



## Exploring For-Profit to Nonprofit Conversion

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2

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3

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## Presentation Topics

- Conversion Economics
- Accreditation Issues / Regulatory
- Transaction Structuring
- Addressing Conflicts of Interest
- Completing the Transaction
- Considerations as a Nonprofit

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## Basic Conversion Economics

- Nonprofits may not have equityholders; may not pay dividends or return profits to individuals
- A conversion is a sale
  - Shareholders exchange equity for cash/debt
  - Shareholders receive the current value of the university
- Shareholders generally receive cash and/or debt (promissory note) in exchange for giving up equity stake
  - Terms of debt subject to review by accreditors / regulators
- Could “convert” without sale; would amount to contribution of current value to nonprofit entity (with or without tax deduction)

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## Allowable Sources of Benefits back to Current Shareholders (always subject to FMV constraint)

- Rent
- Administrative Services (retain interests)
- Licenses
- Compensation
  - Retirement Benefits
- But, may not retain profit-like interest

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## Benefits of Tax-Exempt Status

- Federal and State Income Tax Exemption
  - Still taxable on unrelated business income tax
- Tax deductions for contributions, such as to a scholarship fund
- Sales tax exemption on purchases
  - Depends on state
- Property tax exemption
  - Depends on state law
- Preferential Postage Rates

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## Negotiating Deal Economics

- Nonprofit board has to approve
  - Consideration paid by nonprofit must be no more than FMV of university assets received
  - Approval and conflict of interest procedures discussed below
- Accreditors oversee economic terms of payment
  - Term of promissory note
  - Payment contingencies
    - Debt ratios
  - Amount of retained assets/required reserves
  - Retained contracts
  - Expectation: accreditors will be more demanding than you expect

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## Accreditation Issues / Regulatory

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10

## Accreditation Issues

- Highly scrutinized transactions
  - Benefits received
  - Conflicts of Interest
  - Reactive
- Timing
  - Long-advance
  - Documents have to be prepared well in advance
  - Definitive transaction agreement with an “out” clause
- Governance Structures
  - In place beforehand
  - Alleviating issues with transition
- Expectation of Revisions to Deal Terms

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## Possible Other Interested Parties

- State Attorney Generals
  - Many have specific powers over charitable corporations in state
  - State of incorporation (?)
- Local communities
  - Losing tax base



## Transaction Structuring

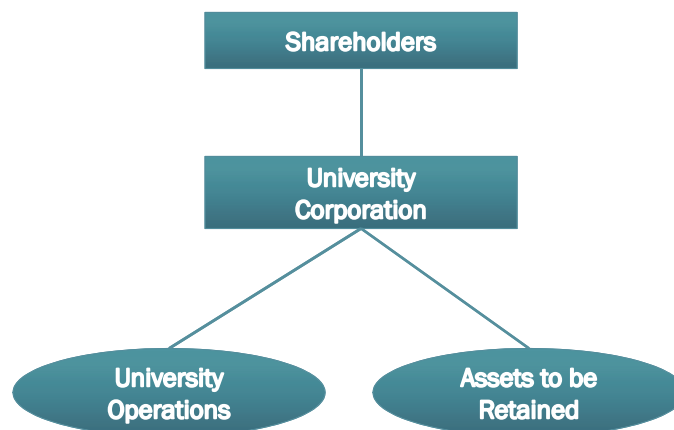


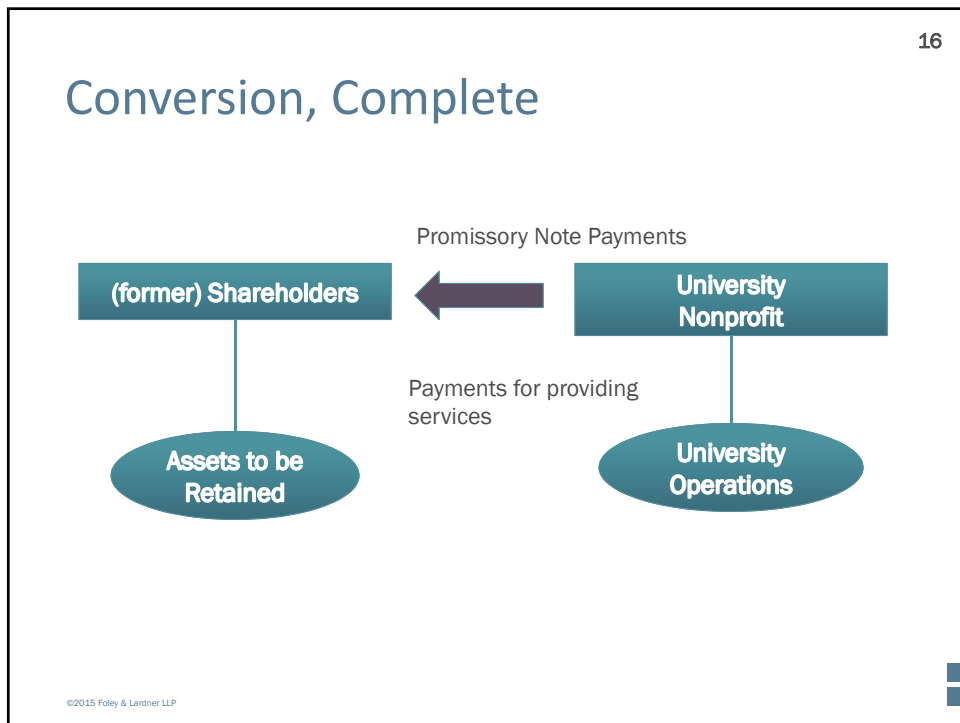
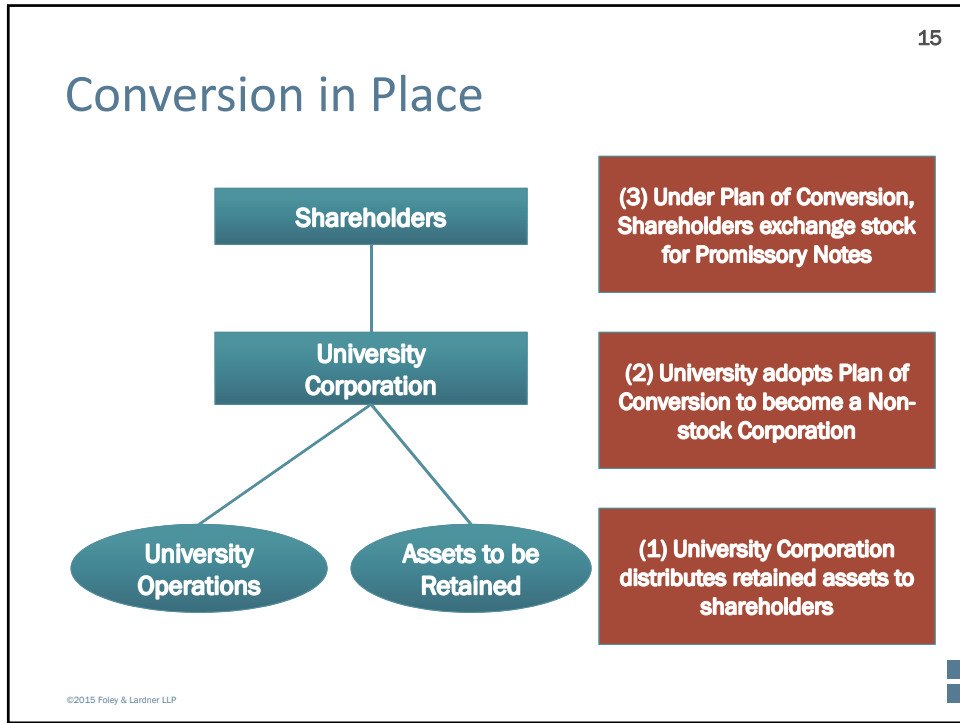
## Issues / Constraints

- Existence of Current Section 501(c)(3)
- State of Incorporation Conversion / Merger Law
  - Non-stock corporations are different
- Income Tax to Shareholders
  - Sale Treatment
  - Installment Sale Treatment
  - Retained Assets
- Conversion to Nonprofit
  - treated as deemed liquidation
- Legal Contracts
  - Corporate survivorship
- Licensing / Regulatory Approval



## Sample For-Profit University Structure







17

## Conversion

### ■ Advantages

- Simple to understand
- Nonprofit corporation is successor to existing university entity

### ■ Disadvantages

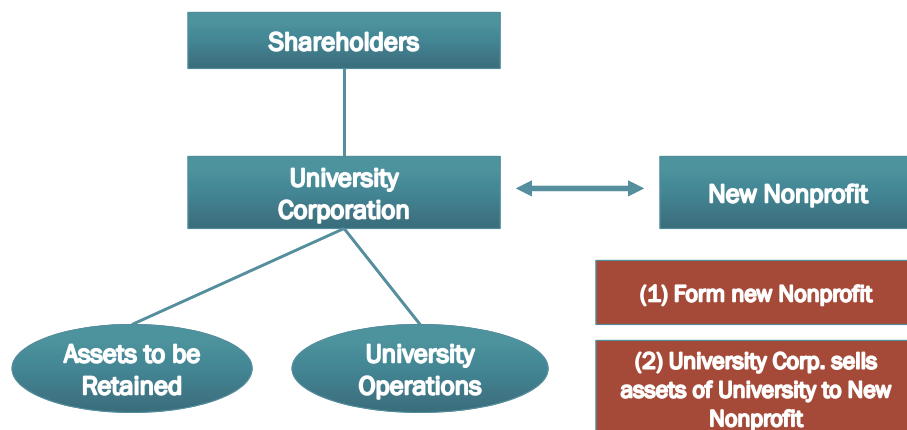
- May not be available in state
- No nonprofit governance in place
- Need to obtain IRS recognition of section 501(c)(3) status
- Retained assets may be subject to tax

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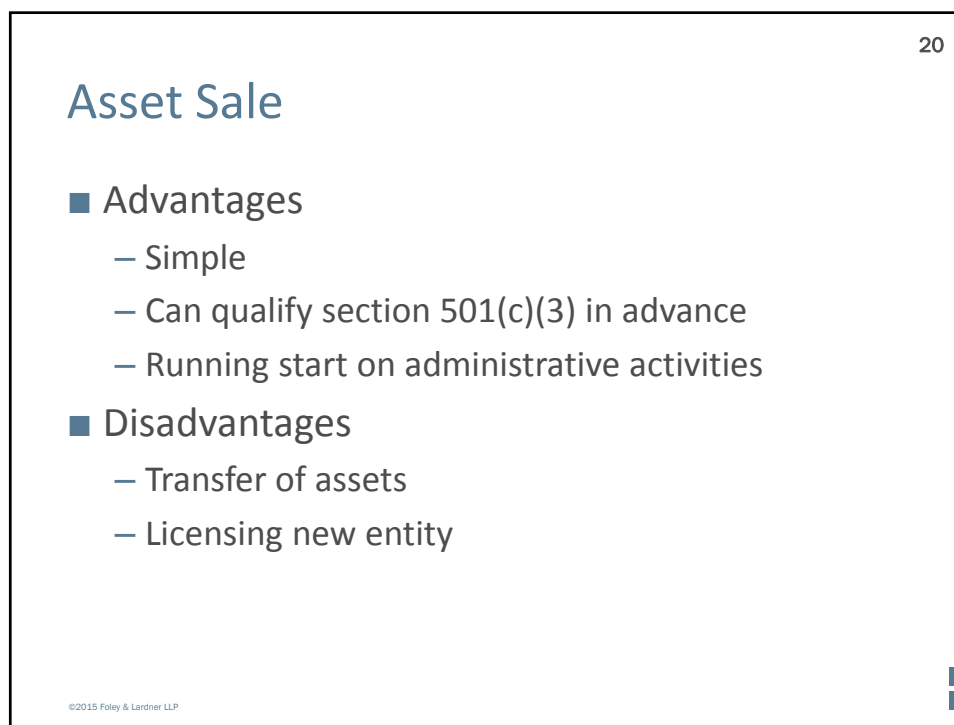
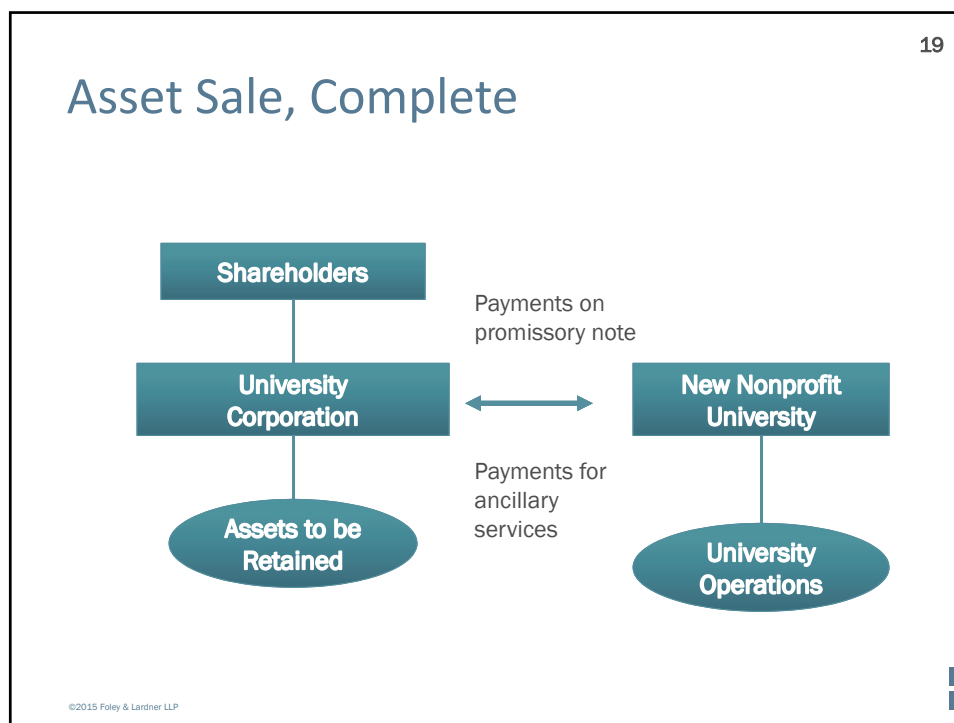
18

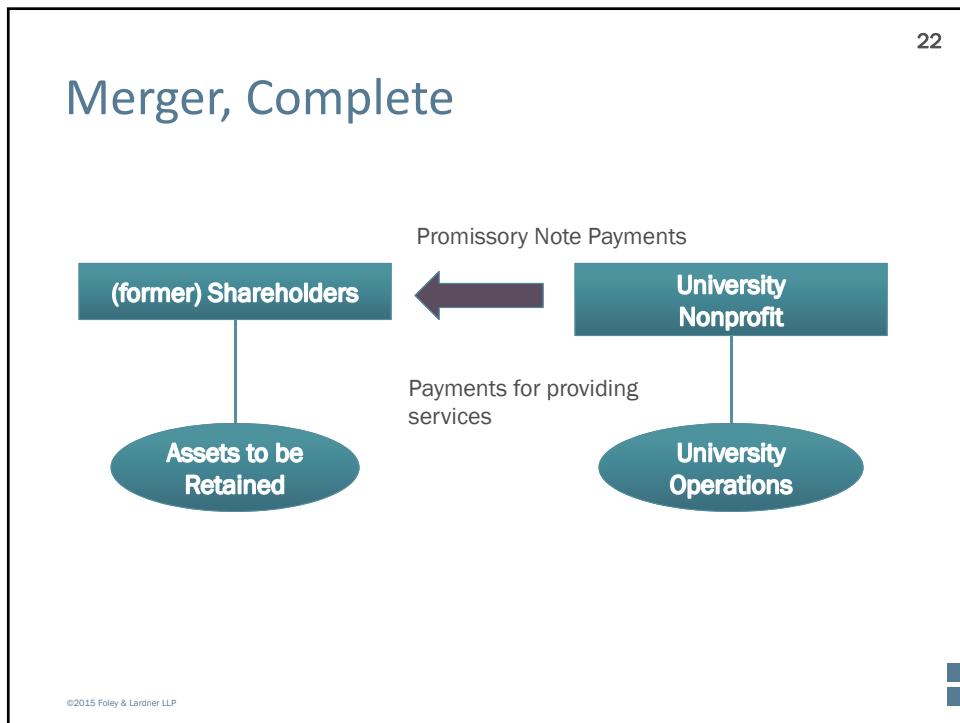
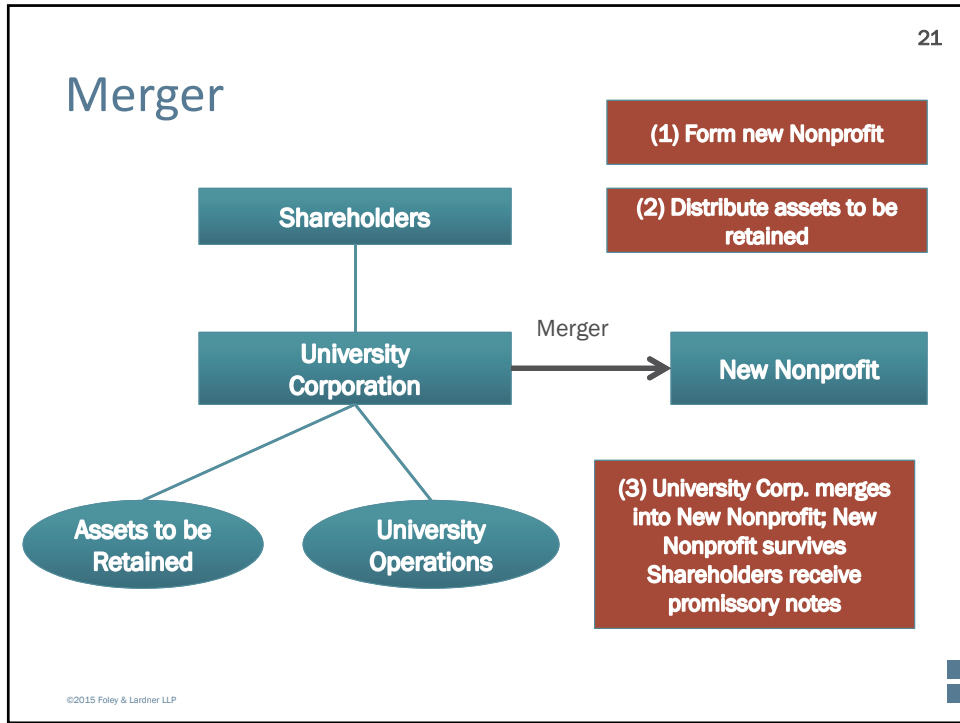
## Asset Sale



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23

## Merger

### ■ Advantages

- Nonprofit entity is corporate successor of university entity, so little/no contract novation needed
- Nonprofit entity assumes all liabilities of university

### ■ Disadvantages

- Merger of for-profit into nonprofit may not be available under your state law

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24

## Addressing Conflict of Interest

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## IRS Rules

- Private Inurement
  
- Prohibition on Excess Benefit
  
- Address both:
  - Conversion Transaction
  - All additional transactions, including continuing compensation agreements

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26

## IRS Rules for Conflict of Interest

- “Intermediate Sanctions” / “Excess Benefit”
- Intermediate sanctions apply when the organization pays an excess benefit to an officer, director, or individual with substantial influence (and their family members and businesses)
- Excess benefit:
  - [What you received] less [what you were entitled to receive].
  - Compensation in excess of reasonable compensation

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27

## Rebuttable Presumption

- Advance approval of a transaction by an authorized body without a conflict of interest relying on adequate information to establish that the transaction is fair to the organization

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28

## Elements of Rebuttable Presumption

- Transaction approved by Authorized Body
- Reliance on appropriate comparability data
- Approved in Advance
- Documented Contemporaneously

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29

## Authorized Body

- Authorization
  - Probably special committee
  - Committee charter—establish procedures
  - Review state law
- Revisions require re-authorizing
- Carefully review any conflicts of interest

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## Appraisal

- Need to review carefully
- Should consider comparables / multiple ways to value income stream
- Need reliable, well-respected professional valuation consultant – probably too large & complex to rely on in-house valuation estimates
- Consider current industry trends
- Should not take into account benefits from nonprofit status

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31

## Requirements for Documentation

- Terms of the transaction and date of approval
  - Terms should be as complete as possible
- List of the Members of the authorized body who were present and voted on the action
- Expert opinion on FMV
- Any actions taken by anyone who was a member of the authorized body but who had a conflict of interest

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32

## Completing the Transaction

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33

## Initial Preparation

- Selling / converting a university is a long and complicated process
  - Can you work the sale / conversion process and run the university?
  - 50-75% of your time will be used to manage and execute the sale process
- Assemble Transaction Team
  - Management team
    - Whom to bring “over the fence”?
  - Legal Advisors
  - Accountants
  - Valuation Firm

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34

## Initial Preparation

- Confidentiality / Nondisclosure Agreement
  - Information control is paramount
  - Develop information protocols early
- Term Sheet / Material Terms of Transaction
  - Transaction structure (conversion, asset or merger)
  - Amount of cash / promissory note
  - Retained assets / contracts
  - Non-binding other than for limited provisions
- Prepare Transaction Timeline/Working Group List

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35

## University Due Diligence

### ■ Why?

- To ensure no problems or issues that could adversely impact sale or conversion
- Identify what consents / approvals are required, including third party consents (i.e., text book vendors, landlord, debt holders)
- Information used to prepare Disclosure Schedules

### ■ When?

- Early as possible

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36

## University Due Diligence

### ■ Time consuming and multi-disciplinary (business, accounting, tax, legal, HR, etc.)

### ■ Key Issues in Due Diligence

- Ownership of assets / equity
- Review of corporate records / documents
- Regulatory process and required approvals
- Employee benefits
- Real Estate /Environmental
- Legal Claims
- Material Contracts / Debt Instruments
  - Need to determine if there are change in control, anti-assignment or other provisions that would be triggered

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37

## Principal Transaction Documents

### ■ Definitive Agreement

- Sale and purchase of shares (merger) or assets (asset sale)
- What is the purchase price and the forms of consideration (cash / promissory note) ?
- Closing; closing date
- Representations and warranties concerning the University and shareholders

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38

## Principal Transaction Documents

### ■ Definitive Agreement

- Nonprofit's representations
- Covenants, including how the university will be conducted between signing and closing
- Closing conditions: events that must occur in order for each party to agree to proceed to closing
- Termination (conditions under which either party can walk away from the transaction)

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39

## Principal Transaction Documents

### ■ Definitive Agreement

- Indemnification: Nonprofit is acquiring the university based on the university's and shareholders' representations and warranties about the university. If those statements turn out to be incorrect, nonprofit needs recourse.
- Indemnification generally applies for breach of any representation, warranty, covenant or agreement

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40

## Principal Transaction Documents

### ■ Disclosure Schedules

- University and its accountants and attorneys will devote significant time to the disclosure schedules, which are critical in setting forth exceptions and clarifications to the representations and warranties, thereby protecting university and/or shareholders from indemnification claims

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41

## Principal Transaction Documents

### ■ Ancillary Documents

- Final valuation report
- Promissory note
- Agreements relating to retained ancillary services
- Debt payoff letters
- Bill of sale (asset deal)
- Assignment and assumption of liabilities (asset deal)
- Officers' certificates
- Closing checklist

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42

## Closing / Post-Closing Integration

- Nonprofit university must be able to operate at closing
- Nonprofit governance structure must be in place
- Required action items
  - Human resources/benefits
  - Make all required filings
  - Name changes
  - Press release
  - Other transition / integration issues

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## Consideration as a Nonprofit



## Considerations before Converting

- Public
  - Form 1023 and Form 990 are publicly available
- Lose Substantial Amounts of Control
- Payments may not be guaranteed
- Higher levels of scrutiny



45

## IRS Colleges and Universities Compliance Project

- Goal: Examine college and university compliance with unrelated business income and executive compensation rules
- Result of UBIT review
  - Additional UBIT for 90% of colleges and universities examined totaling \$90 million
  - Over 180 changes to the amounts of UBIT reported by colleges and universities on Form 990-T
  - Disallowance of more than \$170 million in losses and NOLs which amount to more than \$60 million in assessed taxes.

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46

## Non-Discrimination

- Section 501(c)(3) status requires a non-discrimination policy:
  - Adopt and publish a non-discrimination policy regarding its students and admission process;
  - Include a notice of its non-discrimination policy on certain recruiting materials;
  - Publish its non-discrimination policy at least annually;
  - Retain records regarding admissions policies and procedures, as well as records regarding the racial and ethnic makeup of its university; and
  - Have an authorized officer of the school certify that the policy is effective.

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# Questions?

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