



Nonprofit Financing – Options & Challenges

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Objectives

- Learn the basics of a tax-exempt financing including parties to the transaction, roles of working group members, types of debt instruments and process from start to close
- Understand some of the typical post-issuance reporting and covenant compliance requirements involved in a debt financing
- Learn what to do when debt covenants are breached and how you and your Board can respond
- Hear real world examples of the options nonprofit borrowers have pursued as a result of a debt covenant breach

Introductions

David Nie, Partner at Ice Miller – bond attorney specializing in 501(c)(3) bond financings for nonprofit owners and operators of senior living and skilled nursing facilities

Taryn Stone, Partner at Ice Miller - represents providers on governance, transactional and regulatory issues

Bonds 101

Tax-Exempt Interest Rates

- Interest earned on the bonds is not taxable income to bondholders
- Tax-exempt bonds carry lower interest rates than traditional financing
- Interest rate may be a fixed or variable interest rate

Bond Purchasers (Lenders)

- Banks and other financial institutions – a “direct purchase”
- Capital markets/public offering

Bonds 101 cont'd

Tax-Exempt Bond Qualification – “Qualified 501(c)(3) Bonds”

- Assets financed must be owned and used by 501(c)(3) organization in furtherance of its charitable purpose or governmental unit
- Must be used for capital improvements
 - Adopt a Reimbursement Resolution!
- 95% of net proceeds of the bonds must be used in exempt activities; 90% if governmental unit

Issuance

- Bonds must be issued through a governmental issuer – usually local City, County or State finance authority

Bonds 101 cont'd

Collateral – the Master Trust Indenture (“MTI”)

- MTI establishes base pledge of collateral and affirmative/negative covenants pursuant to which the borrower may secure multiple forms of indebtedness on parity; also allows for two more related entities to pool the credit of two or more related entities by combining them into a single borrowing or credit group
- Typically, a pledge of revenues and can also include a mortgage; remedies can include the right to accelerate all debt secured under the MTI
- Lender’s parity interest is evidenced with a “master note” issued under the MTI

Parties to a Bond Financing

- Borrower – you – the nonprofit provider who needs financing for a capital project; aka the “conduit borrower”
- Borrower’s counsel – represents the borrower; typically issues an opinion that the borrower has taken all necessary action to authorize the transaction documents and that the nonprofit is a 501(c)(3)
- Bond counsel – quarterback of the transaction; engaged by the borrower early in the borrower’s consideration of a plan of finance; issues the tax-exempt bond opinion
- Issuer – the governmental entity the Code requires to issue the bond and loan the proceeds to the borrower; aka the “conduit issuer”
- Issuer’s counsel – represents the issuer; issues an opinion that the issuer has taken all necessary proceedings for the transaction

Parties to a Bond Financing cont'd

- Financial advisor – engaged by the borrower to serve as advisor to the borrower regarding structure and timing of transaction and the economics of the transaction
- Underwriter – investment bank that underwrites bonds sold in public markets; engaged by the borrower; coordinates bond investor disclosure re the bond and borrower
- Bank Purchaser – sole purchaser of a bond typically selected by the borrower through an RFP process
- Bank Purchaser's or Underwriter's counsel – represents the interests of the underwriter or purchaser
- Trustee - financial institution granted trust powers, such as a trust company; has a fiduciary duty to the bond issuer to enforce the terms of a bond indenture and/or MTI; administering the indentures

Post-Issuance Compliance

Risk of IRS Audit

- For the life of the bonds, subject to random or targeted audit
- Schedule K to the Form 990 annual reporting re the status of outstanding bonds

Private Use Restrictions

- Assets financed must be owned and used by 501(c)(3) in furtherance of its charitable purpose; non-501(c)(3) organizations or governmental units are private users
- Greater than 5% private use will result in bonds becoming taxable; reported on Schedule K
- Service or management agreements may be structured to avoid private use

Arbitrate Restrictions/Rebate Calculations

- Borrower may not profit from the investment of bond proceeds in income-generating investments above the yield on the bonds; excess must be “rebated” (or paid back) to the US Treasury Department; calculations every 5 years

Post-Issuance Compliance cont'd

Covenant and Reporting Compliance

- Collateral and financing documents will contain financial and reporting covenants.
- Public bond issues will have reporting requirements mandated by the SEC with reporting to be posted the MSRB's EMMA website
- Failure to comply with a financial covenant can result in bondholders and/or lenders exercising a variety of remedies including engagement of independent consultants, increased reporting, forbearance/waiver fees or acceleration

We've tripped a covenant...now what?

- How do we know we've tripped a covenant?
 - Good post-issuance compliance practices will give early indications of covenant issuers
 - Receipt of a reservation of rights letter from a lender, trustee or bondholder
 - No longer working with regular relationship banker
- What do we do?
 - Be proactive; engage bond counsel; verify covenants violated; comply with contractual requirements; engage consultants/advisors; monitor regulatory requirements
 - Prepare to be negotiating waivers or forbearances with lenders/bondholders
 - Focus on short-term solutions but consider long-term options – have a “Plan B”
 - Inform the Board; review D&O Policy and review fiduciary duties of Board members

Fiduciary Duties of Board of Directors

- Duty of Care
- Duty of Loyalty
- Illinois General Not for Profit Corporation Act (805 ILCS 105/101.1 to 117.05)
 - Directors and officers of a not-for-profit corporation have the same duties as directors and officers of a for-profit corporation under the common law and other statutory duties and responsibilities.

Fiduciary Duties of Board of Directors

- Duty of Care
 - Act with the same level of care that a reasonably prudent person would exercise.
 - GNPCA-silent
 - Best practices:
 - Preparing for and attending board meetings
 - Carefully reviewing meeting minutes
 - Seeking information from officers and other directors to keep reasonably informed;
 - Seeking qualified health
 - Maintaining records of process.

Fiduciary Duties of Board of Directors

- Duty of Loyalty
 - “not actively exploit their positions within the corporation for their own personal benefit or hinder the ability of a corporation to continue the business for which it is developed.”
 - Protect corporation’s interests
 - Refrain from self-interested conduct

Fiduciary Duties of Board of Directors

- Not-for-profit vs. For-Profit
 - No shareholders
 - Caretaker of the nonprofit corporation and its assets
 - “Fiduciary obligation to act on behalf of the corporation in good faith and with reasonable care so as to protect and advance its interests”
 - “Degree of diligence, care and skill which ordinarily prudent men [or women] would exercise under similar circumstances in like position.”

Fiduciary Duties of Board of Directors

- Duty of Obedience
 - Not a duty in Illinois, but recognized in other states
 - Requires the Board to ensure that the corporation complies with all state and federal laws and abides by its stated purposes and goals
 - “[u]nlike business corporations, whose ultimate job is to make money, nonprofit corporations are defined by their specific objectives” central to the mission of the nonprofit.

Fiduciary Duties of Board of Directors

- Duties during insolvency
 - Directors of nonprofit corporations owe a foremost duty to fulfill the purpose of the organization, when the corporation is insolvent, the directors must determine whether their duties remain to fulfill its purpose or whether it must shift its fiduciary duty to include creditors
 - “Special circumstances” fiduciary duty
 - Not disposed of for less than fair value
 - Insider-creditors are not preferred over other creditors

Fiduciary Duties of Board of Directors

- Duties during insolvency
 - “Trust fund doctrine”
 - Ensures that a corporation’s directors do not funnel assets of the corporation to themselves or others, subverting the creditor’s rights in bankruptcy.
 - Does not trigger a duty to liquidate
 - Does not elevate creditors in importance above all other constituencies of the corporation.
 - Interests of multiple constituencies owed which may diverge
 - Beneficiaries
 - Donors
 - Employees
 - Creditors

Fiduciary Duties of Board of Directors

- Business Judgment Rule
 - Directors are largely protected by judgment rule
 - In the absence of bad faith, fraud, illegality or gross overreaching, courts will not interfere with the exercise of business judgment by corporate directors
 - Protects “after-the-fact” scrutiny when the director acted with due care.
 - Must inform themselves fully and in a deliberate manner with respect to a transaction or other business decision that they make on behalf of a corporation.
- Special Rules for Uncompensated Directors
 - May not be sued for “damages resulting from the exercise of judgment or discretion in connection with the duties or responsibilities of such director or officer unless the act or omission involved willful or wanton conduct.”

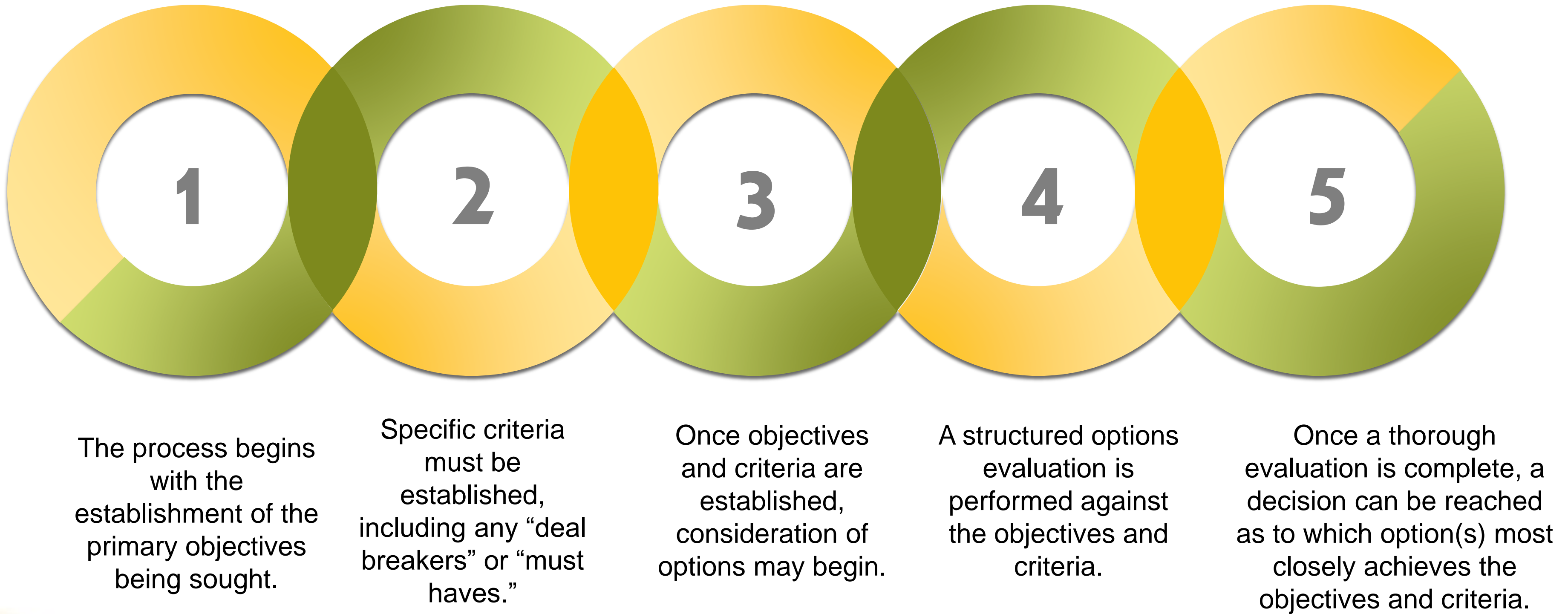
Fiduciary Duties of Board of Directors

- Application-Particular Scrutiny
 - Maximizing the corporation's stated purpose and mission
 - A Fair assessment of the debtor's financial condition
 - Equitable treatment of similarly situated creditors in the absence of business considerations or contractual rights that dictate otherwise
 - Transactions with directors, officers, key creditors, or other parties in a control relationship, and whether such transactions were fair or beneficial to the Company.



A Disciplined Decision-Making Process

An evolving process with a strong focus on objectives and criteria is essential to success.



Identification of Potential Partners

When casting a net for potential partners, there are several key considerations.

- Are there natural “partners?”
 - If so, why?
 - Is the feeling mutual?
 - Is there a cultural compatibility?
- Is a for-profit “partner” an option?
- Do you want to submit “indications of interest” letters to several potential partners?
- Do you want to include a “competitive” process?
- How do you want to manage the process?

A Long Path Forward

- Communicate with key stakeholders
- Implement the affiliation plan



INTEGRATION

- Execute Letter of Intent
- Negotiate terms and conditions of final transaction
- Complete transaction closing



EXECUTION

DUE DILIGENCE



- Conduct organizational due diligence to determine fit
- Evaluate and select desired legal option

TARGETING



- Develop internal Value Proposition
- Identify potential partners
- Gauge initial interest
- Evaluate opportunities

STRATEGY



- Conduct internal assessment and Board education
- Launch a Steering Committee
- Establish a Communication Plan



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