Alternatives to For-Profit Status For Participating in Title IV Programs

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General Advantages of Not-for-Profit Status

- May qualify for exemptions from federal and state income taxes
- May qualify for exemptions from sales tax
- May qualify for exemptions from property tax
- May be able to obtain tax-exempt financing
- May qualify for tax-exempt U.S. postal rates

General Advantages of Not-for-Profit Status

- Students may be able to obtain state grants available only to students of not-for-profit higher education institutions
- May be able to participate in library and other programs available only to not-for-profit education institutions
- May receive charitable donations or participate in grant programs reserved for not-for-profit institutions

Regulatory Advantages of Not-for-Profit Status

- Following the first full fiscal year after completion of the “conversion” transaction, institution is not subject to the 90-10 requirement
- Degree programs of not-for-profit institutions are not subject to GE rule
  - Not clear whether DOE will require a transition period

Disadvantages of "Converting" to Not-for-Profit Status

- Transaction will constitute a disposition at present for market value, which is generally lower than the fair market value of for-profit higher education institutions in 2003-2009.

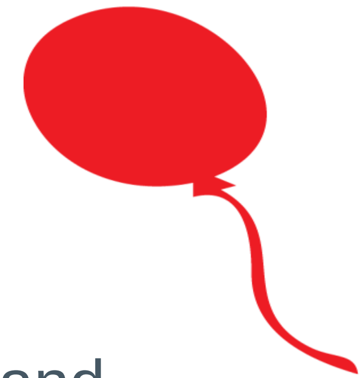
- Very limited amounts payable to management former owners in the event of a subsequent disposition of the institution
  - Any amounts payable to management former owners will be taxed at ordinary income rates

Disadvantages of “Converting” to Not-for-Profit Status

- All or substantially all of the purchase price will be paid in installments after closing
  - Owners bear the risk of nonperformance/nonpayment
- Compensation payable to owners in transaction is limited by federal income tax laws
- Compensation payable to former owners by the not-for-profit after the transaction closes is limited by federal income tax laws

Disadvantages of “Converting” to Not-for-Profit Status

- Proceeds of transaction will be taxable to owners but installment sale treatment should apply to deferred payments of purchase price
  - Tax rates may increase in the future
- Owners lose control of institution
  - Board of directors of not-for-profit corporation must be independent from the former owners



- Greater disclosure of financial results and compensation of 501(c)(3) corporations on IRS Form 990, which is publicly available

Disadvantages of "Converting" to Not-for-Profit Status

- Activities of not-for-profit after closing is limited by federal income tax laws
  - Restrictions on engaging in ancillary, for-profit activities
  - Restrictions on joint ventures with for-profit enterprises
  - Restrictions on political activities

- Generally, more limited financing alternatives for not-for-profit corporations than for-profit corporations

Regulatory Disadvantages of “Converting” to Not-for-Profit Status

- Transaction will constitute a change of control for purposes of participating in federal student aid programs
  - Letter of credit of 25% or more of anticipated federal student aid required to be posted with the DOE
  - Restrictions in PPA on adding new programs or locations or substantially modifying existing programs
  - PPA will be provisional

Regulatory Disadvantages of "Converting" to Not-for-Profit Status

- Substantive change for accreditation purposes
  - Certain accreditors may view negatively and impose new restrictions
  - May take months to obtain accreditor approval as a consequence of document review and schedule of commission meetings
- Change of control for state education agencies
- May lead to change of state regulatory agency

Timing of “Conversion” Transaction: Allow 6-8 months to complete

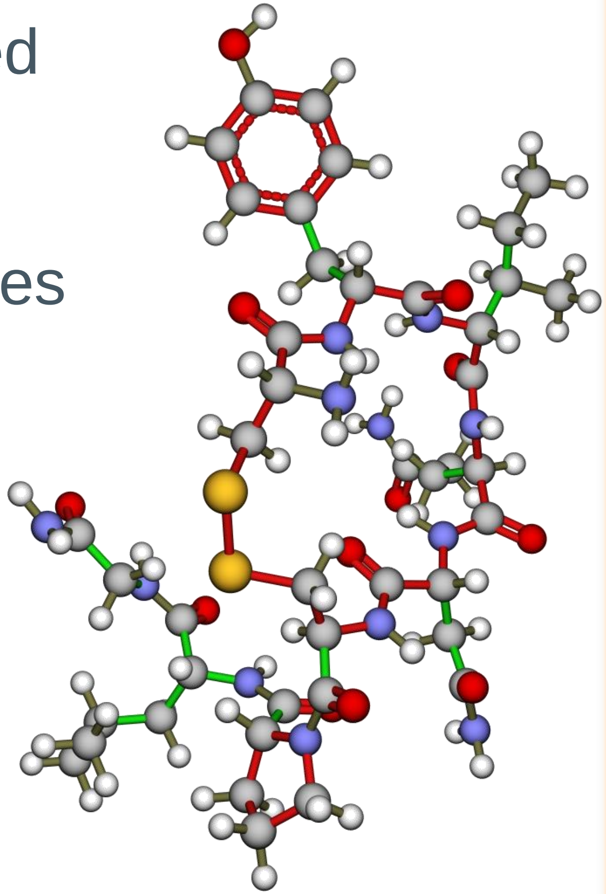
- Retention of professionals, including valuation firm
- Analysis of transaction structure and tax planning
- Selection of independent directors
- Preparation of transaction documents
- Determination of fair market value
- Preparation of application to the IRS

Timing of “Conversion” Transaction: Allow 6-8 months to complete

- Preparation of an application to DOE for pre-acquisition review
- Preparation of substantive change or other application for accrediting bodies
- Preparation of change of control applications for state education agencies
- Obtain required consents of private parties such as financing sources, landlords, equipment lessors and software licensors

Transaction Structure

- Transaction structure is determined by income tax consequences, tax planning objectives, financing objectives, the existence of liabilities outside of the ordinary course of business and any challenges in obtaining third-party consents, as well as flexibility in state law
  - Generally, recommend Delaware law for clarity and flexibility regarding non-profit, nonstock corporations



Transaction Structure

Sale of Assets of For-Profit Entity to Not-for-Profit Corporation

- Define which assets, liabilities and contracts are transferred or assumed and which are retained
- Importance of paying fair market value for acquired assets and fair rental value for leased assets to the Section 501(c)(3) status of purchaser. Fair market value will be determined by independent valuation expert
- Purchase price will be paid over time and evidenced by loan documents which include a market rate of interest
- Likely contain subordination provisions for the benefit of present or future lenders
- Fewer representations and warranties and indemnification provisions than in other sale transactions
- Conditions to closing for regulatory and private party approvals

Transaction Structure

Merger

- Transfer of assets and assumption of liabilities and contracts happens by operation of merger and minimizes transfer and assumption logistics
- If certain asserts, liabilities or contracts will be retained by the for-profit entity, the assets, liabilities and contracts to be transferred can be placed in a newly-formed subsidiary, which is then merged into the not-for-profit corporation
- May not be available under all state laws
- Merger consideration must be for fair market value
- Merger consideration will be paid over time and evidenced by loan documents which include a market rate of interest
- Fewer representations and warranties and indemnification provisions than in other sale transactions
- Conditions to closing for regulatory and private party approvals

Transaction Structure

"Conversion In Place"

- Change in organizational documents of for-profit corporation to not-for-profit corporation which qualify for 501(c)(3) status and eliminate stock
- Election of independent board of directors
- Former stockholders surrender their shares to the corporation and receive fair market value for those shares, which is paid over time and evidenced by loan documents
- Transactional documentation is less than in asset sale and merger structures
- There may be lesser requirements for regulatory and private party approvals. The transaction will constitute a change of control for purpose of participating in federal student aid.
- Variety of administrative changes, such as changes to employee benefit plans

Other Topics

Charitable contributions may be part of the transaction

- Deductions arising from contribution may be very helpful for owners but complexities arise if assets other than cash are contributed

Other Topics

Corporate governance

- Not-for-profit corporation must be under the control of a board of directors which is independent of former owners
- Caution as to persons who serve as directors of other higher education institutions participating in federal student aid programs serving on not-for-profit corporation's board of directors

Other Topics

Corporate governance, cont.

- Board of directors approve compensation arrangements for any former owners who continue to serve as employees. Income tax laws and regulations limit the amount of compensation
- Members of board of directors may be personally liable for “excess benefit” transactions

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For Profit to Nonprofit Conversions

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- Conversions have occurred in many business sectors
- Typically driven by regulatory changes
  - Hospitals
  - HMOs
  - Now higher education

Typical Transaction Structures

- Always taxable, except charitable contribution element
- New or existing tax-exempt entity is the acquiror
  - New organization will require application for exemption and will take time
  - Use existing tax-exempt organization
    - Existing school
    - Existing private foundation (termination of PF status)
- Structure of transaction dictated by form of entity that owns the college and domicile of entity
  - C corporation
  - S corporation
  - LLC

Sale Transaction

- Asset purchase/sale
  - All assets sold including goodwill, except cash
  - Valuation required
  - Use of single-member LLCs as actual acquiror
- Conversion in place deemed sale
  - Amend and restate articles of incorporation
    - Delete power to issue stock and pay dividends
    - Add nonprofit purpose clause and prohibition against making “distributions,” i.e., paying dividends
    - Satisfy organizational test for exempt status

Getting Tax-exempt Status for New Organization

- Valuation of assets, including intangibles, is critical
  - Rev. Rul. 76-91—No presumption of reasonableness
  - Rev. Rul. 76-441—Specific example involving school
- Management contracts
  - Rev. Proc. 97-13 applicable if tax-exempt bonds are used to finance purchase

The Application Process

- Form 1023
  - Basic exemption requirements
  - Public charity status and implications
- "Independent" Board
- Budgets
- Deal documents
- Appraisals
- Patience!!

Pre-conversion Planning

- Tax-exempt financing--uses, opportunities and challenges
- Subordinated debt and interest-stripping
- Charitable contribution planning to reduce tax liability and still control some of the proceeds (e.g., using a family foundation

Post-Conversion Planning Issues

- Management company structure and compensation
- Executive compensation
  - Incentive compensation options
  - Qualified and nonqualified plan issues and differences from for profit environment
  - Accountable plan issues
- Leases (property, plant and equipment) and licenses (intellectual property)
- Excess benefit transaction hazards
  - Subsequent acquisitions
  - Management and executive compensation
  - Rebuttable presumption of reasonableness

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