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Tax-Exempt Financing by Nonprofit Corporations Alternative Financing Methods

I. General Background

States and political subdivisions are authorized, under federal tax law, to issue obligations, the interest on which is exempt from federal income taxation ("tax-exempt bonds"). Each state has statutes and administrative rules that outline the terms under which tax-exempt bonds may be issued. There are circumstances, however, when a political subdivision would prefer <u>not</u> to issue bonds directly for a project. These reasons may be legal, practical or political. A facility may qualify for tax-exempt financing, because of its use by a governmental entity; nevertheless, the governmental entity elects not to finance the project with its own tax-exempt bonds. An alternative method of obtaining tax-exempt financing is available pursuant to Revenue Ruling 63-20. This method of financing is commonly referred to as "63-20" financing.

In a 63-20 financing, a nonprofit corporation created under the nonprofit corporation laws of a state may issue tax-exempt obligations on behalf of a state or political subdivision for the purpose of financing governmental facilities as long as certain requirements are met. The nonprofit corporation must transfer title to the financed facility to a governmental entity when the debt is retired. All of the interpretations and expansions of Revenue Ruling 63-20 by the Internal Revenue Service have been compiled in Revenue Procedure 82-26. See "Federal Tax Limitations" below.

63-20 debt in the form of tax-exempt bonds generally is sold in the same financial markets as governmental tax exempt bonds. The interest rates may be comparable, depending upon the credit strength of the collateral security. Interest on 63-20 debt is exempt from federal income taxation. The cost of capital financing is, therefore, lower than it would be in the conventional capital markets.

An underwriter may underwrite long term (20 years or more) bonds issued by the nonprofit corporation. The credit support for the bonds comes from the lease of the facility to the governmental entity. The bonds may be issued on a nonrecourse basis to the nonprofit corporation, *i.e.*, the bonds are secured solely by lease revenues. In a nonrecourse financing, the owners of the bonds would have <u>no</u> recourse against <u>any other assets</u> of the Nonproft Corporation.

II. Federal Tax Limitations

Revenue Procedure 82-26 sets out the requirements for a 63-20 financing. The requirements of Revenue Procedure 82-26 include, but are not limited to:

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Not for Profit

The issuer of the bonds must be organized under the general nonprofit corporation law of the state, and its articles of incorporation must provide that it is not organized for profit. The state of incorporation must be the same as the state where the facilities to be financed are located.

No Private Inurement

The articles of incorporation must provide that income of the corporation will not inure to the benefit of any private person and, in fact, the income of the corporation does not inure to any private person.

Public Activities

The activities of the corporation must be essentially public in nature. This requirement is automatically met if the activities and purposes of the corporation are permitted under the general nonprofit corporation law of the state.

Location of Facilities

The facilities financed by the bonds must be located within the geographic boundaries of the political subdivision on whose behalf the bonds are being issued or, if outside such boundaries, there must be a substantial economic nexus between such facilities and the political subdivision.

Finance Tangible Property

Unless the bonds are refunding bonds, all of the original and investment proceeds of the bond issue must be applied to tangible real or personal property, costs of issuance, underwriters' discount, interest during construction, or to fund a reserve. There are several significant points made with regard to this requirement:

- The bonds must be sized so as to take into account the fact that there will be earnings available from the investment of bond proceeds during the construction period.
- Bond proceeds cannot be used to finance working capital. Likewise, bond proceeds may not be used to purchase an existing facility from a person who will continue to use the facility after the bonds are issued.
- Any excess bond proceeds remaining after construction is completed must be used to redeem or defease bonds in accordance with Treasury Regulation Section 1.141-12(d).
- Since only tangible property may be financed, bond proceeds must not be used to acquire intangibles such as mortgages or student loans.
- Personal property may be financed.

Political Subdivision Approval

The political subdivision on whose behalf the bonds are being issued must, before the date of issuance, approve both the nonprofit corporation and the issuance of the particular bonds. Although the Revenue Procedure is not explicit, it appears that the governing body of the political subdivision (as opposed to its chief executive officer) must make the approval. Such approval must occur within one year of the date of issuance of the bonds, although a single approval of a series of bond issues for a single project over a five-year period is acceptable.

Benefit Interest in Corporation

The political subdivision on whose behalf the bonds are being issued must have a beneficial interest in the nonprofit corporation while the bonds remain outstanding. This is satisfied if one of the following is true.

- The political subdivision (or an instrumentality thereof) has exclusive use and beneficial possession of 95% or more (measured by fair rental value) of the facilities financed by the bonds (including any additions to such facilities). Such exclusive use and possession must extend for the full term of the bonds, or any refunding bonds, or any bonds issued to finance improvements to the facilities.

or

- The nonprofit corporation has exclusive use and beneficial possession of 95% or more (measured by fair rental value) of the facilities financed by the bonds (including any additions to such facilities), and the political subdivision on whose behalf the bonds are issued controls the nonprofit corporation. The political subdivision is deemed to control the nonprofit corporation if the political subdivision appoints or approves 80% or more of the directors of the corporation, and the political subdivision has the power to remove, for cause, either directly or through judicial proceedings, any director and appoint the successor. Officials of the political subdivision who serve as ex-officio directors count toward satisfying the 80% test.

or

- The political subdivision on whose behalf the bonds are issued has the right to acquire, at any time, unencumbered title and exclusive possession of the property financed by the bonds (including any additions thereto) by paying a sum sufficient to defease the bonds. This alternative is intended to apply where neither the political subdivision nor the nonprofit corporation has exclusive use and possession of the facilities financed by the bonds, or, even if the nonprofit corporation does have exclusive use and possession, it is not controlled by the political subdivision (e.g., an industrial development bond where a private person or entity is the lessee of the facilities, or the financing of a hospital for an organization that is not controlled by the political subdivision). The problem posed by this alternative is that the private user runs the risk of being removed at any time if the political subdivision is able to defease the bonds (the private user is allowed 90 days to vacate the facilities after defeasance).

Option to Purchase upon Default

The political subdivision on whose behalf the bonds are issued must have the option of buying the facilities in the event of default on the bonds. The political subdivision would have to pay an amount sufficient to defease the bonds. This will enable the political subdivision to prevent a default sale of the property. The political subdivision must be given 90 days notice before it must exercise this option to buy, and another 90 days before it must actually pay for the facilities. This option to buy is not necessary where the political subdivision has been the exclusive user of the facilities financed by the bonds.

Title Vesting

The political subdivision on whose behalf the bonds are issued must receive full legal and unencumbered title to the facilities (including any additions thereto) upon retirement of the bonds for no additional consideration and without further demand by the political subdivision. In this regard, the political subdivision may not share its title with any other person, even another political subdivision. Therefore, the nonprofit corporation may not issue bonds on behalf of more than one political subdivision. The vesting of unencumbered title requires that all leases and management contracts cease upon discharge of the bonds. However, the Internal Revenue Service has indicated that it will issue a favorable ruling where, at the end of the term of the bonds, the user of the facilities has the option to lease the facilities for the then fair rental value. Finally, it is not necessary for title vesting to occur upon discharge of temporary financing of five years or less, as long as title vesting will occur upon discharge of the permanent financing.

Resolution to Accept Title

In order to assure the political subdivision's good faith intention to accept title to the property at the end of the term of the bonds or once the bonds are otherwise discharged, the Internal Revenue Service requires that, before the bonds are issued, the political subdivision adopt a resolution agreeing to accept future delivery of unencumbered title to the property (including any additions thereto).

Improvement and Refunding Bonds

Any subsequent bonds issued by the nonprofit corporation to improve the facilities or to refund the original bonds must mature no later than the last maturity date of the prior bonds that were issued to originally provide the facility. This assures that title vesting will not be indefinitely deferred by issuing subsequent series of bonds. Furthermore, the prior issue must be redeemed within 90 days of the date of issuance of the refunding bonds. These requirements need not be fulfilled if the political subdivision has exclusive use and possession of the facilities.

Insurance Proceeds

Any insurance proceeds received as a result of damage or destruction to the facilities financed by the bonds (including any additions thereto) must be used to prepay bonds or reconstruct the facilities or be remitted to the political subdivision on whose behalf the bonds were issued. This assures that a fully operational facility will vest in the political subdivision upon discharge of the bonds.

Residual Value

At the time of issuance of the bonds, it must be determined that the fair market value of the facilities financed by the bonds is estimated to be, upon maturity of the bonds, at least 20% of the original cost of the facilities without regard to inflation. Similarly, it must be determined at the time of issuance of the bonds that, on the date of maturity of the bonds, at least 20% of the useful life of the facilities will remain. With regard to items like equipment, which generally will have a useful life that is shorter than the term of the bonds, this requirement may be met by requiring that such equipment be maintained and replaced periodically, such that the replacement property will, upon maturity of the

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bonds, have at least 20% residual value and life. The residual value and life tests need not be met if the political subdivision has had exclusive use and possession of the facilities for the term of the bonds.

Conveyance of Title

Upon defeasance of the bonds (other than by issuing a 63-20 refunding bond), the political subdivision may agree to convey its interest in the property to any other person, provided the political subdivision had not agreed or committed, before the defeasance, to convey its interest in the property. However, if the political subdivision is conveying its interest in the property to a person who was a user of the property before the defeasance occurred, or related to such person, then such conveyance or agreement to convey must not occur any earlier than 90 days after the defeasance. For example, if a nonprofit organization has been the lessee of facilities financed by a 63-20 bond issue, this organization could acquire title to the facilities (thereby, negating any title vesting in the political subdivision) by causing a defeasance of the bonds and, 90 days later, having the political subdivision convey its future right to title. During the 90-day period, the nonprofit organization is at risk that the political subdivision will, at the end of that period of time, refuse to convey its interest in the property to the organization. On the other hand, if the person who desires to acquire the facilities had not been the user of those facilities prior thereto, the defeasance and conveyance could occur simultaneously.

III. Other Tax Considerations Affecting Tax Exemption

The primary purpose of a 63-20 financing is to obtain tax exempt rates, thereby lowering interest costs. The Internal Revenue Code includes a wide variety of tests and requirements that must be met and observed throughout the term of a bond issue in order to maintain tax exempt status.

In a 63-20 financing, one of the critical requirements involves compliance with “private use” requirements. Interest on private activity bonds is not excludable from gross income under Section 103(a) of the Code unless the bonds are qualified bonds (for example, qualified 501(c)(3) bonds or an exempt facility bond provided for by Section 142 of the Code). The purpose of the private activity bond tests is to limit the volume of tax-exempt bonds that finance the activities of nongovernmental persons (persons or entities other than state or local governmental units). The private activity bond tests serve to identify arrangements that have the potential to transfer the benefits of tax-exempt financing, as well as arrangements that actually transfer these benefits. Bonds generally are private activity bonds if they meet both (1) the private business use test and (2) the private payment or security test.

The private business use test relates to the use of the proceeds of the bonds. The test is met if more than 10% of the proceeds of the bonds are used in a trade or business carried on by a non-governmental person. For this purpose, use of the financed property is treated as the use of the bond proceeds. In addition, indirect as well as direct uses of the proceeds are taken into account.

The private payment or security test relates to the nature of the security for, and the source of, the payment of debt service on the bonds. Payments are taken into account under this test if they are derived from the financed property used for a private business use as well as if debt service on the bonds is secured by an interest in the financed property used for a private business use. The present value of these private payments is compared to the present value of the debt service to be paid over the term of the bonds. If the present value of the private payments is more than 10% of the present value of the debt service on the bonds, the test is met.

If the bonds will be private activity bonds, then the limitations imposed by the Code with respect to private activity bonds must also be considered. In a dock/wharf/airport financing, the facilities financed with bond proceeds must be government owned. They may subject to a lease, provided that the lease does not exceed 80% of the useful life of the facilities financed. In addition, the lessee must make an irrevocable election not to take depreciation with respect to the financed facilities. Dock and wharf facilities do not require a volume-cap allocation.

IV. Security for Bonds

General or Limited Obligation of Issuer

In a 63-20 financing, the bonds are issued by the nonprofit corporation ("issuer"). In a *traditional* financing, the issuer of the debt is the party primarily responsible for the repayment of the debt. This is *not required*, however, in a 63-20 financing. If an issuer with substantial assets is available, the issuer may issue debt and pledge its full faith and credit (thereby adding real value, in addition to the value of the tax-exempt financing to the debt issue). What may be more likely, however, is that the project seeking tax-exempt financing (outside of the government umbrella) is intended to be financed on the basis of "cash-flow," i.e., cash flow from the project and the project itself.

The issuer may be an existing nonprofit corporation or a new corporation formed for the express purpose of financing this project. If the goal is to structure a "cash flow" project, the formation of a new nonprofit corporation is generally preferable. This suggestion is based upon experience with rating agencies and/or bond insurers. If the issuer owns substantial assets and has a long-term operating track record, the rating agencies/insurers are more likely to view the project favorably. For the vast majority of nonprofit organizations, outside the pale of large operating "charitable" hospitals, the organization may not have continuity of management and substantial financial reserves.

If an issuer does not add significant financial support to the project, then the credit enhancers/rating agencies will consider whether the other unrelated activities of the issuer have the potential to adversely affect the financing. Does the issuer retain the right to incur second liens on the project? Do the other activities of the issuer carry financial risk? What would be the impact of the bankruptcy of the issuer? The latter issue generally presents the most compelling case for creating a new nonprofit corporation to act as the issuer. Federal bankruptcy law permits certain types of leases to be rejected (terminated) in bankruptcy. If the lease revenues from the project are the primary source of repayment for bonds, then any risk of rejection of the lease, particularly a risk that would arise from unrelated activities of the issuer, is not acceptable. For this primary reason, therefore, a new nonprofit corporation may be preferred as the issuer.

If a new, nonprofit corporation is formed, the charter may be specifically designed to finance a single project or a limited number of projects on a nonrecourse basis. See Section V. Other Tax Issues Affecting the Selection of a Nonprofit Issuer.

Structure of the Debt

In order to access the tax-exempt market, the debt is commonly denominated as "bonds". Since the debt is corporate, however, there is more latitude available in structuring the debt than would be available in a typical municipal bond issue. There are some market-driven conventions that may be anticipated, e.g., the most customary term for municipal bonds is 20 years. Another, more important characteristic of the municipal bond market is the risk-averse nature of the market. In a public offering, an investor in municipal bonds typically seeks an essentially risk-free investment. Although credit quality impacts pricing somewhat, the most significant factors in pricing are market issues. Tax-exempt bonds sold in public offerings are always investment grade. There is no public market for tax-exempt junk bonds.

If bonds are sold as a public offering, the bonds generally will need to have obtained an investment grade rating from one or more of the traditional rating agencies for municipal bonds, e.g., Moody's Investors Service, Standard & Poor's and/or Fitch. The bonds may be secured solely by the project, or they may be secured with third party credit enhancement, e.g., a policy of municipal bond insurance or letter of credit. Bonds may qualify for an investment grade rating on the basis of their intrinsic credit strength or with the assistance of credit enhancement. Credit enhancement in the tax-exempt market is generally provided by a policy of municipal bond insurance or a letter of credit issued by a bank. Recent events in the credit market have diminished, almost entirely, the role of bond insurers in the financial markets due to their internal financial struggles. Bond insurance may continue to be used in 63-20 financings; however, its role will certainly be diminished until the financial markets resume confidence in the long-term rating stability of bond insurers. Until that time, the underlying rating of a project will prevail in the minds of investors evaluating an investment in 63-20 bonds. Municipal bond insurers include MBIA Insurace Corporation, Ambac Assurance Corporation, CIFG Assurance North America, Inc., and Financial Security Assurance Inc. The insurers are highly rated (generally AAA by the rating agencies) and the addition of a policy of municipal bond insurance permits a bond issue to be rated on the basis of the insurer's ratings. Bond insurance is generally non-cancellable, extends for the full term of the bonds and is obtained by paying a single premium at the time bonds are issued. The insurance premium is a closing cost.

Letters of credit are issued by foreign or domestic banks having a rating of A or better. The letter of credit is an undertaking by the bank to pay debt service directly or upon nonpayment by the issuer. The issuer enters into a reimbursement agreement with the bank. On the basis of the letter of credit, the bank's credit rating is assigned to the bonds. Letters of credit typically have a term of five to seven years, and the governmental sponsor or nonprofit, as the case may be, would be required to obtain a new letter of credit or an extension of the existing letter of credit prior to the expiration date. Letter of credit fees are paid annually and are traditionally priced as a percentage of the credit amount.

The credit enhancer will apply its own underwriting criteria to the bonds and the collateral and, will, if it is satisfied that the transaction has little risk of default, issue a credit enhancement. The credit enhancement (i) acts as a short-cut for investors who make investment decisions relying upon the prior due diligence of the credit enhancer; (ii) provides a recognizable name as the basis for making the investment (e.g., a tax-exempt fund with a requirement that all or a portion of its securities be rated at minimum levels).

The Project as Security

If the security for the bonds is based primarily upon the viability of the property/project, the investor (or the credit enhancer in a credit enhanced deal) will focus on the intrinsic value of the property/project as well as projected cash flow.

The project security must be in place at the time of debt issuance and must remain in place so long as the bonds are outstanding. Accordingly, the credit evaluation examines the project from the date of funding through the date of maturity of the bonds. If bond proceeds will be used to pay construction costs, the credit examination will extend to the construction period as well as the period of operations.

The security may be summarized as follows:

- Prior to completion of the project.
  - **Contractor.** The contractor will probably be required to be substantial, with significant experience and capital. The contractor should be able to demonstrate bonding capacity sufficient to undertake the project.
  - **Payment, Performance, and Completion Bonds.** The contractor may be required to obtain full bonding for the project, insuring against all risks, including those identified as *force majeure* (acts of God).
  - **Developer Guaranty.** During the course of construction, completion risk may be assumed and performance guaranteed by a developer (who has substantial assets or maintains a credit rating from a national rating agency).
- Mortgage on the Project. Title to the property is held by the nonprofit corporation, with title insured by a policy of title insurance. The bonds are secured by a first mortgage (trust deed) on the property. A lender's policy of title insurance (with reinsurance if appropriate) will insure (i) the issuer's title to the property and (ii) the first lien of the mortgage on the property/project. The mortgage may also include a security interest on personal property, if any, financed with the proceeds of the bonds.
- Lease Revenues. Rent payments made under a lease with the governmental sponsor or other 501(c)(3) organization would constitute the principal security and assurance for repayment during the term of the bonds following completion of the project.

Role of the Trustee

The issuer's role in the financing may be limited. It is not expected that the issuer will (i) hold and invest bond proceeds, (ii) make disbursements to pay project costs, (iii) maintain books and records with respect to the bonds, or (iv) hold and administer project collateral. When bonds are issued, the issuer would enter into a trust indenture with the trust department of a bank or trust company. Under the indenture, the bank/trust company will perform these functions. All collateral would be pledged or assigned by the issuer to a bank trustee on the date of closing and issuance of the tax-exempt bonds. The trustee would be responsible for administering construction, insurance and the operating contracts for the term of the bonds, enforcing developer guarantees or warranty claims and assuring the collection of rent and payments to the bondholders during the term of the bonds. Following the closing, therefore, the issuer may have a minimal role, if any, in the construction and operation of the project.

V. Other Tax Issues Affecting the Selection of a Nonprofit Issuer

The issuer must be a nonprofit corporation. Such an organization need not necessarily be exempt from federal income tax as a result of being described in Section 501(c)(3) of the Code, but the federal income tax status of income of the nonprofit issuer and requirements for return filing should be addressed in structuring the transaction.

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An existing nonprofit corporation with an operating history may qualify for a loan in the conventional manner. This loan may be converted into a 63-20 financing, assuming that the nonprofit corporation is willing to abide by the tax limitations described in the foregoing sections. Thus, an ordinary, conventional bank loan may be booked by a bank as a tax-exempt, bank-eligible loan. In the alternative, a bank could determine to add its letter of credit to the transaction, thereby making the nonprofit corporation's obligations more marketable.

In the alternative, a project may qualify for tax-exempt financing because it will be used by a governmental entity. In this case, the nonprofit corporation is selected or formed for the sole purpose of acting as the tax-exempt bond issuer; the tenant or project user is providing the credit support for the repayment of the loan.

Other factors will need to be reviewed in connection with the financing and could affect the selection of an issuer. For example, state and local taxes, including income and property taxes, need to be reviewed for their impact. Also, the internal governing rules of the issuer will affect the ease with which the financing documents involving such issuer can be negotiated and approved. Thus, it may be preferable to work with an issuer that has a small governing board that can easily hold meetings where a quorum will be present.

VI. Formation of a Nonprofit Corporation

One or more people may form a nonprofit corporation by selecting a name and executing and filing articles of incorporation with the Secretary of State. At a minimum, the articles of incorporation must include the name of the corporation, a statement of the purpose and governing law of the corporation, and the name and address of the agent of the corporation. The articles of incorporation should be signed and acknowledged by the incorporators, or by the initial directors, if those directors are named in the articles. The nonprofit corporation is formed upon filing of the articles and payment of a filing fee, and, unless otherwise provided in the articles of incorporation, will continue in existence perpetually.

At the initial meeting of the directors, the directors should fix the time and place of meeting, adopt by-laws, approve a corporate seal, if desired, determine the corporate address, authorize other organizational matters and choose officers of the corporation. Corporations are required to have a chairman of the board or a president or both, a secretary, a chief financial officer, and such other officers as are stated in the bylaws or determined by the board of directors to be necessary.

VII. Real Estate and Construction Related Issues

In a 63-20 bond issue structured as outlined above, the obligations of the issuer will be secured in a manner consistent with conventional real estate financing. The landlord/issuer will grant the bond trustee a first lien mortgage or trust deed on the real property and improvements intended to be financed with the proceeds of the bond issue and will grant the bond trustee an assignment of the rent to be paid by a tenant (governmental entity or 501(c)(3) corporation) which will be occupying the real property once the project is completed. The parties intend that the issuer will repay the bond issue with the rent payments made by the tenant. If the project has not been completed at the time the bond issue closes, the issuer will also assign all of its respective right, title and interest under the various architectural and construction agreements to the bond trustee as additional security for the bonds and the bonds will need to include sufficient capitalized interest to pay bondholders until the project can be completed, the tenant takes occupancy and begins making rent payments for use and occupancy of the project.

In underwriting the bonds, the underwriter and the rating agencies will be vitally interested in and carefully review the actual terms and conditions of the lease and the financial strength of the tenant, governmental or otherwise. The bond financing will be structured around the lease payments to be made by the tenant under the lease which are expected to repay the bonds—not assets or income of the issuer itself. In many cases the issuer will be a single purpose nonprofit corporation incorporated solely to act as the issuer of the bonds and will have no assets other than the real property, the lease and any construction documents which are assigned to the bond trustee.

Only assets owned by the issuer are pledged to the bond trustee and available to pay bondholders. Although a governmental tenant has a contractual obligation under the lease to make lease payments, and may be sued if it fails to make lease payments as and when they become due and payable, the governmental tenant is not itself the issuer of the bonds, nor are any of its assets or revenue pledged to the bond trustee as collateral for repayment of the bonds unless the parties to the transaction require a specific asset or revenue pledge.

VII. Special Real Estate Considerations

Because the basic collateral securing the bonds is real estate and the rental income to be derived there from, the parties need to pay particular attention to the unique risks and characteristics involved in taking real estate as collateral which are not ordinarily part of public financings.

Hazardous Waste Liability

Because the owner of real estate is strictly liable for any environmental contamination of real property that it owns, both the issuer and the tenant will need to undertake a thorough environmental review of the real property that is selected for the project site at an early stage in the financing process. Environmental contamination that is discovered during the course of construction not only will delay completion of the project, but also may be exceedingly expensive or time-consuming to remediate. This initial environmental review should include at a minimum a Phase I environmental assessment performed by an experienced environmental consulting firm and include a physical inspection of the site, review of historical information about the property, review of governmental enforcement files and data bases and a search of all documents recorded in the real property records to determine whether any past uses of the site suggest need for a more thorough investigation of the real property. If the use of the property has changed over time, a physical inspection of the property alone may not alert the parties to a prior use that could have contaminated the groundwater or soil; for example, property that was previously used as a gasoline service station. Depending on the results of the Phase I environmental assessment, more extensive environmental assessment of the real property may be necessary. If contamination is found, the property will need to be cleaned up before the financing can proceed.

The parties to the financing will be concerned not only with the historical use and current environmental condition of the site, but potential liability for environmental problems that might occur during the term of the bond issue and/or the lease, either as a result of the activities undertaken by the governmental tenant itself, a third party unknown to either party (the midnight dumper of hazardous waste) or activities on adjoining properties that migrate off-site and contaminate the real property security for the bonds. These concerns are normally dealt with by including environmental indemnification provisions in the lease signed by the governmental tenant and environmental indemnification provisions included either in the mortgage or a separate "unsecured" indemnity agreement executed by the issuer in favor of the bond trustee.

General Liability Considerations

In addition to the hazardous waste concerns unique to real estate, the parties will also be concerned about liabilities occurring on the property which can include either claims by third parties (slip and fall), claims brought by the tenant in the event the building is defective or persons injured or property damaged as a result of the faulty construction or poor maintenance of the building, or liabilities created by the tenant itself as a result of its use and occupancy of the building. Because of the specialized nature of their business, universities may conduct controversial research programs, and operate hospitals or medical clinics that generate infectious, hazardous and/or radioactive waste that could result in damage to persons, property or the environment, interrupt business operations or generate malpractice liability. These unique business needs and liability considerations need to be negotiated as part of the lease.

The parties' liability concerns can be dealt with in the financing documents in a number of ways. One common approach is to require certain types and amounts of insurance coverage or self-insurance along with provisions in the lease which clearly spell out each party's respective obligations with respect to on-going maintenance and repair of the building. The lease will also generally include broad indemnification provisions by the tenant from claims resulting from its use of the project. If the project being financed is new construction, the parties should obtain warranties from the contractor or the construction manager in the construction documents.

Terms and Conditions of the Lease

In a 63-20 financing which is dependent upon the terms and conditions of the lease, the underwriters and rating agencies will focus their attention on the terms and conditions of the lease and in particular on the rental income stream itself.

- **Term of the Lease**. The term of the lease will determine the term of the bonds, since the parties expect that the rent paid by the tenant under the lease will retire the bonds. Under some circumstances, the tenant's obligation to pay rent may be terminated prior to the maturity date of the bonds or the expiration date of the lease (for example, a "non-appropriation clause").

- **Rent Commencement Date**. To maximize the interest cost savings, the parties may wish to close the bond financing prior to the date that the tenant is obligated to pay rent. As indicated above, the bond issue should include capitalized interest so that there is a source of funds to pay bondholders during the construction process. To alleviate underwriting concerns that the rent commencement date will be delayed because of construction delays or cost overruns, the parties can provide for guaranteed maximum price construction contracts, payment and completion guarantees, surety bonds and/or retain an independent project manager or construction consultant to monitor the course of construction. See "Construction Related Risks" and "Design, Construction and Completion of the Project" below.

- **Certainty of Rent Obligation**. Under certain circumstances, a real property tenant's duty to pay rent may terminate. Common examples include a breach in the landlord's duty to perform its obligations under the lease, commercial frustration of purpose, damage or destruction of the improvements, condemnation of the property or a loss of the landlord's title. The underwriters will seek to eliminate as many defenses to the tenant's duty to perform as possible, and may require that the lease be an "absolute net lease" where the tenant assumes all obligations to maintain and repair the building, pay taxes, assume the risk of interruption of utilities, frustration of purposes, etc.

In the event that the tenant is unable to use the building because of damage or destruction, the underwriters will want no abatement in the duty to pay rent, with the tenant obligated either to rebuild the project or to retire the bonds. In the event of a condemnation or loss of title to the property where restoration of the project is not possible, the condemnation or title insurance proceeds will be used to redeem bonds to the extent available. Business interruption insurance may be used to offset payments made to bondholders during the course of any repair or reconstruction of the project.

- **Default**. Issues that are frequently the subject of negotiation include the source of funds which is the tenant is required to use (or the issuer/bond trustee may attach in the event of a default) to pay rent and whether the issuer/bond trustee has the right to accelerate the rent in the event of a tenant default.

Financial Strength of the Tenant

In many cases, the bonds will be non-recourse to the issuer. On the whole the rating agencies have expressed a preference for an issuer which has no significant assets or ongoing purpose other than facilitating the financing itself. In such cases the bonds will be underwritten on the financial strength of the tenant. If the source of funds available to pay rent is restricted to a particular revenue source, the bonds will be underwritten on that basis.

Construction Related Risks

As noted above, in order to maximize the interest cost savings to the tenant, it may be advantageous to close the financing as early as possible in the construction process.

It is difficult to close a real estate financing before the parties have obtained the key permits and government approvals (including land use and environmental approvals) necessary to construct the project. Once construction is underway, the parties may be able to close the bond financing prior to substantial completion of the project if the underwriters have confidence that any construction-related risks associated with completing the project are minimal.

This is one case in which the parties may minimize the delays and expenses associated with the financing by careful selection of experienced architects, contractors and other construction professionals with good track records of completing similar projects on time and on budget. The construction documents should include warranties of workmanship and materials for a reasonable period of time following closing so that any construction defects are paid for by the contractor and not the tenant. There are also a variety of other financing techniques that can be used to provide comfort to the members of the financing team that the project will be completed in a timely fashion and within the agreed upon budget: payment and completion guarantees, surety bonds and the use of guaranteed maximum price contracts for important construction contracts among others. The tenant may also want to use a project manager or tenant representative to monitor the course of construction and review construction bid documents and draw requests.

Tax-Exempt Financing by Nonprofit Corporations Alternative Financing Methods

Design, Construction, and Completion of the Project

Unlike many projects in which the owner of the real property will retain architects, surveyors, engineers and contractors and execute architectural and construction contracts, an issuer may not have the development expertise, personnel or financial resources necessary to purchase property, obtain permits and otherwise oversee the design, development and construction of a complicated development project until a bond financing can be completed. On the other hand, there may be significant time and cost savings to the tenant if a private party undertakes the design, development, bidding and contracting of a commercial building designed in accordance with design specifications developed by the nonprofit landlord in close cooperation and consultation with the tenant. In either case one or the other of the parties to the lease will either undertake all pre-development design and development risks and expenses and contract with the necessary architects, engineers and other consultants directly or hire a construction manager to oversee (and perhaps fund) land acquisition, due diligence, permitting and project design, development and construction.

Credit Enhancement Options

Depending on the complexity of the construction project, the lease structure, revenue sources or financial strength of the parties to a particular transaction, the creditworthiness of a transaction can be increased through the use of stand-by or direct pay letters of credit, bond insurance, or payment and performance guarantees or different bond structures to increase investor confidence in the bond issue. While these forms of credit enhancement may increase the rating assigned to a bond issue by the rating agencies or reduce the interest rates, they will increase the cost and complexity of the transaction because of the addition of new parties and documentation which must be successfully negotiated to the satisfaction of a larger financing team.

IX. Conclusion

At a time when there are declining resources available to meet expanding infrastructure requirements, a 63-20 financing may enable governmental agencies, such as port districts, cities or counties, working in partnership with the private sector to satisfy demands for additional capital facilities in a very cost effective manner. A governmental entity may utilize 63-20 financing, thus avoiding the practical, legal and political problems associated with the construction of its own facilities or the issuance of its own debt and with the added benefit of receiving unencumbered fee title to the facilities once the bonds are retired.

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