial-in

open-access conference calls, or otherwise, on a periodic basis so that the market has the opportunity to ask questions.

Looking Ahead to the Next Bond Issue

Reimbursement vote

To preserve a borrower's flexibility to get reimbursed with future tax-exempt bond proceeds, federal tax laws require the board of trustees (or someone authorized to act on their behalf) to adopt a reimbursement vote prior to, or no later than, 60 days following any expenditures by the borrower. The rules do not require a reimbursement vote for "preliminary expenditures" so long as such expenditures do not exceed 20% of the bond issue. Preliminary expenditures include architectural, engineering, surveying, soil testing, bond issuance, and similar costs that are incurred prior to commencement of acquisition, construction or rehabilitation of a project, but do not include land acquisition, site preparation and similar costs incident to commencement of construction. The tax rules also do not require a prior vote prior to the expenditure of an amount not in excess of the lesser of \$100,000 or 5% of the proceeds of the issue.

The reimbursement vote can be very simple. An example follows:

Voted: That this [corporation] reasonably expects to incur debt to reimburse expenditures (including expenditures made within the last 60 days) temporarily advanced from internal funds for the following project: [Insert general functional description of the project, property or program]; the maximum principal amount of debt expected to be issued for such project including for reimbursement purposes, is \$_____.

At the time the vote is taken the borrower must reasonably expect to reimburse the expenditures.

The bonds generally must be issued no later than 18 months after the later of (a) the earliest reimbursed expenditure, or (b) the date the project is "placed in service" or abandoned, but in no event later than three years (which can be extended to five years in certain cases) after the earliest expenditure.

Fundraising

If the borrower wants to maximize its ability to issue tax-exempt bonds for capital projects, there needs to be good coordination between the finance office and the development office. The rules are relatively simple in concept. If a borrower has received restricted gifts for a portion of a project, it may not also issue tax-exempt bonds for that same portion. For example, if an addition to a dormitory will cost

\$50 million and the borrower raises \$40 million of restricted gifts for that project, the tax-exempt bond proceeds raised for such project should not exceed \$10 million. Sometimes, short-term tax-exempt financing can be used as a bridge if pledges are to be collected over a number of years.

If tax-exempt bonds are issued for the entire cost of a project, restricted gifts received for the same project must be dealt with appropriately. If such restricted gifts are received for a project after bond proceeds have been dedicated to such project, those gifts must be used to redeem bonds on the first optional call date and invested in

the meantime at a yield no higher than the bond yield.

Gifts for debt service also can be problematic. If the borrower receives a lump sum gift that can only be used for future debt service, the gift amount must be invested at a yield no higher than the applicable bond yield until applied to the payment of the debt service.

Naming bond-financed facilities after donors can raise tax-exemption issues as well. In certain cases, naming a bond-financed building after a corporation may create impermissible private use of that building. Prior to soliciting or accepting a gift from a business

in exchange for naming rights for a facility (or portion of a facility) that either was or will be bond financed, it is important to consult with counsel.

In summary, following the bond closing, borrowers should strongly consider putting procedures in place to monitor compliance with their bond documents and federal tax laws, establish an investor relations program and prepare for its next bond issue. Please contact us if we may assist you with any of these matters.

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