

# An Overlooked Financing Tool: How Nonprofits Can Issue Tax-Exempt Bonds

By Paul Rosenstiel  
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This guide is published by the California Association of Nonprofits (CalNonprofits) and was written by Paul Rosenstiel. Paul worked as a municipal bond investment banker in California for nearly 30 years and completed many transactions for nonprofits as well as for government agencies. From 2007-09, he served as Deputy Treasurer of the State of California where one of his primary responsibilities was overseeing the issuance of the State's bonds.

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The California Association of Nonprofits (CalNonprofits) is a statewide alliance of more than 10,000 nonprofits serving as a “chamber of commerce” for California’s nonprofit community. This booklet is part of our work in the interspace between government and nonprofits to encourage partnerships that strengthen California’s communities.

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**JOHN CHIANG**  
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Every day in California, we rely on nonprofits to help meet our healthcare needs, educate our children, provide services to struggling families and communities, add to our cultural enrichment and much more.

To carry out these services, nonprofits need a place to operate – be it a clinic building, a school facility, a theatre or a service center. Many nonprofits lease their facilities because they think purchasing them would be too expensive or too difficult. There is a way, however, that nonprofits can purchase a facility, and that is borrowing through the issuance of tax exempt bonds. Such bonds are a low-cost technique that many nonprofits utilize.

As State Treasurer, I know how useful tax-exempt bonds can be. In addition to issuing bonds on the State's behalf, I chair several state bodies that assist nonprofits in issuing tax-exempt bonds, including the California Health Facilities Financing Authority and the California School Facilities Authority.

But for nonprofits that haven't yet considered tax-exempt bonds, it can be difficult to know where to start.

*An Overlooked Financing Tool: How Nonprofits Can Issue Tax-Exempt Bonds* is an easy-to-understand guide to help nonprofits take that first step. It equips nonprofits with a basic understanding of bonds, the process for issuing them and questions they need to address before pursuing bonds.

Bonds are not for everyone and nonprofits need to understand the pros and cons. This booklet provides nonprofits with an excellent start. Thank you, CalNonprofits, for bringing this important publication to the nonprofit community.

A handwritten signature in blue ink, reading "John Chiang", is written over a large, light blue, stylized graphic element that resembles a large, open letter 'C' or a similar shape.

## IMAGINE YOU'RE ON THE BOARD OF A NONPROFIT

historical museum, women's clinic, hospice, food bank, orchestra, or affordable housing organization. You and the CEO are looking at a much-needed \$20 million expansion, purchase, or renovation. The prospect of a \$20 million capital campaign is pretty daunting.

But there is a financing tool you may have overlooked. If you issue a \$10 million tax-exempt bond, your capital campaign need only raise \$10 million. While still a challenge, a \$10 million capital campaign looks a lot more do-able than \$20 million.

This booklet is a short introduction to the ideas and processes of tax-exempt bonds for you and your nonprofit. A 20-page guide to Italy can help you decide whether you want to explore a trip there, but you'd want to read more and talk to others before getting on a plane. Similarly, this booklet can help you decide whether tax-exempt bonds are not after all right for you, or whether the idea is worth exploring further.

Our thanks to Paul Rosenstiel, to Stifel, and to State Treasurer John Chiang for their encouragement and assistance with this resource.



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# Bonds for Nonprofits

Nonprofits can issue bonds? I didn't know that . . .

**NOTE:**  
Six case studies  
appear at the end  
of this text.

## What is a bond?

A bond is a type of loan. But instead of borrowing all the money from one lender as you would if you borrowed from a bank, there are usually numerous lenders when borrowing with bonds. Each lender (usually called the “bondholder” or the “investor”) owns bonds representing a portion of the total money lent. As a simple example, if you were to borrow \$1 million, there might be three bondholders – one of whom puts up \$500,000, another \$300,000 and another \$200,000.

The language can be a little confusing: when a person “buys a bond,” that person is lending money. If a person buys \$10,000 worth of bonds, that person has lent \$10,000 to the borrower – perhaps a corporation, perhaps a government, perhaps a nonprofit.

## Are bonds issued on an exchange like the New York Stock Exchange?

Tax-exempt bonds are bought and sold in an informal market known as the municipal bond market or the tax-exempt bond market. The market is informal in that there is no formal exchange – such as the New York Stock Exchange – on which prices are listed. Buyers and sellers simply negotiate directly with each other, or through a broker-dealer (a securities firm), when buying and selling bonds. That said, it is a highly regulated market in which participants must comply with a complex set of securities laws and regulations.

To say that a nonprofit sells bonds in the municipal bond market is to say that, with the help of professionals such as attorneys and securities firms and in compliance with securities laws and regulations, it borrows money from investors and promises to pay the money back with interest.

## What are tax-exempt bonds and why do I care?

As with any type of loan, you the borrower must pay interest to the bondholders. If certain conditions are met, the interest income that a bondholder receives does not count as income when calculating that person's income tax. Therefore, that bondholder will accept a lower interest rate on their bonds than if they had to pay taxes on the interest. For example, taxpayers who are in a 20% tax bracket would be equally happy to receive a 4% interest rate that isn't taxed or a 5% interest rate taxed at 20%. The possibility that a nonprofit could issue tax-exempt bonds and benefit from those savings is the primary reason that borrowing with bonds is attractive.

## What are some examples of purposes for which nonprofits might issue bonds?

Bonds are usually issued to finance the construction or acquisition of a building or other long-term asset. So, some of the many purposes for which nonprofits have issued bonds are to build schools, acquire office buildings, construct hospitals and health clinics, build museum wings, renovate warehouses, and provide low-income



housing. Pretty much any long-term asset a nonprofit needs to carry out its mission is a potential reason to issue bonds. Tax-exempt bonds cannot be issued for operating expenses.

## **Are all nonprofits allowed to issue tax-exempt bonds?**

The short answer is that pretty much any nonprofit has the legal authority to borrow in the tax-exempt bond market. The long answer, however, comes with three caveats.

First, under federal tax law, only governments can issue tax-exempt bonds. So, nonprofits borrow in the tax-exempt bond market in a roundabout way. A government agency must issue the bonds and then lend the money to the nonprofit. The government promises to pay back the bonds — but only from what it receives in loan repayments from the nonprofit. A government performing this function is known as a “conduit issuer.” There are many such issuers, and we describe them further on.

Second, federal tax laws generally limit tax-exempt borrowings to nonprofit corporations that have a 501(c)(3) determination letter from the IRS.

Third, federal tax laws limit the purposes for which bonds can qualify as tax-exempt. In particular, tax-exempt bonds generally must not provide an impermissible level of benefits to private parties (the tax code defines what is impermissible) and they must primarily be for capital projects. For example, a community health organization could issue bonds to build a clinic (a capital project of public use) but couldn't pay the doctors staffing the clinic a percentage share of the net revenues from the clinic's operation since that would be considered providing the doctors with an opportunity to earn private profits from a facility financed with tax-exempt bonds. If the doctors provided services on a fixed fee basis, however, that might not prevent the bonds from being tax-exempt.

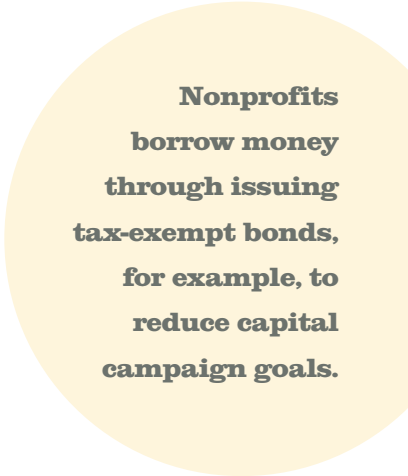
Finally, just because you want to borrow money doesn't mean anyone wants to lend it to you. You must demonstrate that you will be able to pay it back.

## **But I thought bonds have to be voted on?**

Some kinds of bonds require voter approval. These are generally bonds that the public must pay back through some kind of tax or fee. In California, bonds issued to build new school buildings that are repaid through an increase in property taxes must go to the voters. But bonds issued by a nonprofit that the nonprofit pays back don't have to go to the voters.

## **Do we need to do something special for our bonds to be tax-exempt?**

Yes and no. The tax code only allows nonprofits to issue tax-exempt bonds for certain purposes. Usually, this is to further their charitable purpose, but not for the nonprofit or anyone else to make money on unrelated businesses. As another example beyond the health clinic example above, a nonprofit hospital can finance most of its facilities tax-exempt, but wouldn't be able to issue tax-exempt bonds to build restaurant space for a Starbucks on its site. The good news is that there is no requirement that the federal government pre-approve the tax-exemption of your bonds. If your project meets the requirements, a law firm (called bond counsel) will deliver an opinion that investors will trust to conclude that the bonds are exempt from income taxation.



**Nonprofits  
borrow money  
through issuing  
tax-exempt bonds,  
for example, to  
reduce capital  
campaign goals.**

## What government entities will serve as a conduit issuer and do they charge a fee?

Many types of government entities can do this and are happy to do so. But, yes, most do charge a fee. Cities, counties, joint powers authorities and state agencies are among them. Some are specialized, such as the California Health Facilities Financing Authority, which issues bonds for hospitals, community clinics and other nonprofits involved in healthcare. Others are general and will do any transactions that meet their criteria. Because such conduit issuers often have different standards and charge different fees, it's often advisable to shop around for the one that best meets your purposes.

## How do you go about finding a conduit issuer and what steps will they need to take?

The State of California has a number of bond issuance authorities housed within the State Treasurer's Office that are specific to the type of nonprofit that wants to issue the bonds (e.g., health facilities or private schools).

See <http://treasurer.ca.gov/otherboards.asp#finance>

Another state agency, the California Infrastructure and Economic Development Bank (often referred to as the Infrastructure Bank), issues bonds for cultural organizations and other nonprofits.

Many cities or counties issue such bonds. Many other cities and counties, however, defer the issuance to joint powers authorities made up of cities and counties and that specialize in the issuance of bonds. These include the California Statewide Communities Development Authority, the California Municipal Finance Authority and the Association of Bay Area Governments.

Each conduit issuer has its own set of requirements. The issuance of municipal bonds requires adherence to state laws, federal tax laws and regulatory requirements ensuring that the buyers of those bonds are fully informed of the risks of repayment. Some of an issuer's requirements will relate to adherence to these laws and regulations. Further, they usually have requirements to minimize the possibility that investors are not paid or have not been made aware of the risks that could occur. These requirements might include minimum credit ratings on the bonds or limiting the sale of the bonds to sophisticated investors.

Most of the time, a member of your financial team such as a financial advisor or underwriter will do this research for you (more on the team later).

## How can I know if someone will buy my bonds?

Remember, bonds are a loan. The bondholders expect to be repaid and will want to get comfort that they will be. So, a big part of getting a loan – either from a bank or through the issuance of bonds – is to demonstrate your creditworthiness.

For example, if you are issuing bonds to renovate a museum, you'll need to be able to show that admission fees, donations and grants provide strong enough revenue for you to be able to pay back the bonds. A nonprofit preschool will need to demonstrate that its tuitions, fees and donations make them creditworthy.

In the municipal bond market, the principal standard for evaluating creditworthiness is a credit rating. Three agencies – Moody's, Standard & Poor's and Fitch – assign the vast majority of ratings in the municipal bond market. Ratings of a certain strength (Baa3 or higher from Moody's and BBB- from the others) are categorized as "investment grade," meaning there is a strong expectation they will be repaid.

**The principal standard for evaluating creditworthiness is a rating. A higher rating suggests a lower risk of nonpayment, meaning a lower interest rate on the bonds.**

While a credit rating can help lower the cost of borrowing (by demonstrating a borrower is less risky), it is not a requirement to issue bonds. Many nonprofit bonds are issued without a credit rating. However, some conduit issuers will only issue bonds with a minimum of investment grade ratings, or maybe even higher, or will impose requirements on who can buy the bonds if the rating is lower or if there is no rating. This is to avoid getting involved with the issuance of bonds that might get into trouble in the future.

## **How do I know if my bonds will be investment grade?**

A lot of factors determine credit quality. Generally, however, large and well-established nonprofits have the best chance to achieve that status on their own – e.g., universities, hospitals or foundations. Factors such as consistent revenue history from strong market share, and well-managed finances including substantial reserves or endowments, are factors that contribute to investment grade ratings. Other nonprofits often need a third party to back their loan (essentially a co-signer). In the municipal bond market, this is known as credit enhancement. The most common form of credit enhancement is a letter of credit from a bank or insurance from a bond insurance company. There are also specialized providers of credit enhancement (for example, in California, the Cal-Mortgage program is a State-run guarantor of healthcare bonds). In certain cases, foundations have provided credit enhancement for nonprofit bond issues.

## **This all sounds like a lot of trouble! Wouldn't it be simpler to just borrow from a bank?**

Maybe, but there are some key advantages to bonds. Sometimes there aren't banks wanting to make a loan to you or for the purposes you need the money, but there are investors who buy bonds who are happy to do so. Or, banks may not be willing to lend on terms you find attractive.

For example, most banks prefer to make floating rate loans and limit the term of the loan to five to ten years. In contrast, the municipal bond market usually accommodates 25 to 35 year fixed rate debt, which may include construction as well as permanent financing, may allow you to borrow more of your project costs and impose fewer covenants and financial constraints than bank loans. But, most importantly, banks may not be willing to make loans at the lower interest rates reflecting tax-exemption.

And, whether you borrow from a bank or in the bond market, you'll have to build a convincing case that you'll pay the loan back. That said, banks are an option that can be considered, especially those looking to make tax-exempt loans. Often the complexity and the transaction costs can be less with a direct bank loan.

## **Why shouldn't we just save up the money and pay cash for our project rather than incur the effort and expense of issuing bonds?**

Like buying a house, some people might be able to save enough to buy the house with cash, but others will find it more feasible – but still financially sound – to obtain a mortgage. The advantage of borrowing for a long-term project is the ability to spread the costs over the time the project will be in use. Nonprofits often acquire long-term assets through capital campaigns. The capital campaign can be an effective way to reduce the amount of bonds you issue or to pay off the bonds as contributions are received.

**A bank loan is an alternative to bonds, but may offer less flexibility. And banks may not be willing to lend at the low interest rates reflecting tax-exemption.**



Be aware that there are sometimes complicated tax implications if you have the cash to purchase an asset but choose instead to issue bonds. The IRS may conclude you didn't need to issue bonds and determine the bonds are taxable (meaning the investors who bought them have to pay taxes on the interest). On the other hand, investors want to see that you have financial strength to repay the bonds. One important way to do that is to have a lot of cash on your balance sheet. Generally, accumulating operating reserves does not preclude the issuance of bonds, but raising money in a capital campaign for a project and then choosing instead to issue bonds for that project would not be permitted. Bond counsel will be sure to review the circumstances and uses of any cash in doing their legal due diligence on the bond issue.

## **This sounds too complicated for my nonprofit to do by ourselves. How would we go about issuing bonds?**

Yes, there are a lot of moving parts and a lot of parties to a bond transaction! The best way to get started is to identify one or more key members of the financing team you'll need to rely on and they can help you assemble the rest of the team. Your team should include:

- **Bond counsel** – Bond counsel (legal counsel) must opine as to the legality and tax-exemption of your bonds. A bond counsel firm can help you get started by describing the issuance process and whether you have the legal authority to issue the bonds for the purposes you desire and what conditions you may need to satisfy in order for the bonds to be tax-exempt. However, bond attorneys are not expert in determining your creditworthiness, whether investors will be interested in buying your bonds or the interest rate you'd have to pay.
- **Borrower's counsel** – Borrower's counsel represents the borrower's interests in the bond transaction. Their primary responsibility is to review the documents and transaction to ensure you are in compliance with policies of the nonprofit's board, local laws, securities and disclosure regulations. Borrower's counsel also assists you in ensuring that you are providing adequate disclosure to potential investors.
- **Underwriter** – An underwriting firm is a securities firm (such as investment bank) that interfaces between those issuing the bonds and those who buy the bonds. When the actual issuance of the bonds occurs, the underwriter will identify buyers for the bonds and propose interest rates for the bonds. Both buyers (investors) and sellers (the nonprofit borrower) must agree to the interest rates. To the extent that not all the bonds are sold at the agreed-upon interest rates, the securities firm will usually "underwrite" the bonds, meaning it will purchase the bonds itself at those interest rates and hope to sell them later. Underwriters generally have the most knowledge about how a borrower's credit quality can be offered to the market at the lowest interest rate because they know both sides of the market.
- **Financial advisor** – Often a borrower will employ a financial advisor, in addition to an underwriter. The financial advisor has much the same expertise as the underwriter, but it does not buy and sell securities. Therefore, it may not be

**The best way to get started is to identify one or more of the key financing team members you'll need to rely on.**

as knowledgeable as an underwriter about how to identify investors for the bonds on the best terms. On the other hand, the financial advisor works only for the borrower while the underwriter has a responsibility both to the borrower and the investor. Therefore, there are fewer potential sources of a conflict of interest between you and the financial advisor than there could be with an underwriter.

- **Conduit issuer** – Starting with a conduit issuer can be a way to get started, but often a borrower will need advice about which issuer to utilize. A conduit issuer can provide an initial assessment of whether they would issue bonds on your behalf, but you may need to assemble other members of your financing team before you can make an informed choice of issuer.

Be aware that not all team members are working solely in your interest. Depending on their role, they may have obligations to other parties, such as investors or the conduit issuer. And, of course, they also have their own self-interest. Be sure you consult your attorney or ask any team member you bring into the transaction what their responsibility is to you and what potential conflicts of interest exist between them and you.

### **Wow! Sounds expensive!**

Yes, it can be. That's why bonds don't make sense for borrowings of a few million dollars or less. Some conduit issuers have programs for certain types of projects or borrowers that attempt to streamline the process and minimize fees. A direct loan from a bank may also reduce costs.

### **I've heard that a simpler and cheaper way to issue bonds is through a "private placement." What is that? Is that true?**

A private placement is an arrangement with one investor, or a small number of investors, to buy all the bonds in a simplified process. The advantage is that the terms of the bonds can be negotiated directly with the investor or investors. This can simplify the issuance process and reduce issuance costs. For example, it can eliminate the need to draft a disclosure document (known as the Official Statement). It also eliminates the need for an underwriter who must find investors (though often an underwriting firm plays the role of "placement agent" and identifies the private placement buyer).

Offsetting potential savings on issuance costs is the possibility that the interest rates on the private placement bonds would be higher than on publicly offered bonds. The primary reason is that bonds sold through a private placement usually cannot be sold by the original investor to another investor sometime in the future, or if such a sale is permitted, it may be restricted to a small class of investors and, for that and other reasons, may be difficult to sell. This lack of "liquidity" is a disadvantage to the investor for which it would expect a higher interest rate.

A special type of private placement is one where a commercial bank simply buys the bonds to hold them. It's like a bank loan but the interest income is tax-exempt and therefore the interest rate is lower than on a typical bank loan. Banks usually make such loans on a floating rate basis (like an adjustable rate mortgage) and restrict the term of the loan to ten years or shorter. In contrast, bonds sold in the municipal bond market can be issued for as long as 35 years (assuming the asset being financed has a long life and the borrower can be expected to be in operation 35 years in the future).

**A private placement can simplify the issuance process and reduce issuance costs but often carries a higher interest rate.**

## **Besides repaying the bonds, is there anything we need to do after the bonds are issued?**

The borrower will promise, in the bond documents, to do various things that help ensure that the bonds will be repaid. For example, the borrower will promise to maintain in good condition any asset that was financed with bonds and that is security for the bonds. The borrower will also promise not to do anything that would imperil the tax-exemption of the bonds and may promise to maintain financial standards such as financial reserves, cash on hand or other requirements.

In addition, federal regulatory requirements obligate borrowers (such as nonprofits) who are the source of repayment of municipal bonds to provide “continuing disclosure” to the market. This is up-to-date information providing insight into the credit quality behind the bonds, including financial and operating statistics of the borrower. A borrower promises at the time the bonds are issued what information it will provide annually or on the occurrence of significant events. A nonprofit that issues bonds must be aware that this responsibility to investors remains in place for the life of the bonds. Further, failure to provide accurate continuing disclosure in a timely manner could be a violation of federal securities laws.

**Beyond paying back the bonds, a borrower makes certain promises for the life of bonds, including providing ongoing disclosure of its finances and operations.**

## **How do we find buyers to buy the bonds?**

The nonprofit borrower doesn't have to find the buyers. That's the job of the investment banking firm serving as underwriter. The underwriter has relationships with a wide variety of bond investors, including mutual fund companies, insurance companies, banks and individuals. Their responsibility is to find the investors who will buy your bonds at the lowest interest rate and with the fewest covenants.

## **If we issue bonds, how long do we have to repay them and how much will we owe to pay them back?**

A bond functions much like a home mortgage. You have a period of time during which you must repay the loan. The interest rate is either fixed for the life of the bonds or adjusts periodically. You make periodic payments (usually every six months with municipal bonds, which include interest and a portion of principal). The payment is usually the same from one year to the next and is equal to what is needed so that you fully pay off the bonds at maturity. The final maturity is similar to, or shorter than, the useful life of the asset being financed, twing history or a business that might undergo significant changes over a period of decades.

## **What happens if we can't repay the bonds?**

That depends on how the legal documents were drafted. If the bonds were issued to finance the acquisition or construction of a building, the bondholders often have a mortgage on the building and can sell it to be repaid. Of course, they may not want the building or it may have limited value in a sale. A special purpose facility, such as a theatre, may not be very marketable and zoning laws may preclude a new owner from converting the property to a different use. Bondholders would usually like to avoid foreclosure and will often work with the borrower – under the threat of a possible foreclosure – to restructure both the business and the debt. The borrower may get some debt service relief but, in return, usually must adhere to additional restrictions about how it operates its business and spends its money to give the bondholders greater confidence the restructured debt will be repaid.

## What are the simplified steps to issue bonds?

There are a number of key steps any nonprofit that issues bonds must take. Below is a very simplified list assuming the bonds are not being sold as a private placement. It also assumes you've identified your project, determined you can afford it and concluded (or are pretty sure) you want to pursue the issuance of bonds to finance it.

- **Choose your financing team** – This includes a conduit issuer, borrower's counsel, bond counsel, an underwriting firm and maybe a separate financial advisor. These parties may bring others to the table, too, including issuer's counsel, issuer's financial advisor, underwriter's counsel and trustee.
- **Determine the marketability of your credit** – Before going too far down the road, you should determine that your promise to repay the bonds will be considered strong enough to attract investors. As discussed above, this is based either on your own credit strength or your ability to secure a letter of credit or some other kind of credit enhancement. Your underwriter or financial advisor can assist in this.
- **Draft the legal documents** – Bond counsel and other attorneys will draft the various legal documents that memorialize the terms of the borrowing, demonstrate that it qualifies to be tax-exempt and disclose to investors the information they should consider in deciding whether to buy the bonds ("material information"). This disclosure is made in an Official Statement (OS) that will fully describe your organization and finances as well as the details of the bond issue itself. Preparing the OS could require substantial effort on the part of the nonprofit borrower and may require the nonprofit to disclose to the public a substantial amount of information about its finances and operations.
- **Secure a rating** – With the assistance of your underwriter and/or financial advisor, you will request that one or more of the rating agencies will assign a rating to the bonds (if they are strong enough to qualify for a rating). If a rating is not advisable, then the bonds may be marketed without a rating if investors have confidence they will be repaid.
- **Approve the financing** – Both the board of the nonprofit borrower and the board of the conduit issuer must approve the issuance of the bonds and the execution of the associated legal documents.
- **Pre-market the bonds** – The underwriter will pre-market the bonds to investors in advance of the sale date by distributing the OS (actually, at that point the POS, or preliminary OS, since the interest rates the bonds will carry are not yet known) and talking to investors to see if they have interest. Sometimes the nonprofit borrower will be asked to answer questions from investors.
- **Price and sell the bonds** – On the day of sale, the underwriter takes orders for the bonds and, on the basis of those orders, offers interest rates to the borrower at which it is willing to buy the bonds. If the underwriter isn't able to sell all the bonds to investors, it may "underwrite" the bonds at

those interest rates. This means it will buy all the bonds at the agreed-upon interest rates so the borrower has certainty about the interest rates on its bonds.

- **Finalize bond documents** - With the interest rates set, all the documents are updated with the sale information, including updating the POS into the final OS.
- **Close** – About two weeks after the sale, the buyers of the bonds pay their purchase price to the conduit issuer and receive their bonds. The conduit issuer, in turn, lends the funds to the nonprofit which can then use the proceeds for its project. This is known as the closing of the bond issue.

## **I've heard about nonprofit private schools issuing bonds. What's different about a school?**

Private nonprofit schools must meet the same requirements as other nonprofit issuers in terms of compliance with state law, federal tax law and securities regulations. Of course, the application of these requirements will be specific to a business that operates as a school as opposed to a hospital, a museum, a symphony or a senior living facility.

Any nonprofit that expects to borrow must have a convincing business plan for how it will continue to operate in such a way that it covers its operating expenses and has sufficient additional cash flow to repay the bonds. For a private nonprofit school, for example, important considerations include its financial condition, its history and reputation, the quality of its management and teaching staff, its applications and enrollment history, competition from other public and private schools, its tuition, its fundraising and endowment (if any) and the demographics of its service area.

## **What are the biggest mistakes nonprofits make when they think about issuing bonds?**

Any borrower – whether an individual, a business, a government or a nonprofit – must be confident it can pay back its loan. The allure of borrowing to build the best possible building, rather than what is necessary and affordable, may be hard to resist. You get the money today but don't have to pay it back until later.

Borrowers often make rosy predictions about the future to justify borrowing – and sometimes borrow too much. Be realistic – even skeptical – about your assumptions. Maybe you shouldn't borrow to buy a building or other asset, but should lease. Or maybe you should fundraise to cover part of the cost of the project so you need to borrow less. Of course, the people who buy your bonds will perform their own review of your ability to pay back the bonds, so that will be a reality check.

A related mistake nonprofits sometimes make is overestimating the amount they will be able to raise from fundraising efforts. A more prudent approach may be to raise money in a capital campaign at the outset and use the funds raised to reduce the size of the bond issue.

**To avoid borrowing more than you can afford, be realistic – even skeptical – about your ability to repay the bonds from fundraising or operations.**



## **I've heard a number of terms bandied about: coupons, yields, prices, maturities, call provisions. What are these? Do I need to know about them?**

Generally, you don't need to know a lot about these terms as you begin thinking about issuing bonds, but you'll probably eventually become something of an expert! Most important for this discussion and as you look at the bond issues of other nonprofits (e.g., if you check out their Official Statements) is to understand the components of a bond issue.

Bonds are different from a home mortgage. With a 30 year fixed rate mortgage, the entire loan carries the same interest rate, even though some of the principal is repaid earlier and some later. In a municipal bond offering, however, the principal paid back earlier (the earlier maturities) usually carries a lower interest rate than the principal repaid toward the end (the later maturities). The bonds are structured this way because some investors want to buy bonds with a shorter maturity (and are willing to accept a lower interest rate) while others want a longer maturity and a higher interest rate.

The Official Statement will show all the maturities and associated interest rates of a bond issue. Municipal bonds generally give the borrower the right to buy back the bonds prior to maturity, a right usually utilized to refinance the bonds if interest rates drop in the future. Such "call provisions" typically provide that right after ten years.

## **There's a lawyer on our board who says he can do all the paperwork for free. Is this a good idea?**

Your board member can assist and review documents, but generally should not draft the documents unless municipal bonds are his or her area of expertise. Doing things wrong can invite lawsuits from investors, investigations by the SEC, tax bills from the IRS and all sorts of other nasty consequences. Furthermore, every bond issue is "blessed" with opinions from the law firm that serves as bond counsel. Bond counsel says that the bonds have been issued in compliance with state law and federal tax law (assuming they're tax-exempt). Investors rely on the correctness of those opinions because, if they're wrong, the investors could lose their investment or owe income taxes on the interest they receive. Accordingly, most investors will only buy bonds with opinions provided by nationally recognized bond counsel firms.

## **Do we sell our bonds to our donors?**

There are two circumstances in which that might happen. First, if you're raising only a small amount of money, you might choose to borrow directly from donors without going through the significant effort of a public offering of bonds. For the interest to be tax-exempt, you would still need to work through a conduit issuer, but could do it as a private placement. This could reduce issuance costs and enable you to tailor the bonds more to your needs and your donors'. However, any time you reduce the number of potential buyers of your bonds you risk having to pay a higher interest rate, so this might not be an advisable approach. Second, you could also give your donors first crack at buying bonds that are issued through a traditional public offering. The terms would be the same as other investors would get, so it might not save you money, unless it's difficult to find investors to buy the bonds and orders from your donors become important. That is not likely given the size of most bond issues. But it could be an attractive way for your donors to support you in a different way.

**Any time you reduce the number of potential buyers of your bonds, you risk having to pay a higher interest rate.**

## Where can I read more about this?

The California Debt and Investment Advisory Commission, an agency within the State Treasurer's Office, publishes many guides to the issuance of bonds. These can provide more detail on many of the topics covered here. See <http://www.treasurer.ca.gov/cdiac/>.

Conduit issuers, underwriters, financial advisors and bond attorneys that do nonprofit bonds often have primers or other material on their websites. As one example, the law firm of Orrick Herrington & Sutcliffe has published a booklet on nonprofit borrowing with bonds (<https://www.orrick.com/Events-and-Publications/Documents/172.pdf>).

The Municipal Securities Rulemaking Board has information about bonds on its website, though primarily aimed at investors. It maintains a free online database (<http://emma.msrb.org>) of Official Statements and continuing disclosure filings of all municipal bonds. This is a good place to see what goes into an OS and how the bonds and their associated legal documents are described and summarized. If you know of a nonprofit that issued bonds you can find its OS. The search function on EMMA can sometimes be challenging. Be sure to try both the name of the nonprofit as well as the conduit (if known), and try using quotation marks to narrow the search. For the case studies below that were sold with an OS (private placements are not), a link to the OS is provided.

**Despite the lack of a credit rating, Rocketship Education borrowed \$28.6 million to build three schools.**

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## Case Studies

Below are six case studies that provide some indication of the range of approaches that nonprofits can take to issuing bonds. The range includes:

- **The credit rating on the bonds** - rated on the credit strength of the nonprofit, rated on the credit strength of a guarantor, or unrated;
- **The conduit issuer** – an agency of the State of California, a joint powers authority or a local government
- **Type of sale** – a bond issue sold to the public (a public offering) or sold directly to one investor, such as a bank (a private placement)
- **Purpose** – some bonds are sold to provide funds to build or acquire new facilities (new money), while others are used to refinance at a lower interest rate some debt that is already outstanding (refunding). Some are a combination of the two.
- **Type of interest** – Some bonds carry a fixed interest rate throughout the life while others, known as variable rate bonds, involve a periodic resetting of interest rates similar to an adjustable rate mortgage.

### **Case study A – Rocketship Education: a charter school network without a credit rating must limit its offering to sophisticated investors**

Rocketship Education is a nonprofit charter school operator founded in 2007 that operates 13 elementary schools throughout the country. In 2016, it borrowed \$28.6

million by issuing bonds through the California School Finance Authority (CSFA). CSFA is a state agency headquartered in the State Treasurer's Office. The purpose of the bonds was to finance the acquisition and construction of three elementary schools. Rocketship must repay the bonds out of the revenues it earns from the operation of the three financed schools. As is typical in most nonprofit bond issues to acquire property, Rocketship has also given the bondholders a deed of trust in the school buildings and land so that the bondholders can take title to the property if the bonds aren't repaid. No other income or assets of Rocketship are pledged to this transaction.

Due to a variety of factors, including some of the risks inherent in charter schools, the bonds did not qualify for an investment grade credit rating. When that occurs, conduit issuers may worry that the bonds may be sold to investors who don't appreciate the risks and can claim they were misled if the bonds are not repaid. To mitigate that, the bonds were sold only to "Qualified Institutional Buyers" (as defined in the rules of the Securities and Exchange Commission) and the minimum investment was \$100,000.

The bonds provided Rocketship with a 30 year loan carrying an average interest rate of 5.00%.

See the final Offering Memorandum at <http://emma.msrb.org/ES759623-ES596085-ES991773.pdf>.

**Variable rate bonds can save money but also entail risks not present with fixed rate bonds.**

## **Case study B – Harbor Regional Center: over time a nonprofit is able to refinance its bonds to lower interest rates**

The Harbor Regional Center (HRC) is a nonprofit corporation that has contracted with the State of California since 1977 to coordinate services to people with developmental disabilities in part of Los Angeles County. In 2009, HRC borrowed \$25 million through the issuance of bonds by the California Municipal Finance Authority (CMFA). The bond proceeds were used to purchase and improve buildings in Torrance for HRC's use. The borrowing cost to HRC was up to 8.50%. But by 2015, interest rates had dropped and Moody's – one of the three primary rating agencies – had substantially upgraded its evaluation of HRC from a rating of Ba1 to A3. As a result, HRC was able to refinance the 2009 bonds by issuing new bonds that carried a borrowing cost for bonds maturity in 2039 of only 4.12%. Again, CMFA was the issuer.

CMFA is a joint powers authority (JPA) created by a number of cities, counties and special districts. Under California law, such a JPA is a governmental entity with the power to issue bonds. Several, including CMFA, have been created specifically for that purpose.

The bondholders are to be repaid from the revenues that HRC receives from operating the center. Further, bondholders have a deed of trust in the land and property in the event the HRC fails to make debt service payments.

See the Official Statements at <http://emma.msrb.org/EP359732-EP283546-EP678700.pdf> and <http://emma.msrb.org/ER906433-ER708151-ER1109677.pdf>.

## **Case study C – Catalina Island Museum: a bank guarantees variable rate bonds to finance the construction of a museum**

The Catalina Island Museum, in operation since 1953, borrowed \$3.9 million in 2014 to build an 11,000 square foot museum facility. The bonds mature in 2039, providing a 25 year loan to the Museum. The bonds are guaranteed by a letter of credit from the Bank of the West and carry the credit rating of the bank (A/F1 from

Fitch). These are variable rate bonds, meaning that the Museum will pay interest at a rate that will be reset every week and reflect the interest rate of a municipal bond with a one week maturity. The average interest rate on such bonds in 2015 was less than 1%. The Museum will also pay the Bank for its letter of credit (the guarantee) and a securities firm to reset the interest rate every week. These additional fees can make the all-in cost of a variable rate bond issue much higher than just the interest rate on the bonds. In addition, a borrower assumes risks in such a transaction not present with fixed rate bonds. Among these is that the interest rate could rise and that the bank providing the letter of credit could see its rating deteriorate. In that event, the borrower (through no fault of its own) would have to pay a higher interest rate because the rating on the bonds would deteriorate, too.

Because the Bank is guaranteeing the bonds, the details of the arrangement between the Bank and the Museum were not publicly disclosed to investors. Further, the Museum did not disclose any financial and operating data. Instead, investors relied on the credit quality of the Bank in deciding whether to buy the bonds.

The California Economic Development and Infrastructure Bank, more commonly referred to as the Infrastructure Bank, was the issuer of the bonds. The Infrastructure Bank is an agency of the State of California. One of its programs is to serve as a conduit issuer for tax-exempt borrowings by nonprofits. It is especially active in issuing bonds for cultural institutions and schools.

See the Official Statement at <http://emma.msrb.org/ER762594-ER591910-ER993930.pdf>.

## **Case study D – Solvang Lutheran Home: a State of California healthcare program guarantees bonds to expand a continuing care retirement community**

Solvang Lutheran Home operates a multi-level continuing care retirement community in Solvang. In 2014, it borrowed \$3.47 million through the issuance tax-exempt bonds to partially fund an \$11 million expansion of its facilities. The remainder of the funding will come from an equity contribution by Solvang Lutheran Home and a loan from the United States Department of Agriculture through its Rural Development Service.

The bonds are guaranteed by the Cal-Mortgage insurance program of the State of California. This bond insurance program is available for certain healthcare-related financings. The investors rely on the State of California to pay the bonds if the borrower does not. The State then seeks to collect from the borrower. Because the insurance provides the bonds with a rating from Standard & Poor's slightly below the State of California's own rating, the bonds carry a low interest rate reflecting that strong credit rating. The bond issue had a final maturity in 2040 with the highest interest rate being 4.19% for bonds repaid between 2035 and 2040. Solvang Lutheran Home pledged to repay the bonds out of the gross revenues it receives from its operations. Further, it granted a deed of trust in the property to secure its obligation.

The bonds were issued by the City of Solvang. Cities and counties have the power to serve as conduit issuers of tax-exempt securities on behalf of nonprofits.

See the Official Statement at <http://emma.msrb.org/EA621667-EA486597-EA883154.pdf>.

**Case studies  
show range  
of goals,  
vehicles and  
processes used.**

## **Case study E – Family Service Association: bonds are sold directly to a bank through a private placement to acquire and upgrade several service centers**

The Family Service Association has provided social services to residents of Riverside and San Bernardino Counties since 1956. It operates several facilities in the two counties. In 2014, it issued \$7.35 million of bonds for a variety of purposes, including acquiring a new building, improving several existing facilities (including improving the energy efficiency of the buildings) and refinancing some outstanding debt. Done as a private placement, all of the bonds were sold directly to Banc of California. They didn't carry a credit rating and weren't available for purchase by the public or other institutional investors. A small portion of the bonds are not tax-exempt because a portion of one of the buildings is utilized by an entity that is neither a nonprofit nor a government agency. To enhance the security for the bondholder, FSA gave a deed of trust on two buildings in the event it fails to repay the debt.

The issuer of the bonds was the California Infrastructure Bank. Even though the bonds were sold as a private placement to a bank, and therefore look much like a regular bank loan, the use of a governmental conduit issuer was still necessary for the interest to be tax-exempt and the borrower to enjoy the lower interest rates associated with a tax-exempt borrowing.

Because the bonds were sold as a private placement, there was no need for an Official Statement. The following link to the staff report prepared for approval by the California Infrastructure Bank provides some information: [http://ibank.ca.gov/res/docs/2014%20Meetings/Family%20Service%20Assn%20Staff%20Report\\_Final.pdf](http://ibank.ca.gov/res/docs/2014%20Meetings/Family%20Service%20Assn%20Staff%20Report_Final.pdf).

**Even though the bonds were sold as a private placement to a bank and therefore look much like a regular bank loan, the use of a government conduit issuer was still necessary for the interest to be tax-exempt.**

## **Case study F – Marshall B. Ketchum University: bonds are sold directly to a bank through a private placement with an interest rate re-set to potentially save money**

Marshall B. Ketchum University ("MBKU") is a nonprofit university that offers graduate degree programs in the healthcare sciences to about 440 full-time students in Orange County. In 2015, it issued \$36 million of tax-exempt bonds for a variety of purposes, including acquiring a new building to expand their campus, renovating existing buildings and refinancing about \$15.4 million of prior issued bonds. MBKU sold its bonds through a private placement to Torrey Pines Bank. The bonds didn't carry a credit rating and weren't available for purchase by the public or other institutional investors. The bonds are secured by a mortgage on campus property and the net income from MBKU.

The bonds have a 30 year maturity but the interest rate must be reset in 10 years. This gives MBKU a lower-cost interest rate for the first ten years (effectively a 10 year interest rate rather than a 30 year interest rate), but the new interest rate in ten years could be higher or lower.

Even though all the bonds were sold to a bank, a governmental conduit issuer (in this case the City of Fullerton) was still necessary for the borrowing to be tax-exempt. The rate the bank charged MBKU was lower because of the tax-exemption.

There was no need for an Official Statement because the bonds were privately placed. The following link to the staff report prepared for approval by the City of Fullerton provides some information: [www.ci.fullerton.ca.us](http://www.ci.fullerton.ca.us) (Under City Council Agendas for the December 16, 2014 meeting).

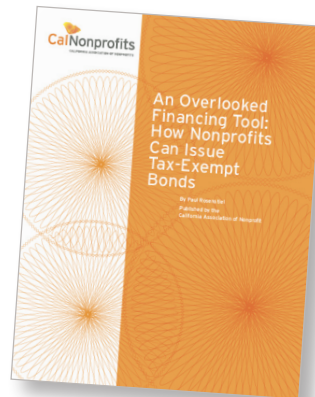


# Closing Comments

As you've seen throughout this booklet, although tax-exempt bonds aren't right for every nonprofit, they can be a very valuable tool for many nonprofit projects. We hope this booklet has been helpful to you.

We encourage your feedback and comments. You can reach CalNonprofits at [info@calnonprofits.org](mailto:info@calnonprofits.org) or (800) 776-4226. We can also relay any comments or questions you have to author Paul Rosenstiel.

For more copies of this booklet or to learn more about CalNonprofits:

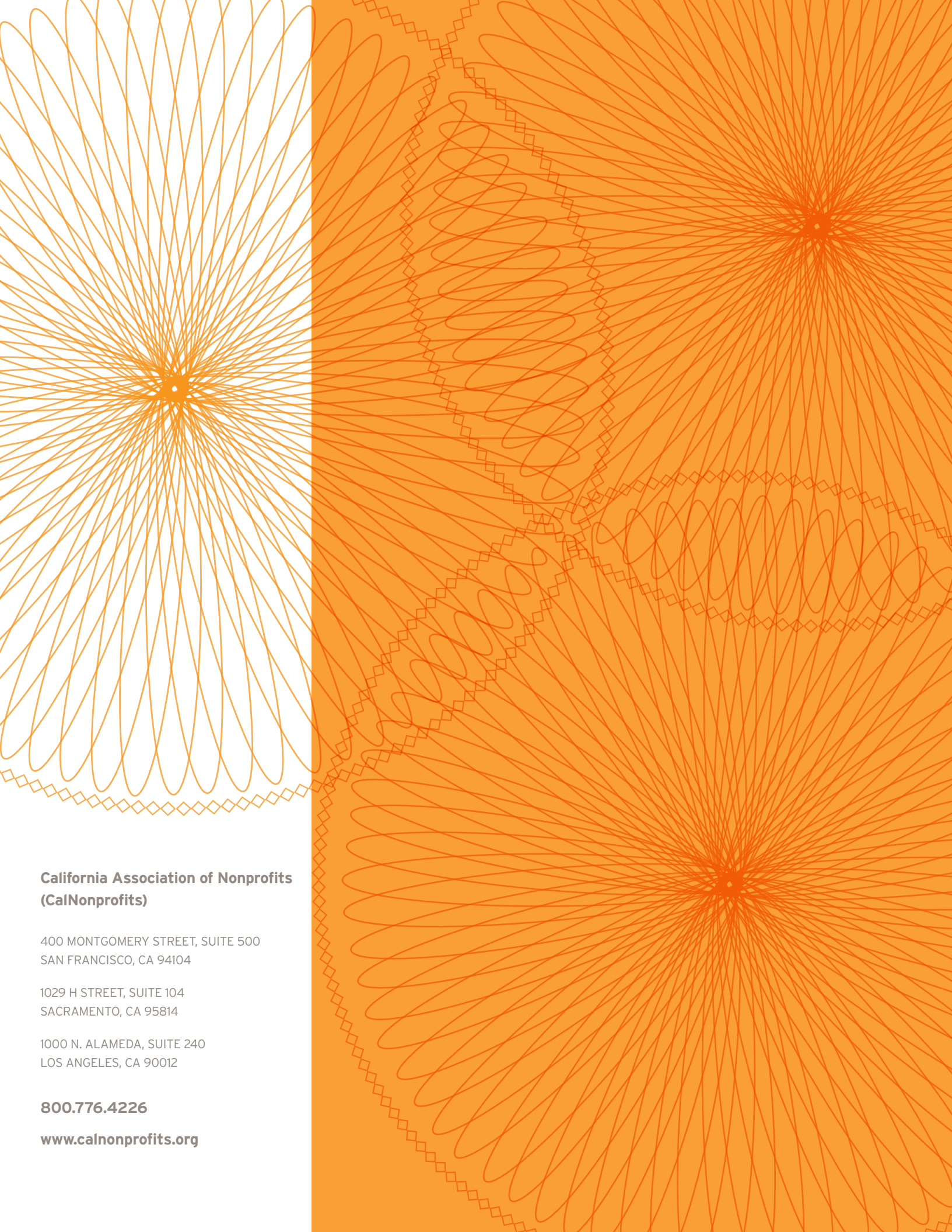


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- Provide more than 19,000 nonprofit employees with health insurance
- Provide more than 800 nonprofits with workers comp, dental/vision insurance, D&O and other insurances
- Conduct research on the economic contributions made by nonprofits
- Work with nonprofits and government on regulatory and legal matters
- Take on issues such as nonprofit overhead, the impact of student debt on the nonprofit workforce, nonprofit voter engagement



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