

# “501(c)(3) Bonds 101”

(Webinar Presentation)

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Tuesday June 8, 2010



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# Procedural Comments for Webinar

- No Charge
- Electronic Submission of Questions
- Slides Available Upon Request (E-mail [mvacha@dilworthlaw.com](mailto:mvacha@dilworthlaw.com))

# Purpose of Presentation

- Overview of 501(c)(3) finance
- Most of the presentation will be applicable for hospitals, colleges and universities, private schools, museums, etc.
- Focus on a number of common issues

## Purpose of Presentation (continued)

- Identify legal and related considerations relevant to these transactions
- Inform members of governing bodies of issuers and conduit borrowers, and management (collectively, “decision makers”) for decision-making processes

## Purpose of Presentation (continued)

- Intended to be at a fundamental and intermediate level
- To help spot issues by the early stages of a transaction
- To raise issues that should be monitored both before and after a bond transaction

## Purpose of Presentation (continued)

- Prime focus will be upon federal tax requirements and, to a lesser extent, federal securities law and some other considerations

## Summary—Putting 501(c)(3) bonds in broader context:

- An awareness of legal considerations is just one part of decision-making process regarding bonds
- Other considerations:
  - Pricing
  - Financial reporting
  - Administrative (i.e. monitoring)
  - Debt management needs of particular issuer or conduit borrower
  - Risk management considerations



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# 501(c)(3) Bonds 101: Certain Basic Requirements

- Conduit issuer-necessary for federal income tax exemption
- Some large institutions (e.g. certain state universities) may be both 501(c)(3) institutions and governmental entities and can issue directly (more the exception than the rule for higher education and hospital financings)
- Securities law exemptions are different matters-a large non-profit institution may be able to issue taxable securities directly without registering with the Securities Exchange Commission (e.g. taxable commercial paper program)



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# 501(c)(3) Bonds 101: Ownership Requirement

- Bond financed project must be owned by:
  - A 501(c)(3) entity (or a state or local governmental entity)
  - For purposes of this presentation (entities other than 501(c)(3) entities or state or local government entities are referred to as “non-qualified persons”)
  - Depending on the circumstances, improvements related to leased property might satisfy this requirement
  - Important that the bond-financed improvements would not have value to a non-qualified person (e.g. landlord or a future tenant) at the end of the lease

# 501(c)(3) Bonds 101: 501(c)(3) entity

- Typically the 501(c)(3) entity is a non-profit corporation under state law (note: not every non-profit will be a 501(c)(3) or other exempt organization under federal tax law)
- Limited liability companies may be able to satisfy the 501(c)(3) requirement in certain circumstances (e.g. utilized to some extent in student housing)
- Partnerships, themselves, are not 501(c)(3) entities
- Disregarded entities may be an acceptable conduit borrower

# 501(c)(3) Bonds 101: Public Approval Requirement

- Public Approval Requirement is commonly referred to as “TEFRA” (based on relevant federal tax legislation)
- General comment—Rarely affects the ability to get a transaction done—more likely to affect timing
- Requires advance publication in a paper of general circulation for each jurisdiction where the project is located (at least 14 days)
- Requires approval of highest elected official for both jurisdiction where the issuer is located (i.e. “issuer approval”) and where the project is located (i.e. “host approval”) (sometimes the issuing jurisdiction and host jurisdiction differ)



# 501(c)(3) Bonds 101: Public Approval Requirement (continued)

- Four main elements for a TEFRA notice:
  - Functional description (often this means number of stories for a building or estimated square footage)
  - Maximum amount of tax-exempt obligations to be issued
  - Initial owner, operator or manager of the project
  - Location of the project (not strictly necessary to use an address)



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# 501(c)(3) Bonds 101: Structuring Restrictions

- 2% of the issue price (i.e. sale proceeds) may be used to pay costs of issuance
- Sometimes a small taxable “tail” is issued to finance costs of issuance in excess
- The average weighted maturity of the bonds cannot exceed 120% of the weighted average useful life of the projects financed



## 501(c)(3) Bonds 101: Structuring Restrictions (continued)

- \$150 million limit for non-hospital bonds that can be outstanding for an entity (look at all bond issues not just a particular series)
- Exception for bonds of an issue where 95% of proceeds (net of amounts in a reserve fund) are applied to capital expenditures
- Practical consideration when trying to finance certain start-up costs for a new facility



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# 501(c)(3) Bonds 101: Basic Disclosure Considerations

- Management's discussion and analysis (not rigid rules for municipal sector but there is significant guidance from the SEC in the corporate context)
- Risk Factors or Investment Considerations Section (these often are more in the nature of industry risks but also can focus on risks specific to the institution—e.g. labor relations, regulatory changes, competition, regional economy, etc...)
- Financial statements/stubs (e.g. may have 6 or 9 month unaudited interim balance sheet, income statement—ideally would be current within 90 days of the offering (if analogizing to corporate SEC finance principles))
- Agreed-upon procedures (need to involve outside auditors in a financing who would perform certain procedures with respect to select financial information included in an official statement)
- Secondary market disclosure (scope of this undertaking must be decided at time of the original offering of the bonds)



# 501(c)(3) Bonds 101: Fundraising

- Tax law arbitrage rules can be implicated if there are donor funds (including monies such as state level grants) earmarked for a project
- Practical consequence may be that the size of the bond issue may need to be reduced on account of these funds or an undertaking may be necessary to redeem bonds promptly upon receiving future earmarked donor funds

# 501(c)(3) Bonds 101: Fundraising (continued)

- Should be little or no issue with general, unrestricted donations and pledges (the expression “you don’t need to be broke to borrow” applies here)
- Important for bond counsel to review fundraising and solicitation documents

# 501(c)(3) Bonds 101: Naming Rights

- Granting of naming rights to bond financed property requires scrutiny-may be private business use concerns
- Generally, naming a facility after a natural person who is a donor will be less problematic
- Naming rights to a corporate sponsor may likely cause private business use—to be measured by economic value of the naming arrangement (analysis includes looking at the payments being made by the corporate entity)

# 501(c)(3) Bonds 101: Certain Short-term arrangements

- Private activity concerns related to certain short term arrangements
- Certain examples tend to be more prevalent for certain institutions—examples:
  - Private schools, colleges and universities—summer camps and seminars sponsored or run by persons or entities other than the 501(c)(3) institution
  - Museums-short-term licenses to use space for receptions and private parties

## 501(c)(3) Bonds 101: Short-term arrangements (continued)

- May be certain safe harbors—E.g. Certain arrangements not in excess of 50 days:
  - All renewal options count versus the 50 day limit
  - Compensation must be at fair market value
  - Property is not financed for principal purpose of providing that property for use by the non-governmental (non-501(c)(3) person)
  - Cannot be an arrangement resulting in ownership of financed property
- Separate issue—to evaluate these uses with respect to unrelated trade or business concerns

# 501(c)(3) Bonds 101: Management Contracts

- Private business use can arise, not only by ownership or a leasehold interest, but by actual or beneficial use of property pursuant to a management or incentive payment contract or other arrangements
- Management contracts with respect to financed property generally result in private business use if the contract provides for compensation based, in whole or in part, on a share of net profits
- Revenue Procedure 97-13 sets forth conditions under which a management contract does not result in private business use

# 501(c)(3) Bonds 101: Management Contracts (continued)

- Certain contracts are expressly considered not to be management contracts, such contracts that are “solely incidental” to primary functions of a financed facility—examples:
  - Janitorial
  - Office equipment repair
  - Hospital billing

# 501(c)(3) Bonds 101: Management Contracts (continued)

- Certain arrangements that generally are not treated as net profits arrangements:
  - Compensation based on a percentage of gross revenues (or adjusted gross revenues) of a facility or a percentage of expenses from a facility, but not both
  - A capitation fee (e.g. fixed dollar amount per month to medical service provider for each member of an HMO for whom the provider agrees to provide all needed medical services for a specified period)
  - Per-unit fee (e.g. a stated dollar amount for specified medical procedure, car parked or passenger mile)

# 501(c)(3) Bonds 101: Management Contracts (continued)

- 97-13 sets forth certain safe harbors:
- 95 percent periodic fixed fee arrangements (cannot exceed lesser of 80% of reasonably expected useful life or 15 years)
- 80 percent periodic fixed fee arrangements (same as above but 10 years rather than 15 years)
- 50 percent periodic fixed fee arrangements (cannot exceed 5 years)
- Per-unit fee arrangements in certain 3-year contracts
- Percentage of revenue or expense fee arrangements in certain 2-year contracts

# 501(c)(3) Bonds 101: Management Contracts (continued)

- Relevant factors in 97-13 analysis:
  - Nature of compensation (most favored are periodic fixed fees (i.e. a stated dollar amount for services rendered for a specified period of time))
  - Term of contract (including renewal options enforceable by service provider) (shorter contracts are favored)
  - Institution's termination rights (important in certain cases that it is on reasonable notice, without penalty or cause)
  - Does the service provider have any role or relationship with the institution that “substantially limits the qualified user’s ability to exercise its rights”

# 501(c)(3) Bonds 101: Research Arrangements

- Private activity concerns-research arrangements
- An agreement by a nongovernmental person (United States is a nongovernmental person) to sponsor research performed by a governmental person (includes 501(c)(3) entities with respect to activities that do not constitute unrelated trade or businesses) may result in private business use of the property used for the research based on all the facts and circumstances
- Basic research is important for certain safe harbors-- “any original investigation for the advancement of scientific knowledge not having a specific commercial objective.”
- E.g.—product testing supporting the trade or business of a specific person is NOT treated as basic research.

# 501(c)(3) Bonds 101: Research Arrangements (continued)

- Certain safe harbors:
- Corporate-sponsored research:
  - For basic research sponsored
  - Any license or other use of technology by the sponsor is permitted only on the same terms as the recipient (e.g. a 501(c)(3) entity) would permit by any unrelated, non-sponsoring party
  - Price paid must be competitive and determined at the time the license or other resulting technology is available for use
  - Recipient need not permit persons other than the sponsor to use any license

# 501(c)(3) Bonds 101: Research Arrangements (continued)

- Certain safe harbors continued:
- Industry or federally sponsored research agreements:
  - Basic research
  - Qualified user (i.e. 501(c)(3) entity) determines the research to be performed and the manner in which it is to be performed (e.g. selection of personnel to do research)
  - Title to any patent or other product incidentally resulting from the basic research lies exclusively with the qualified user (i.e. the 501(c)(3) entity)
  - Sponsors are entitled to no more than a nonexclusive, royalty-free license to use the product of any of that research
- See Revenue Procedure 2007-47

# 501(c)(3) Bonds 101: Change in Use

- Post-issuance issue if use of bond-financed property changes
- Need for remedial action to protect tax-exemption of interest on bonds
- To be able to use remedial action—the entity at the time the bonds were issued needed a reasonable expectation that the bond financed property would be used for its tax-exempt bond-eligible purpose for a substantial period of time (there is no bright-line guidance on how long this would be)



## 501(c)(3) Bonds 101: Change in Use (continued)

- “Deliberate action”, tax term of art, refers to event that triggers private use—there are a few things that may not be intuitive about this concept:
- Knowledge is not relevant
- In the case of a disposition of property—focus on date a binding agreement is entered into (as opposed to a closing date for a transaction)



## 501(c)(3) Bonds 101: Change in Use (continued)

- Three types of remedial action—
  - Use the property for another qualified 501(c)(3) use
  - Defeasance and redeem non-qualified bonds
  - Apply disposition proceeds to another qualified 501(c)(3) use (capital)



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# 501(c)(3) Bonds 101: Swaps

- Can be used to manage interest rate exposure
- Certain types of common risks:
  - Counterparty risk (e.g. Lehman Brothers)
  - Basis risk (mismatch between LIBOR and SIFMA)
  - Credit risk
  - Tax risk
  - Renewal risk of credit or liquidity facilities

## 501(c)(3) Bonds 101: Swaps (continued)

- Swap pricing can be challenging because of quick changes in the markets
- “Mid-market” is not an unambiguous rate (such as certain bank lending rates)
- Swap providers may differ in terms of the spreads they price over mid-market
- Suggests need for a good swap pricing agent or experienced financial advisor when doing a swap transaction
- The rates under a swap transaction may be just as significant as the terms of the related bonds in terms of their financial impact on an institution and overall relevance to a plan of financing and thus should be evaluated carefully

## 501(c)(3) Bonds 101: Swaps (continued)

- Derivative transactions may be more complicated and costly to exit than to enter (an understanding of the likelihood that an issuer will need to unwind a transaction in the future is important to evaluate the overall expected benefits)
- Derivative transactions should be evaluated within the context of an issuer's cash flow and unrestricted reserves (smaller cash flows, more uneven cash flows and smaller reserves suggest need for heightened scrutiny of an issuer's circumstances)

## 501(c)(3) Bonds 101: Swaps (continued)

- Not all hedges and derivatives are similar
- E.g. total return swap (has characteristics of a credit default swap)
- Constant maturity swap (focuses on differences between shorter and longer parts of a yield curve)
- A rate lock (that will be terminated at issuance)
- A more traditional floating-to-fixed swap, etc.

## 501(c)(3) Bonds 101: Swaps (continued)

- Important to discuss a transaction with bond counsel/tax counsel to understand whether a transaction will be integrated and what might be the arbitrage rebate or other tax ramifications

# 501(c)(3) Bonds 101: Certain Recovery Act Bonds Provisions

- 501(c)(3) entities may benefit from certain marketability enhancements in the American Recovery and Reinvestment Act
- Provisions related to the ability of banks to avoid the disallowance of interest expense deduction for tax-exempt obligations were expanded for what is known as “bank qualified” or “BQ” issues
- Small issuer limitation was increased from \$10,000,000 to \$30,000,000 and for purposes of qualified 501(c)(3) bonds, it is the 501(c)(3) entity rather than the conduit issuer, that is treated as the issuer of the bonds (analysis may be complex where parent and subsidiary 501(c)(3)s are involved)
- Practical consideration: Non-profits may have better access to more investors, including greater use of direct bank loans
- THIS CURRENTLY IS FOR BONDS ISSUED BEFORE THE END OF 2010 CALENDAR YEAR—BUT THERE ARE PROPOSALS TO EXTEND



# 501(c)(3) Bonds 101: Securities laws- 15c2-12- recent developments

- On July 17, 2009, the SEC published proposed amendments to the Rule (Release No. 34-60332; see [www.sec.gov](http://www.sec.gov)).
- On May 26, 2010 the SEC adopted amendments (the “Amendments”) substantially as proposed (Release No. 34-62184A).
- December 1, 2010 compliance date
- The Rule has essentially provided an exemption for variable rate bonds
- The Amendments delete the current exemption for demand securities (i.e. bonds that investors can put back)(subject to certain grandfathering).
- Thus, the Amendments result in the need (subject to the grandfathering provision) for issuers to undertake continuing disclosure obligations with respect to variable rate bonds.

# 501(c)(3) Bonds 101: Securities laws- 15c2-12- recent developments (continued)

- The Amendments expand the list of specified events which might require a notice to include four additional events:
  - (i) tender offers;
  - (ii) bankruptcy, insolvency, receivership or similar proceedings;
  - (iii) certain mergers, consolidations, acquisitions or sales of substantially all assets not in the ordinary course of business (this probably applies infrequently to municipalities and would be most likely to apply to securities issued for the benefit of 501(c)(3) health care systems and similar types of entities); and
  - (iv) appointment of a successor or additional trustee, or the change of name of a trustee, if material.
- Notices would be required to be given within 10 business days.

# 501(c)(3) Bonds 101: Certain Pre-issuance Considerations

- If expenditures will be made prior to bond issuance—likely need a declaration of official intent to reimburse the entity for such expenditures from proceeds of the bond issue—a relatively short resolution
- Look at useful lives of components of the project (tax law limits weighted average maturity of bonds to 120% of weighted average asset lives) (may be opportunities to blend shorter-life assets with longer-life assets)
- Evaluate draw down schedule—timing of bond issue can be done to take advantage of certain spend-down exceptions to arbitrage rebate
- The project should be evaluated in terms of any private users—depending on the nature and extent of such use it may be necessary to make plans to free up equity or taxable proceeds to allocate to a portion of the project
- Depending on market expectations—may want to evaluate entering into a rate lock prior to the issuance of the bonds (i.e. an anticipatory hedge); this process should involve bond counsel as to tax treatment of the rate lock



# 501(c)(3) Bonds 101: Six Key Post-issuance timing considerations

- #1: If the bond transaction is variable rate, the deadline for seeking a renewal or extension of the term for the letter of credit or standby bond purchase agreement (note: some transactions have “evergreen” or other provisions for automatic renewals)
- #2: The six month anniversary of the bond issuance—certain tax requirements for spending proceeds
- #3: The 12, 18 and 24 month anniversary dates for arbitrage rebate spend down purposes
- #4: The placed-in-service date/completion date of the project—often certain indenture requirements related to documenting this and to the use of remaining proceeds (general rule of thumb: more flexibility from a tax standpoint if remaining unspent proceeds are addressed by or shortly after the time of completion of the project)
- #5: Potentially, any quarterly periods—some credit enhancers may have reporting requirements per the applicable credit agreement
- #6: The annual filing period if a continuing disclosure undertaking has been made (usually for fixed rate issues) per SEC Rule 15c2-12 (often 120-180 days after end of institution’s fiscal year)

# 501(c)(3) Bonds 101: Post-issuance considerations (Rebate basics)

- Subject to certain exceptions, arbitrage earnings above the bond yield have to be rebated to the U.S. Treasury
- A portion is due every five years—balance is due within 60 days of final retirement of the bonds
- Important to retain rebate consultant
- Yield may be fixed and known as of closing—may change if variable rate bonds—if a swap is used the yield might be fixed or subject to adjustment taking account of swap payments (this depends on whether and how the swap might be “integrated” with the bonds)

# 501(c)(3) Bonds 101: Post-issuance considerations (Rebate basics) (continued)

- Various funds and accounts might be subject to rebate—two of the most significant instances are the project fund and any debt service reserve fund
- Project fund arbitrage earnings might be excluded from rebate if certain exceptions are met (generally, if proceeds are spent in certain required percentages by certain six month intervals—6, 18 and 24 month exceptions) (exceptions reward quick application of proceeds to the project)
- DSRFs do not have an exception but one approach is to spin off earnings from a DSRF to the project fund during the construction period

# 501(c)(3) Bonds 101: Post-issuance considerations (Form 990-Schedule K)

- Purpose of Schedule is to provide certain information on an organization's outstanding liabilities associated with tax-exempt bond issues
- For organizations with one or more related organizations, only one organization should report the liability (multiple subsidiaries could report the amount of proceeds it is loaned or allocated)
- Schedule O is to be used for additional information or comments (e.g. describe certain assumptions when information provided in Schedule K is not fully supported by existing records)

# 501(c)(3) Bonds 101: Post-issuance considerations (Form 990-Schedule K) (continued)

- An organization must report if it had an outstanding principal amount in excess of \$100,000 as of last day of tax year and
- Bond was issued after December 31, 2002
- Can use same period as that for Form 990 or any other 12 month period in accordance with requirements under Sections 141 through 150 (e.g. a bond year) (thus different 12 month periods can be used for different tax-exempt liabilities reported)

# 501(c)(3) Bonds 101: Post-issuance considerations (Form 990-Schedule K) (continued)

- Schedule K is divided into four parts:
- Part I—list of bond issues—need to list CUSIP number for latest maturity (i.e. same as for Form 8038), among other things—issue price and purpose of the bond issue
- Part II—information regarding use of proceeds, among other things—unspent proceeds, year in the financed project was substantially completed, whether or not final allocation of proceeds have been made

# 501(c)(3) Bonds 101: Post-issuance considerations (Form 990-Schedule K) (continued)

- Four parts of Schedule K:
- Part III—private business use matters, questions address, among other things: status as partner or LLC member in entities that included non 501(c)(3) entities; leases; research agreements; average percentage of the property financed by the bond issue that was used in a private business use
- Part IV- arbitrage matters, among other things—whether Form 8038-T, Arbitrage, Rebate, Yield Restriction and Penalty in Lieu of Arbitrage Rebate, has been filed; payments made or received under a qualified hedge; investments in a guaranteed investment contract; qualification for an exception to rebate

# 501(c)(3) Bonds 101: Recent Developments

- The Patient Protection and Affordable Care Act, enacted March 23, 2010 added a new Section 501(r) to the Internal Revenue Code
- New section 501(r)(1) imposes additional requirements that “hospital organizations” must satisfy to be described in section 501(c)(3)
- The Affordable Care Act did not otherwise affect substantive standards for tax exemption

# 501(c)(3) Bonds 101: Recent Developments (new section 501(r) continued)

- Section 501(r) applies to hospital organizations on a facility-by-facility basis (not on a system-wide basis)
- Section 501(r)(3) requires a hospital to conduct a community health needs assessment every 3 years and adopt an implementation strategy to meet identified needs
- Requirement to include in Form 990 a description of how the organization is addressing these needs
- Section 501(r)(4) requires a hospital organization to establish a financial assistance policy and a policy relating to emergency medical care



# 501(c)(3) Bonds 101: Recent Developments (new section 501(r) continued)

- Section 501(r)(5) limits amounts charged for emergency or other medically necessary care for individuals eligible under the financial assistance policy to not more than amounts generally billed to individuals who have insurance covering such care
- Also, prohibition on use of gross charges
- Section 501(r)(6) requires a hospital to forego extraordinary collection actions before making reasonable efforts to determine eligibility for assistance



# 501(c)(3) Bonds 101: Recent Developments (new section 501(r) continued)

- Section 4959 excise tax provisions (i.e. \$50,000 for failure to meet CNHA requirements of section 501(r)(3))
- Most of 501(r) is effective for taxable years beginning after March 23, 2010
- The community health needs assessment requirements are effective for taxable years beginning after March 23, 2012



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# 501(c)(3) Bonds 101: Recent Developments (IRS Exempt Organizations Colleges and Universities Compliance Project-Interim Report (May 2010))

- Report based on responses to questionnaires the IRS sent in October 2008 to a sample of 400 public and private nonprofit colleges and universities
- The report and executive summary are available through IRS website
- Preliminary data focused on demographic and organizational information, activities conducted including a focus on international activities, endowment funds, executive compensation and governance

# 501(c)(3) Bonds 101: Recent Developments (IRS Exempt Organizations Colleges and Universities Compliance Project-Interim Report (May 2010)) (continued)

- IRS' "Next Steps.": The IRS indicated that:
  - IRS is conducting more than 30 examinations based on responses to the questionnaire
  - These exams focus on executive compensation, unrelated business income and review of controlled entity issues
  - IRS is conducting additional analysis focusing on transactions between related organizations, unrelated business activity losses and reporting, use of comparability data and initial contract exception to set executive compensation

## 501(c)(3) Bonds 101: Recent Developments (Colleges and Universities-CBO Study on Arbitrage)

- April 2010 Congressional Budget Office Study “Tax Arbitrage by Colleges and Universities”
- Study prepared at request of Ranking Member of Senate Finance Committee (Chuck Grassley, R-Iowa)
- Focused on “indirect” tax arbitrage not prohibited by federal law where colleges and universities finance operating assets on a tax-exempt basis while holding investment assets that earn a higher return
- Study concluded that an expansion of definition of tax-arbitrage would probably lead to a reduction in tax-exempt debt by colleges and universities
- In accordance with CBO’s mandate, the paper makes no recommendations



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# 501(c)(3) Bonds: 10 Situations that May Implicate Bond Issues

- Not exhaustive
- Intended, in part, as a review of earlier topics
- Concerns may vary—may be tax oriented, may be indenture covenants, may be securities oriented

# 501(c)(3) Bonds 101: 10 Situations that May Implicate Bond Issues (continued)

#1: Sponsored research arrangements

#2: Fundraising

#3: Joint ventures with for-profit entities

#4: Naming rights/corporate sponsorships

#5: Leasing, sale or other disposition of property (both tax and indenture considerations)

# 501(c)(3) Bonds 101: 10 Situations that May Implicate Bond Issues (continued)

#6 Merger and acquisition activity (generally more relevant in the health system context)

#7 Management contracts

#8 Supplemental revenue generating opportunities (e.g. summer camps at private schools or colleges and universities)

#9 Press releases (particularly if near or in the middle of a bond offering) (securities law concerns)

#10 Transactions with members outside an obligated group (generally more in the health care context)

# 501(c)(3) Bonds 101: Six On-going activities where Bond Professional Input May Help

- #1 Institution's website (for consistency with offering documents, secondary market filings)
- #2 Form 990s
- #3 Investment policy (for consistency with permitted investment provisions of indentures)
- #4 Input in preparation of any standardized or preferred forms of contracts (particularly management contracts)
- #5 Input in preparation of any standardized donor solicitation materials relevant for any capital projects
- #6 Annual continuing disclosure filings

