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EMPLOYING ONE'S "TALENTS": THE POWER OF INNOVATIVE BOND TRANSACTIONS TO FINANCE CATHOLIC NONPROFITS

Christopher Blain

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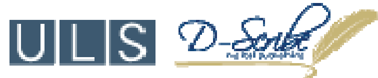

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EMPLOYING ONE'S "TALENTS": THE POWER OF INNOVATIVE BOND TRANSACTIONS TO FINANCE CATHOLIC NONPROFITS

Christopher Blain[*]

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INTRODUCTION

In the Parable of the Talents in the *Gospel of Matthew*, the master entrusts his talents—a unit of currency[1]—to three servants before leaving on a journey.[2] Upon his return, he asks his servants to account for what they have done with the talents he has given them.[3] While the first two servants managed to trade and double the amount of talents they had been given, the third servant simply dug a hole in the ground and buried his master's money.[4] Indignant, the master condemned him as a "wicked, lazy servant," rebuked him for not investing his money in a bank so that he could have interest on his return, and took his talent back from him before throwing him into the "outside darkness."[5] Of the many interpretations of this parable, perhaps the most common is that of an exhortation to not waste one's talents, but to instead productively employ one's talents in the service of God.

It is ironic then, that the Catholic Church in the United States itself should have "talents" literally buried in the ground while schools struggle to keep their doors open, churches are in desperate need of repair, and charities lack the necessary financing to further their missions. These "talents" that remain buried in the ground consist of the Church's immense real estate holdings. For example, Timothy Dolan, the Cardinal-Archbishop of New York, is believed to be Manhattan's largest landowner![6] Consider also that the Catholic Church in the United States consists of over 190 dioceses and archdioceses containing over 17,900 individual parish churches.[7] While there are no exact numbers disclosing the amount and value of the Church's real estate holdings in the United States, add to this the over 6,000 elementary and secondary schools, Catholic universities, hospitals and other affiliated entities, and it is clear that the Church owns an

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1 ARLAND J. HULTGREN, THE PARABLES OF JESUS: A COMMENTARY 271–81 (Eerdmans Publishing 2002).

2 *Matthew* 25:14-30.

3 *Id.*

4 *Id.*

5 *Id.*

6 *The Catholic Church in America: Earthly Concerns*, THE ECONOMIST (Aug. 18, 2012), http://www.economist.com/node/21560536.

7 *Id.*

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enormous amount of American soil.[8] To be clear, the "talent" actually being wasted is the *value* sitting latent in this real estate. One solution to unearthing this value latent in the land in order to help struggling schools, churches and charities has come from bond financing, specifically the nascent use of Catholic mortgage bonds.

Take, for example, the case of St. John's Catholic School in Beloit, Kansas. St. John's opened in 1879 and has managed to keep its doors open for over 130 years while low enrollment and economic downturns closed countless other Catholic schools across America.[9] Despite being located in a town of only 3,800 people and struggling to obtain adequate financing, St. John's has been able to continuously maintain its presence, all while charging only $700 in tuition per year per student.[10] In 2008, St. John's Catholic School enrollment had dwindled to only 140 students (Pre-K through High School) and faced the prospect of closing due to a "confidence crisis," as parents feared sending their children to a School that might not be financially viable for the long-term. Instead, St. John's made the bold announcement that the School was building a $20.0 million endowment by utilizing the innovative "Endowment Funding Program" (described in Part II below), enabling the school to stay open and provide long-term financing solutions into its future.[11]

Flash-forward to 2014, after the successful implementation of the Endowment Funding Program, no one mentions the prospect of the School closing anymore. Rather, the School is now in the planning stages of implementing a $2.0–$4.0 million campus expansion using conduit mortgage bonds (described in Part I below) secured by the very same real estate and buildings constituting the new campus expansion. St. John's Catholic School is a shining example of the power and potential of harnessing the Church's untapped "talents" (in the form of both real estate and the unused insurable interests of its members and donors). Today,

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[8] *Frequently Requested Church Statistics*, CENTER FOR APPLIED RESEARCH IN THE APOSTOLATE, GEORGETOWN UNIVERSITY (2014), http://cara.georgetown.edu/caraservices/requestedchurchstats.html.

[9] Carl Bunderson, *Kansas School Upholds Catholic Identity, Fosters Vocations*, CATHOLIC NEWS AGENCY (Nov. 21, 2012, 4:03 AM), http://www.catholicnewsagency.com/news/kansas-school-upholds-catholic-identity-fosters-vocations/.

[10] *Id.*

[11] *Id.*

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St. John's embodies what many people believe Catholic education ought to be.[12]

In addition to conduit mortgage bonds and mindful of the Parable of the Talents, bond financing is being used in other innovative ways to facilitate financing for churches, charities and other nonprofit entities in need that previously would not have had access to capital on such favorable terms. Julius Capital Partners, L.P., in conjunction with Immaculata Law Firm, LLC, in Chicago, has developed complex methods of financing called "Legacy Bonds," consisting of the aforementioned "Endowment Funding Program" and the "LIFT (Legacy Income Financing Trust) Bond Program."[13] Legacy Bonds have the same goal of providing financing to cash-strapped nonprofit entities—charities, churches, etc.—but they employ bond-financing in very different ways. In brief, the Endowment Funding Program works by enabling an organization with elderly members to purchase life insurance policies on those elderly members' lives, with their consent.[14] The organization names itself as the beneficiary of the policies and is then entitled to the death benefits under those policies as and when the insureds die.[15] In order to pay the annual policy premiums and to fund needed construction projects, repairs, etc. in addition to a regular annual fund program, the organization may issue bonds, the proceeds from which, combined with death benefits payable over the course of time, are used to fund sufficient reserves to ensure premium payments as well as to fund the desired projects.[16] Under complex actuarial calculations, the death benefits from insureds' lives are actuarially projected to exceed the costs of servicing and ultimately pay off the bond principal. The excess funds, along with the jump-started annual fund donation component of the overall Endowment Program, are available to build an endowment for the organization.[17]

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[12] *Id.*

[13] JULIUS CAPITAL PARTNERS, *FlexEndowment Funding Program (FlexEFP) Program Overview* (2012) [hereinafter *FlexEFP*] (on file with author); JULIUS CAPITAL PARTNERS, *LIFT Bond Funding Program Overview* (2012) [hereinafter *LIFT Bond Funding*] (on file with author).

[14] *FlexEFP*, *supra* note 13.

[15] *Id.*

[16] *Id.*

[17] *Id.*

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A different financing mechanism, the LIFT Bond Program, utilizes bond financing to facilitate various tax-favored forms of structured giving.[18] Under the LIFT Bond Program, the nonprofit organization issues long-term "interest only" taxable bonds, which are purchased and then donated by charitably inclined donors to a Charitable Remainder Trust. Under such a charitable trust, the organization makes the "lead" interest payments due on the bonds to the donor and perhaps other family members for their lives or for a term of years.[19] The "remainder" interest of the charitable trust reverts back to the organization, thereby effectively extinguishing the principal due on the bonds.[20] Essentially, the nonprofit has created interest only financing with no principal repayments. By setting up a Charitable Remainder Trust (or variations of it), a donor may receive favorable income tax charitable deductions at the time the trust is created, notwithstanding that his "donation" to the organization occurs in the future.[21] Charitable trusts used under the LIFT Bond Program thus couple income tax savings opportunities with charitably donative desires.[22] Moreover, the LIFT Bond Program can actually be one part of a larger Endowment Funding Program, compounding the contributions to the organization's endowment.[23]

This article discusses such new and innovative methods of bond financing that utilize unique security devices and repayment techniques in order to provide financing to nonprofit entities that otherwise would not have had access to capital on favorable terms. In Part I, this article will discuss how Catholic conduit mortgage bonds compare to more common municipal bonds, the specific terms of Conduit Mortgage Bonds, and offer a case study intended to demonstrate the mechanics of these bonds. Part II will discuss the comparative advantages of the Endowment Funding Program, explain the role of bond financing in the Program, and provide another case study. Part III will explain how the LIFT Bond Program is being used to facilitate structured giving—again with a focus on the role of bond financing as part of the Program—and analyze its role as one

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[18] *LIFT Bond Funding*, *supra* note 13.
[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] *Id.*
[23] *Id.*

component in the larger Endowment Funding Program. Finally, Part IV will discuss the newest developments in the realm of Catholic conduit mortgage bonds.

I. CATHOLIC CONDUIT MORTGAGE BONDS

Mortgage bonds issued by a Catholic diocese or archdiocese—Catholic conduit mortgage bonds—are similar to municipal bonds; that is, bonds issued by a municipality or other governmental entity. Municipal bonds, for the most part, have a strong record of timely meeting interest and principal payments, and they have historically exhibited stronger repayment patterns than similarly rated corporate borrowers.[24] Hence, it is appropriate to begin with some background information on municipal bonds in order to compare and explain how and why Catholic conduit mortgage bonds are so effective.

A. Municipal Bonds

Municipal bonds are debt obligations issued by governmental entities, such as cities, states and counties.[25] A city, for example, issues bonds and uses the proceeds to build schools, roads, sewers or hospitals.[26] The city then pays investors interest over the life of the bond and repays the bond principal to the investor on the bond's maturity date.[27] Municipal bonds are either "tax-exempt," meaning the interest income is *not* taxable to the investor for federal income tax purposes and usually state income tax purposes as well, or "taxable," meaning the interest income *is* taxable to the investor.[28] A bond issue may be structured as tax-exempt if its use meets certain carefully prescribed requirements under the Internal Revenue Code. Very generally speaking, tax-exempt bond proceeds are used for "public

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[24] *How Safe are Municipal Bonds?*, SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION, http://www.investinginbonds.com/learnmore.asp?catid=5&subcatid=24&id=235 (last visited Apr. 23, 2015).

[25] *What Are Municipal Bonds?*, SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION, http://www.investinginbonds.com/learnmore.asp?catid=5&subcatid=24 (last visited Apr. 23, 2015).

[26] *Id.*

[27] *Id.*

[28] *Id.*

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benefit" projects, such as schools, hospitals, roads and affordable housing developments.[29] As of December 31, 2008, the tax-exempt municipal bond market exceeded $2.67 trillion, and the largest owners of these debt obligations were individuals, mutual and money market funds, property and casualty insurance companies, and commercial banks.[30] All other bond issues are taxable, and may be used for sectarian projects, such as churches, by for profit corporations for their capital needs, or for projects that do not provide a significant benefit to the general public, such as a new sports stadium.[31] Taxable bonds typically require a higher interest rate on issue than tax-exempt bonds for similar financings; tax-free interest is inherently more attractive.[32]

There are two main types of municipal bonds: general obligation bonds and revenue bonds.[33] General obligation bonds are secured by the full faith and credit of the issuer—the municipality—and their repayment is typically guaranteed by the municipality's taxing power.[34] Indeed, these bonds are primarily repaid from the municipality's tax revenue sources.[35] Revenue bonds, on the other hand, are limited to being repaid from revenues derived from a specific project itself, and not any other revenue sources.[36] For example, revenue bonds might be used to build a toll road or an affordable housing facility. The bonds would then be repaid only from tolls or housing rental income.[37] Because revenue bonds are typically not guaranteed by the municipality's taxing power, they carry somewhat higher interest rates than general obligation bonds.[38]

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[29] *Id.*

[30] *The Tax-Exempt Municipal Bond Market—How Big and Who Buys?*, SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION, http://www.investinginbonds.com/learnmore.asp?catid=5&subcatid=24&id=243 (last visited Apr. 23, 2015).

[31] *Taxable Municipal Bonds*, SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION, http://www.investinginbonds.com/learnmore.asp?catid=5&subcatid=24&id=241 (last visited Apr. 23, 2015).

[32] *Id.*

[33] *Types of Tax-Exempt Municipal Bonds*, SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (2013), http://www.investinginbonds.com/learnmore.asp?catid=5&subcatid=24&id=240 (last visited Apr. 23, 2015).

[34] *Id.*

[35] *Id.*

[36] *Id.*

[37] *Id.*

[38] *Id.*

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B. Comparison to Catholic Conduit Mortgage Bonds

Bonds issued by a Catholic diocese or archdiocese, i.e. "church bonds," have many features in common with traditional municipal bonds. First, most Catholic dioceses are incorporated under the civil law of the State in which their territory resides, either as a nonprofit corporation or a "corporation sole." A corporation sole is a distinct legal entity with the same rights and obligations as other non-profit corporations, except that a corporation sole has one officer—the Bishop of the diocese—whose office is incorporated and continues in perpetual existence notwithstanding temporary vacancies.[39] Thus, just as a municipality is a collection of individuals, corporations and legal "persons" residing within a designated physical boundary, so a Catholic diocese is a communion of local Catholic parishes, schools and affiliated church entities (such as affordable housing units) residing within a defined physical boundary.[40] Second, just as municipalities levy taxes within their boundaries, the Code of Canon Law permits the Bishop of a diocese to impose a moderate tax on parishes subject to his authority.[41] All dioceses throughout the United States rely almost exclusively on donations from parishioners to support parish and diocesan financial needs.[42] While some dioceses tax parishes up to 25% of their total income, the Diocese of Scranton, for example, taxes parishes within its boundaries at a rate of 9.5%.[43] Just as municipalities can adjust tax rates year to year in order to meet their financial obligations, so can Catholic dioceses. In that respect, bonds issued and guaranteed by a Catholic diocese or archdiocese are similar to general obligation bonds issued by a municipality. Both are secured by the full faith and credit of the issuer and its taxing power. This diocesan structure reduces credit risk for repayment of the bonds, thereby reducing interest rates and the cost of financing for the parish borrower.[44] When the diocese itself issues bonds

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[39] 9 B.E. WITKIN, SUMMARY OF CALIFORNIA LAW § 399 (10th ed. 2005).

[40] THE DIOCESE OF SCRANTON: FINANCES OF THE DIOCESE, http://www.dioceseofscranton.org/about/finances-of-the-diocese/ (last visited Apr. 17, 2014).

[41] *Id.*

[42] *Id.*

[43] *Id.*

[44] WALTER J. COUGHLIN, INTRODUCTION TO CATHOLIC BONDS FOR DIOCESES, RELIGIOUS ORDERS AND OTHER CATHOLIC BORROWERS 16 (Coughlin & Company, Inc.).

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and then "lends" the proceeds to a parish within its jurisdiction, there obviously is less risk associated with repayment of the bonds than if an individual parish alone sought to issue bonds.[45] The same result occurs where the diocese guarantees the bonds issued to a parish.[46] Of course, the "talents" of parish or diocesan real estate will primarily secure bonds issued by a Catholic diocese.[47] Thus, the term "conduit mortgage bond" derives from the mortgage security provided by a parish's real estate and the fact that the diocese serves as a conduit issuer through which the bond proceeds pass to the ultimate borrower. The diocese, as a mere "conduit issuer," typically bears no repayment responsibility unless it also guarantees the bonds.

The structure of Catholic dioceses and archdioceses provide benefits in addition to their taxing power. The defined boundaries of each diocese allow for the convenience of utilizing a master indenture; that is, the contract between the bond issuer and the bondholders, in conjunction with supplemental indentures, which provide for individualized bond issuance terms for a particular parish or diocesan ministry. To accomplish this, the master indenture is designed to permit the diocese to create special-purpose nonprofit "corporate finance" subsidiaries that will succeed to the obligations of the diocese as issuer.[48] Instead of each individual parish entering a new indenture with bondholders for each subsequent bond offering affecting only a specific parish project, the diocese is able to issue bonds for a specific parish project subject to the diocese's umbrella master indenture. Where a parish needs financing for a project within the diocese, a supplemental indenture under the master indenture simplifies and streamlines the bond issuance process. However, while the municipality-like structure of Catholic dioceses enables those dioceses to issue bonds on behalf of its constituent parishes with greater ease and security, "church bonds" also differ significantly from municipal bonds in a variety of ways.

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[45] *Id.*
[46] *Id.*
[47] *See infra* notes 66–79 and accompanying text.
[48] *Final Prospectus*, THE ROMAN CATHOLIC CHURCH OF THE DIOCESE OF PHOENIX, Series 2010A Taxable Mortgage Bonds, St. Mary Magdalene Roman Catholic Parish Gilbert 5 (May 15, 2010).

C. Terms of Catholic Conduit Mortgage Bonds

It is important to consider why a Catholic diocese or parish may need to issue bonds in the first place.[49] The most common reason a diocese might issue bonds is for the construction or acquisition of land, buildings, equipment and related infrastructure.[50] As demand requires, new parish churches need to be built. Historically, Catholic institutional borrowers have typically adhered to the notion that because new facilities or improvements benefit and serve a generation of users, the funds should be borrowed and paid for over a long-term period of time that matches the useful life of the new facilities.[51] Hence, bond offerings are often preferable to other methods of financing such capital projects. For example, conventional methods of financing such as a bank loan, typically involve relatively short terms after which the borrowing must be repaid or the interest rate is reset.[52] While a bank might offer a 20-year amortization period, typically it only offers a fixed interest rate for a much shorter period of time before switching to a floating interest rate.[53] Catholic bonds however, are typically fixed for the entire term of the bond and can have up to 30-year maturities.[54] Thus, comparatively, "church bond" transactions with long-term fixed interest rates will often reduce the required debt service payments and overall cost of financing for the borrower. Next, while Catholic bonds still contain various financial covenants, they can be significantly less onerous and restrictive than those required under comparable bank financings.[55] Moreover, insurance company lenders generally do not provide construction financing, thereby requiring the borrower to complete multiple financings for a single construction effort.[56] Consequently, in order to finance large capital improvement projects as the diocese will generally require, issuing bonds is often the most logical course of action for a Catholic parish or diocese.

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[49] *Id.* at 15.
[50] *Id.* at 11.
[51] *Id.* at 8.
[52] *Id.* at 9.
[53] *Id.*
[54] *See infra* notes 80–89 and accompanying text; *see* COUGHLIN, *supra* note 44, at 4.
[55] *See infra* notes 66–79 and accompanying text.
[56] *See* COUGHLIN, *supra* note 44, at 9.

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Another common reason to issue bonds is to refinance earlier financings, whether outstanding taxable bonds, bank loans or mortgages.[57] There are a variety of reasons to pursue a refinancing transaction, including saving money, obtaining superior repayment terms, or accelerating the maturity of existing debt obligations in order to eliminate cumbersome covenants.[58] Finally, bonds might be issued simply to meet working capital needs.[59] The flexibility offered by church bonds has generated other innovative methods of financing, such as financing life insurance policy premiums in the Endowment Funding Program.[60]

Because, for the most part, Catholic bonds are not used for "public benefit" projects—such as public schools, roads or sewers, etc.—the interest payments to investors may be taxable, in contrast to most municipal bonds.[61] Indeed, tax-exempt bond proceeds may not be used to finance church buildings or "other facilities whose primary purpose is to host religious events or which exclusively serves the purposes of the religious sponsor."[62] Despite the higher interest rate a borrower must pay versus a tax-exempt financing, taxable "church bonds" have several advantages to the borrower: their use of proceeds is very flexible, they mitigate potential conflicts with municipal authorities, and taxable bonds are much better structured assets.[63]

Even with a higher interest rate, no rational investor will risk investing in Catholic bonds unless there is adequate security for their investment. The biggest underutilized "talent" of the Catholic Church is its real estate. Whether a new or existing project, the church can unlock the value of its real estate by issuing mortgage-backed bonds.[64] The mortgage in connection with the project provides the bondholders with certain rights, such as foreclosure in the event of default, as outlined in the indenture.[65] The mortgage is recorded in the county where the real property is located.

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[57] *Id.* at 11.
[58] *Id.* at 11–12.
[59] *Id.* at 12.
[60] *See infra* Part II.
[61] *See* COUGHLIN, *supra* note 44, at 8.
[62] *Id.* at 22.
[63] *Id.* at 8.
[64] *Id.* at 16.
[65] *Id.*

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Moreover, depending on the nature of the transaction and property at issue, UCC-1 Financing Statements may be filed with the appropriate Secretary of State. Under some circumstances where the borrower has a strong credit rating, a mortgage may not be required; instead, a negative lien, meaning the borrower agrees to not encumber the property with other liens, may be sufficient.[66]

In some transactions it may be necessary for the diocese to guaranty the borrowing where the creditworthiness of a subsidiary entity is not as strong.[67] This is where the municipality-like structure of the Catholic Church can be of great benefit because it enables a local parish or other less-creditworthy entity to obtain necessary financing it otherwise might not have been able to obtain or would have been able to obtain only on much less favorable terms. Indeed, the presence of a diocesan guaranty will often lower the cost of financing for the underlying borrower by reducing risk and lowering interest rates due to its taxing power and superior ability to raise funds.[68] While the diocese technically is the issuer of the bonds, the supplemental indenture to the master indenture essentially operates so as to make the ultimate borrower (e.g., the Catholic parish or school) solely responsible for making the debt service payments on the Bonds issued by the diocese.[69] Hence, whether a diocesan guaranty of the bonds is necessary depends upon the creditworthiness of the ultimate borrower, as the diocese itself really is just a "conduit" through which the bond proceeds pass.

As additional security the borrower might, depending on the transaction, include the funding of a debt service reserve fund.[70] A debt service reserve fund is typically funded from the bond proceeds and earmarked to make interest and principal payments to the bondholders in the event the borrower is unable to pay them for a short period of time—for example, six to twelve months.[71] Additionally, the borrower enters into a series of covenants for the benefit of the bondholders.[72] For example, the borrower often covenants to not incur additional indebtedness, which would

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[66] *See* COUGHLIN, *supra* note 44, at 16.
[67] *Id.*
[68] *Id.*
[69] THE ROMAN CATHOLIC CHURCH OF THE DIOCESE OF PHOENIX, *supra* note 48, at 5.
[70] *See* COUGHLIN, *supra* note 44, at 16.
[71] *Id.*
[72] *Id.*

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weaken its ability to make interest and principal payments on the bonds.[73] Liquidity ratio covenants are often utilized as well to ensure the borrower has sufficient cash available for debt service payments.[74] Finally, additional covenants include maintaining adequate insurance on, and upkeep of, assets serving as collateral for the bondholders.[75] Again, these covenants will typically be less onerous than those required under traditional bank financing.

Next, because most Catholic entities in the United States are nonprofit corporations pursuant to Section 501(c)(3) of the Internal Revenue Code, the bonds they issue will be exempt from registration with the Securities and Exchange Commission pursuant to Section 3(a)(4) of the Securities Act of 1933, which exempts securities issued by "person[s] organized and operated exclusively for religious . . . purposes."[76] However, depending on where the bonds are being offered and sold, the issuer will need to review the relevant state's Blue Sky laws, though most states have an exemption from registration that mirrors the federal exemption.

The final terms of Catholic conduit mortgage bonds to be considered are interest rate and repayment terms. As discussed above, Catholic conduit mortgage bonds typically offer fixed interest rates for the entire term of the bond and are set at a spread above U.S. Treasury rates.[77] The rates are comparable to corporate bond interest rates.[78] Moreover, because taxable bond offerings are often sold using "serial" interest rates, within each bond transaction there are multiple bond maturities.[79] In other words, if bonds totaling $1 million are issued, some of the bonds may mature in five years with a low interest rate, some may mature in ten years with a slightly higher interest rate, and some may mature in twenty years and bear a much higher interest rate. Naturally, the longer the maturity, the higher the risk of default, and the higher the corresponding interest rate. Knowing the unique nature of the church, lenders (i.e., buyers of conduit mortgage bonds) often offer favorable prepayment options for the borrower. This means that the

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[73] *See* COUGHLIN, *supra* note 44, at 16.
[74] *Id.*
[75] *Id.*
[76] Securities Act of 1933, 15 U.S.C. § 77c(a)(4) (2006).
[77] *See* COUGHLIN, *supra* note 44, at 9.
[78] *Id.*
[79] *Id.*

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Catholic borrower may opt to prepay some of the bonds *without penalty* from non-borrowed funds within five years of issuance, and thereafter from borrowed funds.[80] Prepayment has the effect of lowering future bond debt service payments depending on how many bonds are prepaid and what their maturity dates and interest rates were.[81] As a result, serial interest rates and prepayment options offer the Catholic borrower a cost effective and efficient form of financing.

But how exactly does a nonprofit church repay millions of dollars worth of bonds? The answer is through a combination of the weekly offertory at Mass, investment/endowment income, and donations/capital campaigns.[82] As of 2010, for example, the average U.S. parish's total operating revenue exceeded total expenses by about $68,000.[83] Moreover, many bishops conduct annual appeals to address diocesan and parish needs. The average amount of annual appeals collections in the United States was $5.3 million.[84] Dioceses with over 200,000 registered households collected an average amount of $12.9 million annually, with the Archdiocese of Detroit leading the way with over $25 million collected in its annual appeal.[85] Consequently, not only are conduit mortgage bonds a flexible and effective financing tool for Catholic entities, but they are also a relatively safe investment because a Catholic borrower will be able to repay the bonds and they are secured by mortgages on real estate. Below is a schematic diagram outlining the flow of funds for a typical conduit mortgage bond transaction.

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[80] *See* COUGHLIN, *supra* note 44, at 9.

[81] *Id.* at 9.

[82] *Id.* at 8.

[83] "Church Finances," UNITED STATES CONFERENCE OF CATHOLIC BISHOPS, http://www.usccb.org/about/media-relations/statistics/church-finances.cfm (last visited Apr. 17, 2014).

[84] *Id.*

[85] *Id.*

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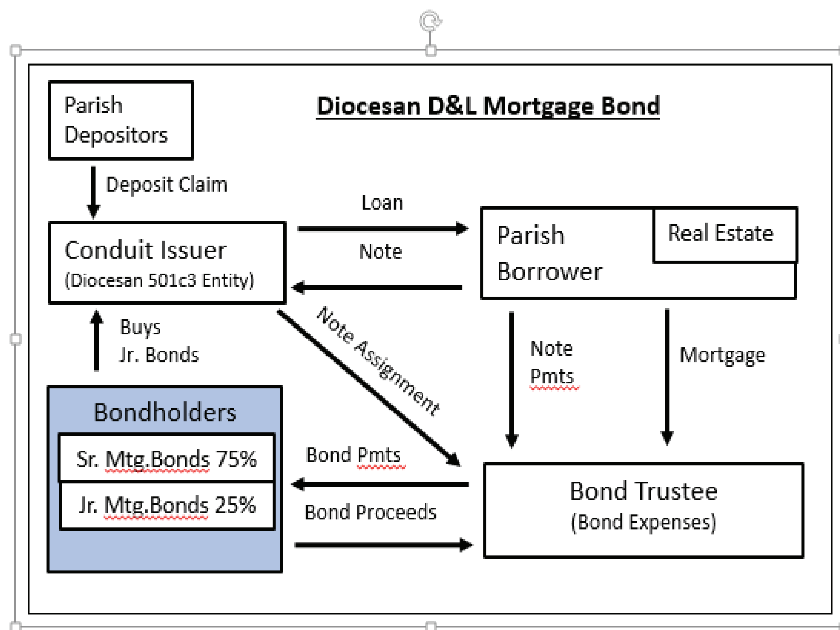

D. St. Mary Magdalene Roman Catholic Parish Gilbert Case Study

The case of St. Mary Magdalene Roman Catholic Parish in Gilbert, Arizona is an excellent example of the efficacy of Catholic conduit mortgage bonds secured by real estate. Established in July 2002, St. Mary Magdalene Parish initially held its services in a local elementary school gymnasium.[86] However, by August 2006, attendance had grown to over 1,900 people each week, and the Parish needed to move to a larger school's gymnasium to celebrate weekly Mass.[87] In need of a permanent home, the Diocese of Phoenix conveyed 20 acres of real estate to the Parish in March 2009 pursuant to a warranty deed.[88] In exchange, the Parish agreed to build a new church, school, administrative offices and parking lot on the property.[89]

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[86] THE ROMAN CATHOLIC CHURCH OF THE DIOCESE OF PHOENIX, *supra* note 48, at 9.
[87] *Id.*
[88] *Id.*
[89] *Id.*

In order to finance the acquisition of real estate and construction costs, the Parish submitted a $4.1 million loan request to the Diocese.[90] The Diocese agreed to issue $4.1 million in bonds pursuant to its Master Indenture in exchange for the Parish's promissory note.[91] Next, the Diocese engaged an investment banking institution, which recommended the use of taxable bonds because a parish church is not an eligible use of funds for a tax-exempt offering.[92] The investment banker also confirmed that a Diocesan guaranty of the bonds would *not* be needed, provided that the Diocese agree to purchase 25% of the total offering in the form of junior priority, subordinated B-bonds at a 7% interest rate.[93] The rest of the bonds would be in the form of senior priority A-bonds.[94] The parties determined that the offering would consist of $3,075,000 of Senior A-bonds maturing in years 1 through 22 and bearing interest rates ranging from 4.5% (Senior A-bonds maturing in year 1) to 6.875% (Senior A-bonds maturing in year 22) and $1,025,000 of Junior B-bonds maturing in years 22 through 25, each bearing a 7% interest rate.[95] Naturally, the Senior A-bonds rank senior to the Junior B-bonds in the payment of principal and interest following any redemption or in the event of default/foreclosure.[96] The Diocese's purchase of the B-bonds is a form of credit enhancement to induce the transaction and better attract the sale of the A-bonds. The Diocese risks the first losses with the junior B-Bonds, reducing risk as to the A-Bonds and their purchasers. Moreover, the Diocese has the option to prepay the A-bonds without penalty in whole or in part with non-borrowed funds in the first five years after issuance and from any source of funds after five years.[97]

Upon distribution of the prospectus, the investment banking institution obtained commitments for the $4.1 million bond issuance. Finally, on May 15, 2010, the Diocese of Phoenix closed the transaction, issued $4.1 million in bonds and loaned the proceeds to St. Mary Magdalene Parish in

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[90] JULIUS CAPITAL PARTNERS, *Flex-Design Deposit & Loan Program (DLP) St. Mary Magdalene Parish* 3 (2012) (on file with author).
[91] *Id.*
[92] *Id.*
[93] *Id.*
[94] *Id.* at 4.
[95] *Id.*
[96] THE ROMAN CATHOLIC CHURCH OF THE DIOCESE OF PHOENIX, *supra* note 48, at Cover Page.
[97] JULIUS CAPITAL PARTNERS, *supra* note 90, at 2.

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exchange for a promissory note.[98] St. Mary Magdalene Parish used the proceeds in several ways. First, the proceeds were used to repay in full an outstanding bank loan and another outstanding loan to the Diocese of Phoenix itself.[99] Next, the Parish paid issuance costs and accrued interest on the bonds between the Bond Dated Date and the Scheduled Closing Date.[100] Finally, the Parish used the remaining proceeds to construct the new parish church building, estimated to have a final development value of $6.3 million.[101]

Three different types of security formed the collateral, or "Trust Estate," which secured the bonds.[102] The bonds were first secured by a Deed of Trust—a type of mortgage—which unconditionally granted, conveyed and assigned to the Trustee for the benefit of the bondholders, all of the Issuer and Parish's rights, title and interest in all property held by the Issuer related to the new church development site.[103] The Deed of Trust granted the Trustee the right to foreclose on the property in the event of default, as defined in the Indenture.[104] Second, the Diocese collaterally assigned the Parish's promissory note—evidencing its obligation to repay the loan back to the Diocese—to the Trustee for the benefit of the bondholders.[105] Third, in the event the Parish was unable to make interest and principal payments for a short period of time, a Bond Reserve Fund established under the Indenture was pledged as security.[106]

Finally, the Master Indenture granted the Diocese the right to, by supplemental indenture, issue additional series of bonds in any amount as determined by the Diocese, so long as any such issuance was in compliance with conditions outlined in the Master Indenture.[107] Among other uses, such an additional issuance pursuant to a supplemental indenture could be for the purpose of refunding, in full or in part, the bonds of any prior series.[108]

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[98] *Id.* at 3.
[99] THE ROMAN CATHOLIC CHURCH OF THE DIOCESE OF PHOENIX, *supra* note 48, at 16.
[100] *Id.*
[101] *Id.*
[102] *Id.* at 30.
[103] *Id.* at 31.
[104] *Id.* at 32.
[105] *Id.* at 23.
[106] *Id.*
[107] *Id.* at 27.
[108] *Id.* at 47.

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The conduit bond transaction enabled St. Mary Magdalene Parish to obtain $4.1 million in construction financing through the Diocese of Phoenix by issuing taxable fixed rate bonds. With a 25-year amortization schedule, the Parish was able to reduce its monthly debt service payment amount to about 50% of the monthly payments otherwise available to the Parish from local bank financing or diocesan loans.[109] Significantly, the financing did not require a separate guaranty from the Diocese of Phoenix, enabling it to provide additional financing as needed to other entities under its umbrella pursuant to the Master Indenture.[110] The St. Mary Magdalene Parish transaction is but one example of the efficacy and power of conduit mortgage bonds to take advantage of the value latent in the Church's real estate, thereby enabling it to obtain financing on favorable terms it otherwise would not have been able to obtain.

II. ENDOWMENT FUNDING PROGRAM

The power of using Catholic bonds to finance needed church projects has bred innovative thinking among those seeking to actuate the meaning of the Parable of the Talents.[111] While a straightforward conduit mortgage bond transaction secured by the project is often sufficient for the initial construction, expansion, or refinancing of an entity, it does not address the entity's other long-term financial needs. Enter the "Flex Design" Endowment Funding Program. Developed by Julius Capital Partners, L.P., in conjunction with Coughlin & Company, Inc., and Immaculata Law Firm, LLC in Chicago, the Endowment Funding Program is a specialized giving campaign designed to assist a nonprofit organization in building a uniquely designed endowment intended to meet the organization's longer term funding needs.[112] Before discussing how the Endowment Funding Program works and analyzing a case study, it makes sense to first address the purpose of building an endowment.

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[109] JULIUS CAPITAL PARTNERS, *supra* note 90, at 5.
[110] *Id.*
[111] *See supra* text accompanying notes 50–62.
[112] *Final Prospectus*, CORNERSTONE CHARITABLE FOUNDATION, Series 2012A & Series 2012B Taxable Bonds 5 (June 1, 2012).

A. Why Build an Endowment?

Endowments are created to establish a financial bedrock for an organization.[113] Donors contribute "permanently restricted" funds to an investment reserve that typically cannot be used for the organization's current needs.[114] While the principal cannot be used without the express consent of the donor or a court order, the organization may use investment income from that principal in its discretion.[115] As a result, organizations with an endowment benefit from the solidity of unrestricted income that does not have to be earned or solicited.[116] Moreover, the existence of an endowment sends a sharp signal to potential donors that the organization plans to be around for a long time, which often comforts donors who want assurance that their donation will continue to benefit the organization and their community long after they are gone.[117] The "Flex Design" Endowment Funding Program was created to help build such endowments for nonprofit entities through the use of Catholic bonds.

B. "Flex Design" Endowment Funding Program Explanation

The Endowment Funding Program works best with an organization consisting of a significant number of elderly members, the importance of which is discussed below.[118] For that reason, the Endowment Funding Program was originally designed to help Catholic religious orders build endowments, as religious orders commonly have large numbers of elderly priests, nuns or brothers.[119] However, in 2008, Julius Capital partnered with Coughlin & Company, Inc. to modify the Endowment Funding Program to provide a "Flex Design" concept in order to make it available to a wider array of nonprofit organizations, such as schools, parishes and other

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[113] Mark A. Hager, *Should Your Nonprofit Build an Endowment?*, NPQ (June 21, 2006), https://nonprofitquarterly.org/management/639-should-your-nonprofit-build-an-endowment.html.
[114] *Id.*
[115] *Id.*
[116] *Id.*
[117] *Id.*
[118] *FlexEFP*, *supra* note 13.
[119] *Id.*

charitable ministries.[120] Since May 2004, there have been over fourteen completed Endowment Funding Program transactions resulting in Catholic nonprofits owning over $272 million of life insurance policies funded with over $58 million worth of bonds.[121]

The Endowment Funding Program consists of two components: a life insurance component and a donation component.[122] The Program is based on an organization purchasing life insurance policies on the lives of its eligible members, subject to their consent. The organization then names itself as the beneficiary of the policies, entitled to the death benefits as and when the insureds die.[123] For the Program to work most effectively, the organization should have "eligible participants" consisting of employees, members, donors, and constituents between the ages of approximately thirty-six and eighty-six in whom the organization has a "demonstrative insurable interest" under all applicable state regulations and statutes.[124] Ideally, the organization will be able to identify approximately seventy-five "eligible participants" willing to participate in the Program by allowing the organization to take out policies on their lives.[125] The endowment is intended to grow from the death benefit proceeds of the life insurance policies the organization owns as and when the elderly members die—the life insurance component.[126] The life insurance component also serves the important role of building the close relationships with potential donors in order to facilitate donations. Indeed, the "eligible participants" are asked to make either annual cash donations or an estate gift to the organization in order to help fund the Program, reduce the required size of bond financing, and build the eventual endowment—the donation component.[127]

Of course, the organization is required to pay the life insurance policy premiums to service the policies in order to ultimately collect the policy death benefits. This may be done through the issuance of bonds, but there are also other funding methods such as, *inter alia*, direct payments by the

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[120] *Id.*
[121] *Id.*
[122] CORNERSTONE CHARITABLE FOUNDATION, *supra* note 112, at 5.
[123] *Id.*
[124] *Id.*
[125] *FlexEFP*, *supra* note 13.
[126] *Id.*
[127] CORNERSTONE CHARITABLE FOUNDATION, *supra* note 112, at 5.

organization, death benefit proceeds available over time, charitable donations from the "eligible participants" and other donors, and policy loans or other loans to the organization.[128] These combined proceeds are used to fund sufficient reserves to ensure premium payments. Although it varies by the number of policies, typically $5 million of bond proceeds will fund approximately five years of life insurance policy premiums.[129] Depending on the age of the insureds and based on expected mortality rates under complex actuarial calculations, the organization is projected to experience negative cash flow for at least the first five to seven years of the Program, as the annual Program expenses (life insurance policy premiums, bond debt service, if any, fundraising expenses, etc.) are expected to exceed the Program's annual revenue (policy death benefits, annual fund donations and estate gift donations).[130] However, after that period, the Program's annual cash flow is expected to turn positive as the organization starts to receive the policy death benefits and estate giving and other fundraising increases.[131] Upon generating positive cash flow, such cash flow will be used to repay any outstanding loans and principal on the bonds.[132] Once the bonds have been repaid, subsequent positive cash flow passes directly to the organization, thereby building an endowment.[133]

The Endowment Funding Program utilizes so-called "Catholic bonds" as the primary method of paying the life insurance policy premiums during the initial five to seven year negative cash flow period. The organization issues taxable fixed rate bonds in three classes: A-bonds (shortest maturity and lowest interest rate), B-bonds (medium term maturity and interest rate), and C-bonds (20-year maturity and highest interest rate).[134] Naturally, the A-bonds rank senior in priority to the B-bonds, and the B-bonds rank senior in priority to the C-bonds.[135] Until the Program achieves positive cash flow,

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[128] *Id.* at 8.
[129] *FlexEFP*, *supra* note 13.
[130] *Id.*
[131] *Id.*
[132] *Id.*
[133] *Id.*
[134] *Id.*
[135] *Id.* "The offering is structured so that each class of Bonds has Loan-To-Value of less than 100% in the five years prior to stated maturity based on the 'expected case' mortality set forth in the actuarial opinion." *Id.*

the bonds are "interest only," meaning no principal is due.[136] Moreover, while the issuer will typically authorize several million dollars worth of bonds, they are typically not all issued at the same time.[137] Indeed, some of the authorized bonds will often be kept on the "shelf" to be issued in subsequent future closings as new investors are identified or as the issuer needs funds.[138]

The Endowment Funding Program is novel in the sense that the bonds are secured by the very endowment the bonds were issued to create. More specifically, the bonds are secured *solely* by a Trust Estate consisting of all of the organization/issuer's rights, title and interest in (1) the EFP Life Insurance Policies and (2) the EFP Pledged Account.[139] First, until all of the bonds have been repaid, the issuer collaterally assigns to the trustee, for the benefit of the bondholders, all of the issuer's rights, title, and interest in the life insurance policies.[140] Thus, in connection with the collateral assignment of the life insurance policies, the insurance company will pay all death benefit proceeds to the EFP Pledged Account until the bonds have been repaid.[141] In addition to the death benefit proceeds securing the bonds, the EFP Pledged Account will receive the total proceeds of the bond issuance transaction, certain minimum contributions from the donation component of the Program, and occasionally other policy loans.[142] As proceeds from the previously authorized bonds on the shelf are issued, they are placed in the EFP Pledged Account in order to pay the life insurance premiums.[143] Moreover, monies raised through annual donations and estate gifts are also in part directed to the EFP Pledged Account in order to further secure the bonds, as required under the Indenture.[144] In sum, the EFP Pledged Account has two purposes: First, it pays the operating costs of the Program, such as paying the life insurance policy premiums and bond debt service; second, it secures the repayment of the bonds.[145]

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[136] *Id.*
[137] *See infra* note 162 and accompanying text.
[138] *See infra* note 162 and accompanying text.
[139] CORNERSTONE CHARITABLE FOUNDATION, *supra* note 112, at 44.
[140] *Id.* at 45.
[141] *Id.*
[142] *Id.* at 6.
[143] *Id.*
[144] *Id.*
[145] *Id.* at 5.

The EFP Pledged Account uses the bond issuance proceeds, the death benefit proceeds, donation component proceeds, and occasionally other loans in order to *both* pay the life insurance policy premiums *and* make debt service payments on the bonds until they are repaid.[146] Again, depending on the age of the insureds, five to seven years later, death benefit and donation proceeds are actuarially projected to exceed the amount of the bond debt service payments and remaining insurance premiums.[147] This positive cash flow will serve to redeem the bonds, at which point the trustee will release the collateral assignment of the life insurance policies, and all future death benefits and donations will flow directly to the organization, thereby building an endowment.[148] The insurance companies themselves also have a variety of incentives to participate in the Endowment Funding Program. Insurance companies will reinvest premiums, obtain portfolio or risk balancing, increase their volume of issued policies, and may hedge their insurance exposure with annuities.[149]

While perhaps the best way to understand the Endowment Funding Program is by analyzing a case study, attached below are schematic diagrams outlining the Endowment Funding Program's flow of funds. The first diagram focuses on the role of conduit mortgage bonds (secured by life insurance policies) in the Endowment Funding Program, while the second diagram encompasses the entirety of the Endowment Funding Program.

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[146] *Id.* at 6.

[147] *See supra* text accompanying note 131.

[148] CORNERSTONE CHARITABLE FOUNDATION, *supra* note 112, at 5.

[149] Insurance companies receive premiums for many years, on average, before they pay death claims and they have sophisticated investment departments that reinvest these premiums until they are paid out as death claims. Therefore, even though insurance companies generally do not expect to collect more in gross premiums than they pay out in death claims, the time value of money may permit them to satisfy their return requirements because the bulk of premiums are collected earlier than the bulk of death benefits which are paid out later in the Endowment Funding Program life cycle. Moreover, insurance companies seek to balance their insurance risks so that they do not have too much exposure to one age group, type of policy, health risk, etc. By accepting the older men and women participating in the Endowment Funding Program, they are "balancing" the size and scope of their exposure. Finally, with the Endowment Funding Program, the insurance company knows that they can efficiently complete thirty to an unlimited number of cases in one effort which is much more attractive than attempting to complete a similar number of single, unrelated cases. JULIUS CAPITAL PARTNERS, *Why Do Insurance Companies Participate in the Endowment Funding Program?* (2007) (on file with author).

National Conduit Issuer Bonds

Diocese (or 3rd Party)
Conduit Issuer
Loan
Note
Borrower (Parish)
Real Estate
Securities
Insurance
Guaranty (if needed)
Note Assignment
Note Pmts
Mortgage & Pledge
Bondholders
Private Bank Bonds
Public CUSIP Bonds
Bond Pmts
Bond Proceeds
Bond Trustee (Bond Expenses)

FLEXDESIGN PROGRAM
ISSUER creates
SEPARATE EFP for benefit of
EFP BENEFICIARY
FLOW OF FUNDS

BOND INVESTORS
SERIES BONDS-1 (A,B and/or C-Bonds)
SERIES BONDS-2 (A,B and/or C-Bonds)
EFP PARTICIPANTS
INSURANCE
ANNUAL FUND & ESTATE GIFTS
Series Bond Proceeds
Series Bond Debt Service
Series Bond Proceeds
Series Bond Debt Service
Policy Applications
Cash Donations
TRUSTEE
BRIDGE LENDERS
Bond Debt Service
Total Bond Proceeds
Policy Collateral Assignment
Bridge Loan Debt Service
Bridge Loans
BOND EXPENSES
Trans.Costs (1)
Place. Agent (2)
Trustee (3)
Issuance Fee (4)
Facility Fee (5)
Policy Servicing (6)
INSURANCE COMPANY
ISSUER
OPERATING EXPENSES
FR Services (A)
Issuer Distrib (B)
Bond Expenses
Policy Death Benefits
Policy Premium Expense
Restricted Gifts
Sole Member Contributions
Operating Expenses
CAMPAIGN LLC
EFP Pledged Account Owned by Issuer (Included In Trust Estate)
Min.Contributions Required By Bond Indenture
Campaign Operating Account Owned by LLC (Excluded from Trust Estate)

Bond-Related Expense Assumptions:
(1) Transaction Costs: (% of Bond Proceeds)
(2) Placement Fee: (% of Bond Proceeds - To Placement Agent)
(3) Annual Trustee Fee: Fixed Annual Dollar Amount
(4) Bond Issuance Fee: (% of Bond Proceeds - To Issuer)
(5) Annual Facility Fee: (% of Bonds Outstanding - To Issuer)
(6) Annual Policy Servicing Fee (Fixed $ amount per policy)

Operating Expense Assumptions:
(A) Through turnkey fundraising contract with FlexDesign Consultants.
(B) An estimated % of Non-EFP Donations transferred directly to Issuer or EFP Beneficiary.

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C. Cornerstone Charitable Foundation Case Study

Cornerstone Charitable Foundation ("Cornerstone") is a Kansas nonprofit corporation created in order to financially strengthen Catholic schools, parishes and other Catholic-affiliated organizations throughout the United States.[150] St. John's Catholic School, discussed above, engaged Cornerstone and Julius Capital Partners to build an endowment for the school, which enabled St. John's to keep its school open. While this case study is specifically about Cornerstone's Endowment Funding Program for the benefit of St. John's, Cornerstone can facilitate the implementation of separate Endowment Funding Programs for the benefit of additional, separate Catholic organizations located throughout the United States by acting as a conduit on the bond issuance.[151] Indeed, Cornerstone's Master Indenture permits such replication of the Endowment Funding Program through supplemental indentures, each secured by another parish's own separate trust estate.[152] Cornerstone implements such separate Endowment Funding Programs by creating a separate subsidiary for each such Program—in St. John's case, Campaign, LLC1.[153] Each specific subsidiary maintains its own EFP Pledged Account, securing the bonds.[154] This structure is similar to Catholic dioceses issuing conduit mortgage bonds; indeed, just as a diocese utilizes a master indenture to provide bond financing to entities under its umbrella, Cornerstone utilizes a master indenture to start up separate Endowment Funding Programs for organizations under its umbrella.

To implement the Program, Cornerstone identified and purchased eighty-three life insurance policies on eligible participants in whom St. John's had a "demonstrative insurable interest,"[155] primarily members of the immediate and extended community of St. John's, along with a few priests within the Diocese of Salina.[156] As of December 31, 2011, the life

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[150] *Prospectus Supplement*, CORNERSTONE CHARITABLE FOUNDATION (Aug. 24, 2012).
[151] CORNERSTONE CHARITABLE FOUNDATION, *supra* note 112, at Cover Page.
[152] *Id.*
[153] *Id.*
[154] *Id.* at 1.
[155] *Id.* at 12.
[156] *Id.*

insurance policies had an aggregate death benefit value of nearly $23 million with an aggregate annual premium expense of nearly $1.1 million.[157] For its donation component of the Program, Cornerstone initiated an annual fundraising goal of $225,000 per year and total estate gift goal of $10 million (an average commitment of $100,000 per eligible participant).[158]

In order to pay the life insurance premiums, Cornerstone authorized three series of bonds to be sold in multiple closings.[159] In 2010, Cornerstone issued $3 million of taxable C-bonds maturing in 2030 with a 7% interest rate.[160] In 2012, Cornerstone authorized $2.5 million of taxable A-bonds maturing in 2015 with a 4% interest rate and $1 million of taxable B-bonds maturing in 2020 with a 5% interest rate,[161] but issued only $100,000 of A-bonds and $320,000 of B-bonds.[162] The remaining authorized bonds remained on the "shelf" until subsequently sold in multiple tranches during 2012 and 2013.

The Trust Estate in this example consisted of the Collateral Assignment of the life insurance policies to the trustee for the benefit of the bondholders *and* the EFP Pledged Account to secure the bonds.[163] Moreover, donations raised will be contributed to the EFP Pledged Account in order to meet financial covenants under the indenture.[164]

Risks to investment in the Cornerstone bond offering are set forth in the Prospectus of the bond issuance. The delayed mortality of the insured pool of lives, for example, will affect actuarial assumptions.[165] Indeed, if the insureds live beyond mortality assumptions used in the prospectus, the anticipated average life of the bonds could be extended or even challenge the ability of the issuer to repay the bonds at maturity.[166] Thus, the timely repayment of the bonds depends on the material accuracy of the life

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[157] *Id.*
[158] *Id.* at 14–15.
[159] *Id.* at Cover Page.
[160] *Id.*
[161] *Id.*
[162] *Closing Memorandum*, CORNERSTONE CHARITABLE FOUNDATION, Series 2012 A & 2012B Taxable Bonds 44-45 (June 1, 2012).
[163] CORNERSTONE CHARITABLE FOUNDATION, *supra* note 112, at 44–45.
[164] *Id.* at 1–2.
[165] *Id.* at 44–47.
[166] *Id.*

expectancy assumptions used in the prospectus.[167] The success of the Program also depends upon closing on at least all of the B-bonds.[168] A failure to issue all of the bonds could impair the value of the trust estate and impact the issuer's ability to repay the outstanding principal of issued bonds.[169] Finally, it is important that Cornerstone meets or exceeds projected fundraising goals under the donation component of the Program.[170]

Cornerstone's Endowment Funding Program for the benefit of St. John's seeks to build an endowment of approximately $20 million by the end of year thirty-one.[171] If Cornerstone, for example, only meets 75% of its projected fundraising goal, this would significantly reduce the size of the year thirty-one endowment to $12 million.[172] For this reason, qualified actuarial studies and diligent scrutiny of fundraising goals are important for the Endowment Funding Program to fully satisfy the organization's medium and long-term future funding needs.

III. LIFT BOND PROGRAM

Similar to the "Flex Design" Endowment Funding Program, the LIFT (Legacy Income Financing Trust) Bond Program also uses the flexibility of Catholic bonds to facilitate different forms of structured giving to charitable organizations. Consider the following situation: A donor is interested in making a substantial contribution to a nonprofit charity, but still wants, or needs, to receive income from his intended contribution. The LIFT Bond Program enables the donor to satisfy both of these goals, while also providing *immediately* available funds to the designated charity.[173] The LIFT Bond Program achieves this through the use of Charitable Remainder UniTrusts (CRUTs) in conjunction with the issuance of long-term "interest only" taxable bonds.[174]

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[167] *Id.*
[168] *Id.* at 48.
[169] *Id.*
[170] *Id.* at 49.
[171] *Id.* at 10.
[172] *Id.* at 25.
[173] *Lift Bond Funding*, *supra* note 13.
[174] *Id.*

A. Charitable Remainder UniTrusts

A Charitable Remainder UniTrust (CRUT) is a tax-exempt split-interest irrevocable trust to which a donor transfers property and retains an income stream from the CRUT.[175] The CRUT is required to make a minimum annual distribution of at least 5% of the fair market value of the trust corpus.[176] The income stream to the donor may last for a term of years, the lifetime of the donor, or the lifetime of other specified beneficiaries.[177] Upon termination of the CRUT, the CRUT "remainder" assets are distributed to the designated charity.[178] Furthermore, the use of a CRUT also provides attractive tax benefits for the donor. For example, upon establishing a CRUT, which is designed as a "grantor" trust, the donor is entitled to a current income tax charitable deduction for a portion of the value of the gift transferred to the CRUT notwithstanding that his "donation" to the organization occurs in the future.[179] Alternatively, where the CRUT is designed as a "non-grantor" trust, it can sell highly appreciated assets without incurring capital gains tax on the transfer to the CRUT.[180] Not only does the donor avoid capital gains on such appreciated assets, but also removes those assets from the donor's estate, thereby reducing the donor's gross estate for estate tax purposes, which is an estate tax planning opportunity.[181]

Under the LIFT Bond Program, the donor has the satisfaction of making a charitable contribution to an organization while simultaneously receiving beneficial tax treatment and an annual cash flow from the donated funds. However, the charitable organization is still required to wait until the termination of the CRUT, at the end of a term of years or the death of the donor, to receive the donated "remainder" corpus of the trust. The LIFT

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[175] JULIUS CAPITAL PARTNERS, *What is a Charitable Remainder UniTrust?* (2012) (on file with author).

[176] *Id.*

[177] *Id.*

[178] *Id.*

[179] Giving to Stanford, *Charitable Remainder Unitrusts*, STAN. UNIV., http://giving.stanford.edu/planned-giving/giving-options/charitable-remainder-unitrust; "In the current low interest rate environment, a CRUT creates a substantial current-year charitable deduction." JULIUS CAPITAL PARTNERS, *supra* note 175.

[180] JULIUS CAPITAL PARTNERS, *supra* note 175.

[181] *Id.*

Bond Program modifies this result, enabling the charity to immediately receive the donated funds through the issuance of bonds.

B. LIFT Bond Program Explanation

The LIFT Bond Program enables a charitable organization to issue long-term "interest only" taxable bonds that ultimately, through a CRUT, the organization will not be obligated to repay the bond principal.[182] The first step is for a donor to contribute assets to a CRUT with the intention of making a donation to a charitable organization participating in the LIFT Bond Program.[183] The donor realizes the previously discussed tax benefits. The CRUT then uses the donated assets to purchase previously authorized LIFT-qualifying bonds from the donee-charitable organization's shelf offering, the proceeds of which will be *immediately* available to the organization.[184] Because the CRUT is required to make a minimum annual distribution of at least 5% of the trust corpus, LIFT-qualifying bonds must have a fixed rate of at least 5% interest.[185] Once the CRUT purchases a LIFT-qualifying bond from the charity, the charity pays interest on the bond for the term of the CRUT or the life of the donor, whichever is less.[186] These interest payments then flow back to the donor—the "lead" interest annual cash flow the donor was expecting.[187] Finally, upon termination of the CRUT, the remainder—i.e., the bond principal and any cash-build up—reverts to the charity, thereby effectively extinguishing the principal due on the bonds.[188] Thus, from the charity's perspective, the bonds are "interest only" as it is not obligated to repay the principal. The charity may spend the LIFT Bond proceeds immediately and without restriction.

Charitable organizations participating in the LIFT Bond program typically utilize a shelf offering enabling it to issue bonds as needed or as donors are identified.[189] The master indenture saves time, effort, and

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[182] JULIUS CAPITAL PARTNERS, *supra* note 175.
[183] *Id.*
[184] *Id.*
[185] *Id.*
[186] *Id.*
[187] *Id.*
[188] *Id.*
[189] *Id.*

expense as smaller "take downs" off the shelf can be completed efficiently.[190] Moreover, the organization is not under any obligation to issue the entire amount of the bonds.[191]

Finally, it is important to note that any bond with an interest rate over 5% could potentially qualify as a LIFT Bond. In the Cornerstone Charitable Foundation case study from above, Cornerstone issued A-bonds at 4%, B-bonds at 5%, and C-bonds at 7%. A donor seeking to make a charitable contribution to St. John's Catholic School could do so by purchasing $200,000 worth of C-bonds through a CRUT. Cornerstone would make interest payments on the bonds—which would flow back to the donor via the CRUT—and, upon termination of the CRUT, the $200,000 would revert back to Cornerstone for the benefit of St. John's. This raises a few implications. First, while the LIFT Bond Program can serve as its own distinct structured giving program for a charity, it can also be a part of the "donation component" of the larger Endowment Funding Program. Indeed, the LIFT Bond Program enhances the Endowment Funding Program because the donation becomes immediately available to the charity, enabling it to immediately contribute those funds to the EFP Pledged Account during the initial negative cash flow period of the Program, instead of having to wait up to 20 years to receive the funds. This brings us to a second implication—LIFT Bonds are very flexible in terms of how they are secured.[192] They can be secured by life insurance policies, the Endowment Funding Program's Pledged Account, mortgages on real estate, guarantees from a third party (such as a Catholic diocese), or by other assets.[193]

In conclusion, the LIFT Bond Program provides benefits to both the donor and the donee. The donor is able to make a donation to a charity of his choosing while still receiving an annual cash flow and enjoying beneficial tax treatment. The charity receives the donated funds immediately and without waiting a term of years. Moreover, the LIFT Bond Program typically results in debt service savings of at least 30% for the

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[190] *Id.*
[191] *Id.*
[192] *Id.*
[193] *Id.*

charity.[194] As such, the Program is a very cost-effective method of financing for Catholic nonprofit organizations.

IV. NEW DEVELOPMENTS—COMBINING THE PROGRAMS

Until recently, Catholic conduit mortgage bonds, the Endowment Funding Program, and the LIFT Bond Program were used as distinct alternative financing transactions and implemented separately, depending on the organization's financing needs. The latest development in the realm of Catholic bonds is to combine all three programs into one comprehensive financing structure. For example, consider a school that needs to repair its facilities, but is also interested in building an endowment for the future. In that case, conduit mortgage bonds (for repairs) can be issued with the Endowment Funding Program structure already in place for future endowment building. Below is a brief discussion of how such a transaction may be structured.

In order to issue conduit mortgage bonds with the Endowment Funding Program and LIFT Bond Program already in place, the Master Indenture must authorize such an issuance. Simply put, the Master Indenture will need to authorize by supplemental indenture the issuance of four series of bonds—X-bonds, A-bonds, B-bonds, and C-bonds. However, the X and A-bonds require separate security from the B and C-bonds. Under this example, the X and A-bonds serve as the conduit mortgage bonds and are primarily secured by a mortgage on the organization's real estate, as discussed above. The B and C-bonds constitute the Endowment Funding Program and/or LIFT Bond Program bonds and are primarily secured by life insurance policies, as discussed above. As such, the X and A-bondholders may look *only* to X and A-bond trust estate (consisting of the real estate, etc.) upon default and *not* to the B and C-bond trust estate, and vice versa. All four series of bonds are to be authorized, but the B and C-bonds may well sit on the shelf until the organization is ready to implement the Endowment Funding Program or as structured giving opportunities arise.

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[194] *Id.*

CONCLUSION

Bonds have proven to be an important solution in enabling Catholic nonprofit entities to keep their doors open, construct new facilities, further their missions, build endowments, and facilitate structured giving. Indeed, but for the Endowment Funding Program, St. John's Catholic School likely would have closed its doors, an unnecessary fate that far too many other Catholic schools around the country have needlessly suffered. The innovative Endowment Funding Program enabled St. John's to build an impressive endowment, thereby ensuring its long-term viability as an academic institution. Finally, the LIFT Bond Program has proven to be instrumental in facilitating structured giving and an ideal counterpart to the Endowment Funding Program. These methods of bond financing are innovative in their application of basic finance concepts to the Catholic context. Indeed, Catholic conduit mortgage bonds are essentially a mortgage-backed security. While these innovative methods of bond financing are currently being employed primarily in the Catholic context, they certainly have applicability to other nonprofit organizations in financial need. Without a doubt, so long as the Parable of the Talent's mandate to productively employ one's talents in the best possible manner is kept in mind and taken to heart, innovative financing solutions will continue to be unearthed.

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