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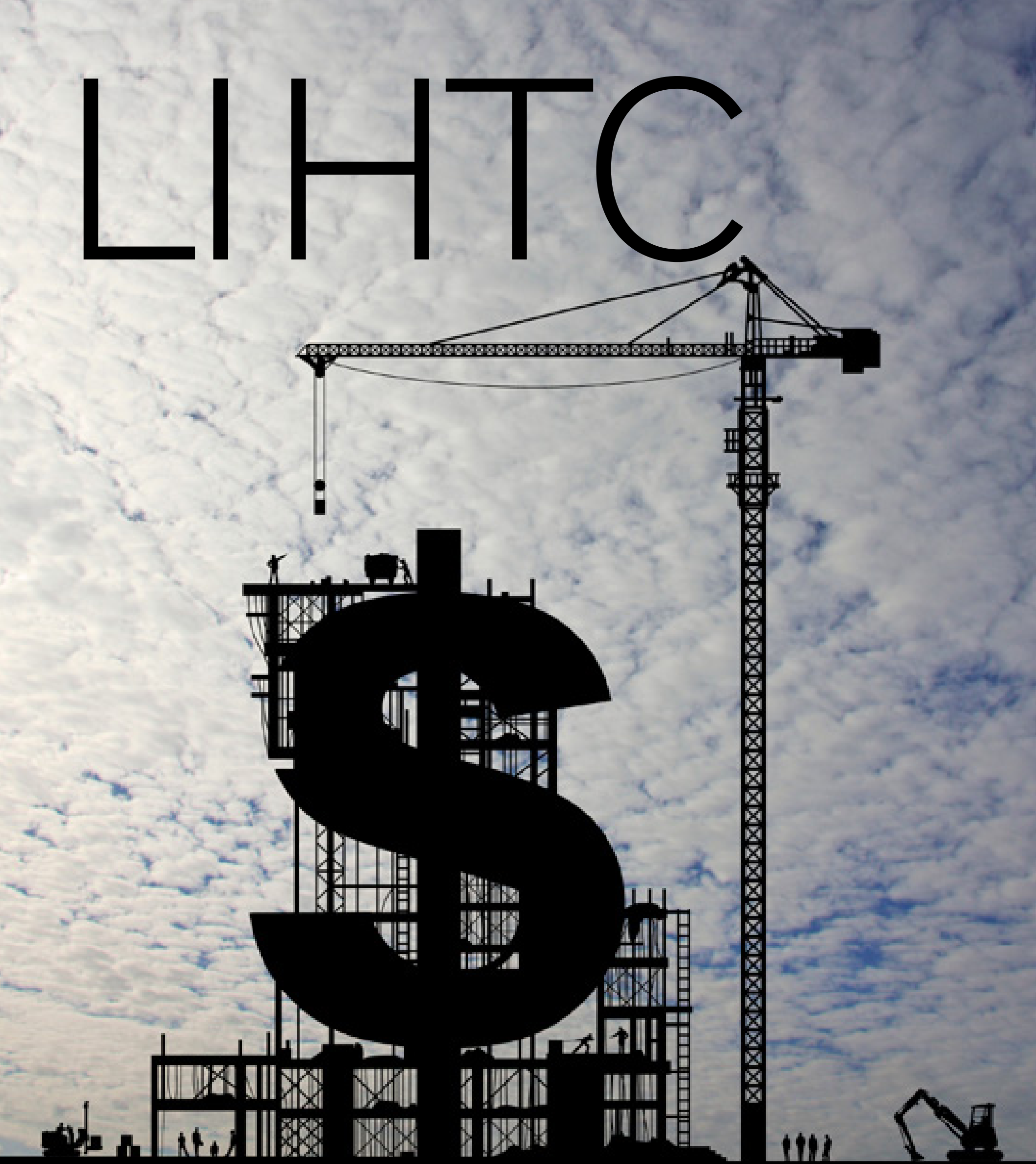

Workouts and Bankruptcies Involving Low-Income Housing Tax Credits

An Informational Guidebook

THOMPSON COBURN LLP

Table of Contents

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LIHTC

Low-income housing tax credit workouts and bankruptcies: Understanding the basics

Over the last several years there has been an increase in defaults in loans made to finance affordable housing projects. Many of these projects involve a blend of senior debt financing from a bank lender and investor equity obtained through the sale of low-income housing tax credits (LIHTCs) awarded for the project. When these projects fail, they present unique restructuring and insolvency issues. This first section is meant to familiarize the reader with the basic concepts of LIHTC financing that must be understood before becoming involved in workouts or bankruptcies involving LIHTC projects.

The subsequent sections of this booklet will discuss specific issues unique to LIHTC project workouts and bankruptcies.

What is the LIHTC program?

As part of the Tax Reform Act of 1986, Congress established the federal LIHTC program to incentivize the acquisition and development of affordable housing. Under this program, federal tax credits are awarded to a developer in consideration of the developer's commitment to lease a fixed portion of units in a housing project to low-income tenants. Various states have state low income housing tax credit programs that award state tax credits and mirror the federal program in many respects. Both the federal and, where applicable, state programs are administered at the state level by the designated housing finance agency for each state.

When a project is initially approved, tax credits are allocated to the project by the state housing agency. The aggregate amount of tax credits allocated to a project is based on the qualified costs of the project and the amount of units dedicated to low-income tenants. The tax credits are earned in equal installments over a 15-year compliance period, but may be claimed on an accelerated basis over a 10-year tax credit period, beginning when the project is placed in service. When used, the credits reduce the tax liability of the taxpayer on a dollar-for-dollar basis.

A developer may claim the tax credits directly, but most developers do not have an immediate use for the credits and sell them to raise equity capital for the project. The developer can sell the right to receive the credits either directly to an investor or to a syndicator, who assembles a group of investors and acts as their representative. Importantly, however, the credits cannot be sold outright because they are earned by the project on a yearly basis and must be claimed by a party with an interest in the project.

As a result, a "sale" of the credits is structured as a sale of an equity interest in the project and the tax credits are allocated pursuant to the entity organizational documents to the purchaser/equity investor at the end of each year in which credits may be claimed over the 10-year tax credit period. In the event that the project is sold or foreclosed upon, the right to receive any future credits that may be claimed will pass to the new owner of the project, assuming continuing compliance with the applicable conditions/restrictions on the project.

Rent and occupancy restrictions

As a condition to receiving tax credits for a project, the developer must agree to lease a certain portion of units to tenants that meet specified income limitations at a rental rate fixed by the state housing agency. At a minimum, the developer must set aside either 40% of the units for residents that earn no more than 60% of the area's median income or 20% of the units for residents earning 50% or less than the area's median income. Many developers agree to greater restrictions in order to induce the state housing agency to award tax credits for their project.

The rent and income restrictions on the project initially extend for 15 years from the date that the project is placed in service, but the project must also maintain the rent and income restrictions for an additional 15-year period known as the "extended use" period. The restrictions are evidenced by a Land Use Restriction Agreement (LURA) that is recorded as an encumbrance against the property and is generally binding on a subsequent owner of the property.

One exception to the binding nature of the LURA is that it typically may be foreclosed away by the secured lender on the project. Both the LURA and federal law provide that a foreclosure terminates the LURA, subject to the secured lender's compliance with a "decontrol period." The decontrol period is a 3-year period following a termination of the LURA, during which the secured lender may not (i) evict or terminate the tenancy of any low-income tenant other than for good cause, or (ii) increase the rent for any such tenant above the rent-restricted rate established by the state housing agency.

Typical ownership structure of LIHTC projects

The typical ownership structure for an LIHTC project is a limited partnership in which the tax credit purchaser/investor is a 99%+ limited partner. The general partner is responsible for managing the project and the partnership, while the limited partner is typically limited to a passive investment role. In today's market, investors typically pay anywhere from $.80 to $1.00 per dollar of federal tax credits allocated for a project, depending upon the quality of the project and the reputation of the developer.

If state tax credits are also awarded for the project, they are typically purchased by a different tax credit investor, who retains a small limited partnership interest in the project. State tax credits are considerably less valuable than federal credits because there is a much lower demand for state credits.

LIHTC project development and placement into service

The construction (or rehabilitation) of a project is generally financed by both senior secured debt, in the form of a construction loan, and by the tax credit investor's equity that is received in return for the right to receive the tax credits awarded for the project. Usually, both the senior debt and the investor's equity are advanced in installments as construction progresses. When the project is completed and placed into service, the final installment of the investor's equity is normally due and is used by the partnership to pay-down the senior debt to a "permanent" (long-term) amount, to fund various reserves required under the senior loan and to pay a fee to the project's developer.

Upon the paydown of the senior debt to the permanent loan amount, any guarantees given by the developer or its principals to the senior lender must terminate. This is a unique aspect of the federal tax credit program, which requires senior debt on LIHTC projects to be non-recourse following the placement of a project into service.

Once the project is placed into service, the state housing agency will review the construction and the cost allocations and, assuming the project is compliant, will issue IRS Form 8609 certifying the project and triggering the annual flow of the tax credits.

Tax credit recapture

Because the tax credits are paid out over a 10-year period but earned over a 15-year period, one-third of the tax credits received each year during the first 10 years of a project's life are unearned and subject to recapture in the event that the project fails to comply with the income and rent restrictions or is otherwise not in compliance with LIHTC regulations.

The closer the project approaches its 10-year anniversary, the greater the amount of credits that have been distributed to the investors that have not yet been earned and are subject to recapture. For example, if the project becomes non-compliant at the end of year 10, a full 5 years of credits will be subject to recapture.

Residual interest in the project

At the end of the 15-year compliance period, the tax credit investor will have received all of the tax credits for which it bargained and is no longer at risk of recapture. As a result, the investor typically exits the partnership by selling its interest in the project to the developer.

What are the unique dynamics of a low-income housing tax credit workout?

In any negotiation, there is one critical factor that ensures a successful outcome: Leverage. In the still-developing area of low-income housing tax credit workouts and bankruptcies, secured lenders may feel relatively powerless. But armed with knowledge concerning several key leverage points, a lender can better protect its interests and negotiate an advantageous outcome of a troubled loan.

To begin, a secured lender should carefully consider and have a firm understanding of the following three important topics: (i) the dynamics between the project developer and the tax credit investor(s) and what each has at risk in the project; (ii) the status of the project and its position in the LIHTC lifecycle; and (iii) the value of the project, both as a rent-restricted property and as a market-rent property, and the impact of any future unclaimed tax credits on the overall value of the project.

The relationship between the developer and the tax credit investor(s)

The first issue that a secured lender must confront in a LIHTC workout is who must be summoned to the negotiating table.

The developer of a LIHTC project is in operational control of the project, acts as the general partner/managing member of the borrower and is the lender's primary point of contact. As a result, the developer will be at the negotiating table by default. Unfortunately, however, in most circumstances, the developer formally owns less than a 1% interest in the project and does not have a primary economic interest in its success or failure. Moreover, although the developer initially guarantees the secured lender's construction loan on the project, once construction is complete and the project is placed into service, the developer's guaranty will terminate and the developer will have little direct exposure to the lender for a failed project.

This is not to say that the developer doesn't have any interest in the success of the project. However, its interests are not the typical interests of an owner. The developer's primary interests include (i) its right to receive cash flow from the project (typically in the form of management fees), (ii) its residual interest in the project at the conclusion of the 15-year tax credit compliance period, and (iii) the risk to its reputation should the project fail. In addition, the developer typically has guaranty exposure to the tax credit investor in the event that the investor fails to receive the tax credits that it has been promised.

Until the end of the 15-year compliance period, the tax credit investor (or investors, if state tax credits have also been awarded for the project) is the primary economic stakeholder in the project. As a result, it's a critical party to have at the negotiating table in a workout. Not only may the tax credit investor have unfunded capital contributions that can paid into the project (which are typically pledged to the lender), but even if it has fully funded its required capital contributions, it has a significant incentive to avoid a foreclosure. If a workout is possible, the tax credit investor can preserve its right to receive future tax credits and avoid the risk that credits it has already claimed will be subject to recapture.

To assess a tax credit investor's incentive to invest additional capital into a project, it is important to know whether the limited partner has purchased the tax credits for its own benefit or whether it has syndicated the tax credits to a group of investors. If the limited partner has syndicated the tax credits, its motivation and ability to commit additional capital to a cash-strapped project may be compromised in two ways. First, the pool of remaining funds from the syndication may be limited, and the syndicator may be unable or unwilling to approach its investors for additional capital to inject into the project. Second, the risk associated with the loss of future tax credits and/or a recapture of credits previously claimed will be spread among many investors and tied to the success or failure of other projects, leaving them with less of an incentive to protect their investment on any given project.

One additional advantage to having the tax credit investor at the negotiating table is that the lender may be able to influence change in management without having to resort to litigation. A tax credit investor typically has the right under the partnership's organizational documents to remove and replace the developer/general partner any time the mortgage loan is in default, the project is out of compliance, or the tax credits are otherwise in jeopardy. Thus, if a managerial or operational change is deemed necessary by the secured lender, the lender may subtly (or not so subtly) motivate the tax credit investor to invoke its right to replace the developer/general partner. A secured lender should be careful, however, not to insist on such a change without good cause, and should be wary of an accusation by the general partner that the secured lender is "colluding" with the limited partner to oust the general partner from the project.

The final important point for the secured lender to keep in mind when negotiating with the general partner and tax credit investor(s) is that while the developer and the tax credit investor(s) have differing roles, interests, and risks, their primary objectives in a workout are usually the same — to preserve their interests in the project and forestall a foreclosure for as long as possible. Each month that the borrower continues to own and operate the project, (i) the developer is paid a management fee, (ii) the tax credit investor(s) continue to receive the benefit of the tax credits associated with the project, and (iii) the developer's exposure to the tax credit investor(s) under its tax credit guaranty is reduced. Indeed, because tax credits are pro-rated at the end of any year in which a transfer of ownership occurs — based on the number of days each party owns the property — the general partner and tax credit investor(s) have a strong incentive to do whatever is necessary to "hold on" just one more day.

The importance of the LIHTC lifecycle

The timing of a default — in relation to when the project is placed into service and its tax credits start to flow — has a significant impact on a secured lender's leverage against the developer and the tax credit investor.

If the project has not yet been placed into service, a foreclosure will leave the secured lender with a project that is potentially uncompleted. However, the developer's guaranty will still be in place and the lender will have a direct claim against the developer for repayment of its loan. There may also be one or more significant installments left on the tax credit investor's capital contributions. Although the lender typically has a pledge of those installments, the tax credit investor's obligation to pay the installments is typically subject to various conditions, including the absence of a default under the mortgage loan documents. Thus, whether the tax credit investor will make the installments (thereby putting more of its capital at risk) when the project is in default depends upon the investor's assessment of the certainty of receiving the full stream of tax credits which it has been promised.

If the project has already been placed into service when there is a default on the secured lender's loan, it is important for the lender to assess the value of the allocated but unearned tax credits and the recapture exposure to the tax credit investor.

It has been suggested by some commentators that the value of the remaining tax credits on a project should always be two to three times the mortgage loan balance and that, as a result, a tax credit investor always has a strong incentive to support a troubled project to avoid a foreclosure. Indeed, in a white paper published by Vine Associates, the author concludes that "for the first 12 years the tax credit investor would be better off economically to pay off the mortgage loan balance at a total loss, than to take the consequences of a foreclosure." In our experience, however, the value of the remaining tax credits frequently does not exceed the balance of the mortgage loan, let alone by two to three times. In such a scenario, the tax credit investor's decision to invest additional capital into the project in order save its credits is not so clear cut.

In our experience, the tax credit investor's decision to invest additional capital into the project to cure defaults under the mortgage loan is a function of (i) the value of future unearned tax credits that will be lost in the event the lender forecloses on the project, and (ii) the tax credit investor's assessment of its risk of recapture and the seriousness of that risk in the event that the mortgage lender forecloses on the project and the project is converted to a market-rent property. Thus, it is important for the secured lender to determine as best it can the fulcrum at which the tax credit investor is better off investing additional capital into the project versus taking the consequences of a foreclosure.

Understanding the value of the project

The third important topic that the secured lender must confront is the value of the property at the moment of foreclosure. In a foreclosure, the lender has the option of foreclosing out the Land Use Restriction Agreement (LURA) and converting the project to a market-rent project. However, not all projects are more valuable as market-rent projects. In fact, given the location and condition of the project, it may not be possible to raise rental rates beyond the rent-restricted rates. Moreover, although the secured lender can extinguish the LURA and the rent restrictions, it (and any subsequent owner) must still honor a three-year decontrol period, so the economic impact of converting the project to a market-rent project will not be immediate. Finally, and most importantly, if the property is converted to a market-rent project, the value of any remaining tax credits, which may be claimed by a subsequent owner of the project, will be lost.

To evaluate its options, a secured lender should obtain an appraisal of the project that values the project as both a rent-restricted property and a market-

rate property, and identifies the impact of the decontrol period on conversion. Moreover, within the rent-restricted valuation, the appraisal should include values for both the bricks and mortar of the property and for the remaining tax credits allocated to the project.

Appraisers have very different methodologies for valuing remaining "mid-stream" tax credits. We will address the issue of valuation in a later section. For now, however, it is sufficient to note that the lender should select an appraiser with significant experience in valuing LIHTC projects. In addition, the lender should be knowledgeable in the practical aspects of what must be done to market the project for sale following foreclosure in order to realize the appraised value of the tax credits.

The valuation process for LIHTC projects in financial distress: Part I

In the previous section, we wrote about the importance of a secured lender understanding the value of its collateral in a workout or bankruptcy involving a low-income housing tax credit (LIHTC) project. In Part I and Part II of this section, we'll delve into the subject of valuation in greater depth.

Why is valuation important?

In any workout or bankruptcy, it is important to understand the value of a lender's collateral, because the value of the collateral will largely determine the amount of the lender's recovery. This is particularly true in a workout or bankruptcy involving an LIHTC project because under the federal LIHTC program, once a project is placed into service, all senior debt of the project owner must be non-recourse to the partnership and its partners. In other words, the lender's only recourse will be to the project itself.

If the project is in bankruptcy, the valuation of a lender's collateral can be even more important. Under Section 506(a) of the Bankruptcy Code, a lender's claim is bifurcated into (i) a secured claim in an amount equal to the value of the lender's interest in its collateral, and (ii) an unsecured claim for the balance of the debt owed to the lender. A borrower/debtor may "cram-down" a plan of reorganization on the lender if it pays the lender the full amount of its secured claim, with interest, over a reasonable period of time and satisfies various other requirements set forth in the bankruptcy code (which, in most cases, do not require the payment in full of the lender's unsecured claim). In short, the amount that a lender receives in a bankruptcy is also largely determined by the value of its collateral.

What is unique about the valuation of an LIHTC project?

There are four unique aspects of an LIHTC project that impact valuation when compared to the valuation of a typical real estate project.

1. An LIHTC property is burdened by rent and occupancy restrictions of a Land Use Restriction Agreement (LURA), which limit to whom units in the project may be rented and the amount of rent that may be charged.
2. An LIHTC project benefits from federal (and in some cases state) tax credits that can be used to reduce the tax liability of the owner on a dollar-for-dollar basis, provided the property remains in compliance with the rent and occupancy restrictions.
3. While a lender can likely foreclose away the LURA and convert the property to a market-rate property, the lender (and any subsequent owner) must still honor a three-year "decontrol period" during which rents may not be increased for existing tenants.
4. Many LIHTC projects benefit from and are burdened by a Section 8 Housing Assistance Payments (HAP) contract that may, or may not, survive a foreclosure and resale of the project.

It is imperative that a valuation of an LIHTC property addresses each of these unique aspects of an LIHTC project.

Who is qualified to appraise an LIHTC project?

The Uniform Standards of Professional Appraisal Practice (USPAP) contains guidelines for the appraisal of real estate. Licensed appraisers are compelled to comply with USPAP through state law. Advisory Opinion 14 of USPAP specifically addresses the appraisal of subsidized housing and states that "the competency required to appraise subsidized housing extends beyond typical residential appraisal competency." The Advisory Opinion warns that the appraiser must understand the programs, definitions, and relevant tax considerations of subsidized housing, as well as local market conditions, and supply and demand characteristics of subsidized housing. In addition, the appraiser must be aware of anticipated changes that may affect the durability of the benefits and restrictions to subsidized housing projects and understand the interpretation and enforcement of subsidy programs.

In short, great care should be taken in the selection of an appraiser with experience in appraising LIHTC projects.

Should remaining tax credits be included when valuing an LIHTC property?

It has been argued that tax credits are intangible property that should not be considered when determining the value of a lender's lien on an LIHTC project. However, three different appellate courts* have been presented with this issue and have concluded that the value of an LIHTC project must include consideration of the value of any remaining tax credits available for the project. In the Lewis and Clark Apartments case, the 8th Circuit Bankruptcy Appellate Panel states:

"[T]ax credits – like a low property tax rate or good schools – are a benefit which accrues only to those who have an ownership interest in the apartment complex itself. For that reason, we hold that those credits and the accompanying restrictions have an effect on the amount that a willing buyer would pay to purchase the real estate: i.e., its value."

Unfortunately, no court has provided any clear guidance regarding the methodology to be used in valuing the tax credits or for determining the contributory value of the tax credits on the project itself. Rather, these courts have left it to the discretion of the bankruptcy courts to hear evidence and determine what "due consideration" should be given to the value of any remaining tax credits.

Not only have the courts failed to provide any clear guidance as to how appraisers are to value remaining tax credits, there is no "industry standard" or uniform methodology for determining such value. Fannie Mae's Appraiser

Engagement Instructions (Form 4825) states:

"The Appraiser or third-party valuator should consider the current secondary market for tax credits and consider what incremental value, if any, would be added to the price of the Property by virtue of the Tax Credits remaining. The Appraiser or third-party valuator needs to determine what net proceeds would result from a re-syndication or resale of the Property. Because there is no one 'industry standard' for how appraisers make such a determination, the Appraiser or third-party valuator shall set forth factors utilized in reaching his/her determination."

*In re Creekside Senior Apartments, 477 B.R. 40 (6th Cir. BAP 2012); In re Lewis and Clark Apartments, L.P., 479 B.R. 47 (8th Cir. BAP 2012); In re Sunny Slope Housing Limited Partnership, U.S. District Court for the District of Arizona, Case 2:11-cv-02579-HRH at Dkt. 92.

The valuation process for LIHTC projects in financial distress: Part II

In Part I of this two-part section, we covered the various unique aspects of LIHTC project valuations and how the value of tax credits factors into a valuation. In this section, we'll dive deeper into how an appraiser might approach a valuation, and some concerns that courts have raised about the valuation process for these types of redevelopment projects.

What does a typical LIHTC appraisal look like?

A comprehensive LIHTC appraisal covers four separate valuation scenarios:

1. The value of the "bricks and mortar" of the project, assuming the project is continuously operated as a rent restricted project.
2. The value the bricks and mortar under a hypothetical assumption that the project is immediately converted to, and operated as, a market-rate property.
3. The value of the property assuming compliance with the three-year decontrol period, during which units may only be increased to the market-rate when and if low income tenants vacate units.
4. The value of the tax credits associated with the project, which will be available only if the project is continuously operated as a rent-restricted project.

The appraisal will then determine which of the scenarios, or combination thereof, yields the highest and best overall market value of the project. The overall market value will typically be either a combination of the first and fourth scenarios (i.e. the collective value of the bricks and mortar and the tax credits assuming the property remains a rent-restricted property) or the fourth scenario (the value of the property assuming conversion to a market-rate property following compliance with the three-year decontrol period).

How are remaining tax credits valued?

Tax credits are typically valued using one of two methods. The starting point for both methods is to determine the remaining dollar amount of allocated but un-earned tax credits (i.e. the amount of tax credits that may be taken over the remaining tax credit period). The first method (the comparable sales method) values the credits based on what investors are paying for similar tax credits in the market. The second method (the discounted cash flow method) determines the present value of the tax credits using a discounted cash flow analysis.

Appraisers usually place the most emphasis on the comparable sales method. But the problem with the comparable sales method is that there is very little empirical data regarding the sale of "mid-stream," non-investment grade tax credits. As a result, many appraisers rely on a survey of prices paid by institutional investors for newly issued tax credits and then choose a mid-value or low-end of the range of such prices to account for the risk factors associated with a purchase of the particular tax credits at issue. While this approach seems logical, it has been criticized by at least one Court for its simplicity and its failure to consider the actual characteristics of the tax credits at issue.

In Sunnyslope Housing*, the Court heard testimony from two expert appraisers which the Court determined "are among the most highly skilled and respected experts in the field [of LIHTCs]." Despite the experts' credentials, the Court criticized the methodologies undertaken by both experts and concluded that neither expert's ultimate conclusion of value was persuasive.

The lender's expert utilized a survey of prices paid by for newly issued tax credits and testified that an investor could be expected to pay at the lower end of the range reported in that survey. The Court criticized this approach on the basis that it "fail[s] to take into account any risk factor based on the lack of a tax credit guarantee [which a purchaser would normally receive in connection with a new project], or the fact that this is a mid-stream deal and clearly not investment grade." The Court also pointed out that this approach also results in a double-counting of the value of tax benefits flowing from owning property other than LIHTCs. "These other tax benefits [namely, depreciation and interest expense deductions] exist for all income producing property regardless of whether LIHTCs are associated with it, and therefore these values have already been accounted for when the Court determined the value of the real property." The Court concluded that these deficiencies, "render the [expert's analysis] almost useless in determining the current fair market value of the Debtor's LIHTCs. It amounts to little more than adding up the total future amount of tax credits and then discounting that to present value, while ignoring virtually all of the salient risk factors."

The Court was similarly unimpressed with the valuation analysis proffered by the Debtor's expert. The Debtor's expert testified that based on a market survey she conducted (which included only one response from a non-traditional investor) there is no market for tax credits like those owned by Debtor. She further testified that because the potential market for the Debtor's tax credits could not exceed 2% of the total market, a discounted cash flow analysis that she performed using a 30% discount factor should be given a weight of only 2%.

The Debtor's expert testified that based on a market survey she conducted (which included only one response from a non-traditional investor) there is no market for tax credits like those owned by Debtor. She further testified that because the potential market for the Debtor's tax credits could not exceed 2% of the total market, a discounted cash flow analysis that she performed using a 30% discount factor should be given a weight of only 2%.

The Court commended the Debtor's expert for attempting an actual market survey based on the characteristics of the Debtor's remaining tax credits, but concluded that the survey was "far too small to be conclusive." The Court also criticized the expert for giving only a 2% weight to her discounted cash flow analysis and concluded that the best evidence of the value of the remaining LIHTCs was the value determined by her discounted cash flow analysis using a discount factor of 30%.

The Sunnyslope case illustrates the complications involved in valuing "mid-stream" tax credits. Such credits have very distinct characteristics that must be taken into consideration by the appraiser on a case by case basis. Where the value of the credits will be contested, an in-depth market survey based upon the actual characteristics of the remaining tax credits is highly recommended.

Does appraised value translate into actual value?

The final point for a lender to keep in mind is that the appraised value of an LIHTC project is nothing more than an "educated guess." It does not necessarily translate into actual value. If the lender forecloses on the project or accepts a deed-in-lieu, the lender must ultimately be able to sell the project in order to realize value. Because the pool of prospective purchasers for a LIHTC property is much different, and much smaller, than the pool of purchasers for a market-rate property, lenders are well advised to develop a marketing plan prior to taking over an LIHTC property. Moreover, if the lender has an OREO group that manages foreclosed properties, it should involve that group early in the foreclosure process.

* In re Sunnyslope Housing Limited Partnership, 2012 WL 6479735 (Bankr. D. Ariz. 2012)

Getting the house in order: The early stages of a LIHTC workout

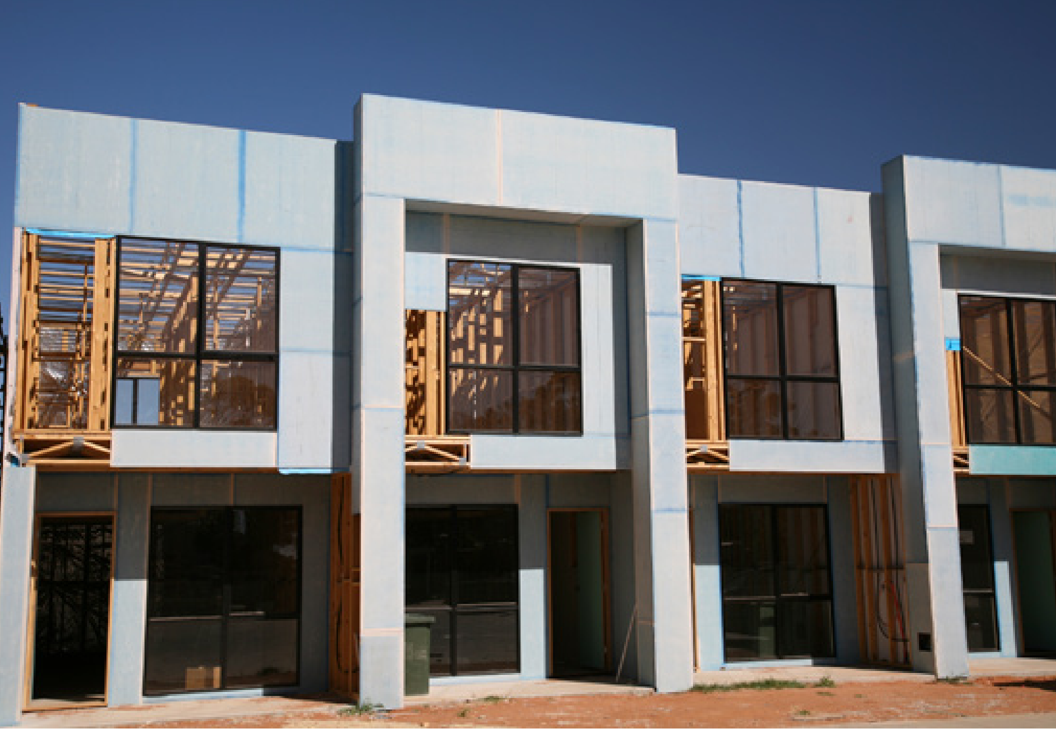
Loan workouts involving distressed LIHTC projects are similar to workouts involving market-rate properties in some respects. In particular, they both frequently involve an initial "forbearance period" during which the borrower is given an opportunity to improve performance and then, if performance is not improved, result in one of three outcomes: (i) a negotiated re-structuring or "right-sizing" of the loan, (ii) a foreclosure or receivership, or (iii) a sale of the loan by the lender.

While these ultimate outcomes are the same as those involving workouts of market-rate properties, there are unique issues that must be addressed and analysis that must be undertaken in determining which outcome is the most appropriate in a LIHTC workout. In this section, we will explore how a lender should use the early stages of a workout to better its position, analyze its alternatives and select the best workout or exit strategy. Then, in the next several sections we will explore each of the ultimate outcomes of a LITCH workout, along with their unique advantages, disadvantages, and challenges.

What is a pre-negotiation agreement?

Prior to engaging in any discussions with the borrower regarding a problem LIHTC loan, a lender will typically want the borrower sign a pre-negotiation agreement (PNA). A PNA sets the ground rules for the workout negotiations and will typically include the following acknowledgements and agreements:

- Neither party shall be deemed to have waived or given up any rights as a result of the discussions
- The parties shall have the right to continue to pursue their rights and remedies during the pendency of the discussions
- Neither party shall be bound by any statements or agreements unless and until reduced to a written agreement
- The parties' discussions shall be inadmissible as evidence in any litigation
- Either party shall have the right to terminate the discussions at any time



Because of the importance of having the tax credit investor(s) at the negotiating table in a LIHTC workout, we recommend that a lender insists on the inclusion of the tax credit investors(s) as a party to the PNA and an acknowledgement by the borrower that the lender can have separate discussions with the tax credit investors(s) concerning the loan.

How does a forbearance period benefit a lender?

Once a PNA has been signed, a lender will often agree to a short-term forbearance period, during which it forbears from exercising its rights against the borrower and the property in return for various concessions from, and agreements of, the borrower.

A lender typically has at least five objectives in a forbearance: (i) obtain a better understanding of the underlying causes of the borrower's financial distress and to assess whether the problems are operational in nature and can be fixed or whether the property is simply burdened by too much debt, (ii) repair any holes in its loan documentation and "cleanse" its prior dealings with the borrower through a general release, (iii) obtain additional information and due diligence that may be necessary in the event that it forecloses on the project, (iv) assess its negotiating leverage, and (v) either improve (or at least prevent further deterioration of) its economic position.

To further these objectives, a forbearance agreement will typically include most, if not all, of the following provisions:

- The borrower's acknowledgement of the indebtedness, the defaults and the lender's liens
- A requirement that the borrower deliver various financial, LIHTC and property information to the lender
- A requirement that the borrower cooperate with the lender in obtaining an updated appraisal, a capital needs survey and an environmental report for the project
- A specified period during which the lender will forbear and after which it will be free to exercise its rights and remedies
- A general release of the lender for all activity prior to the date of the forbearance
- "Adequate protection" of the lender's economic interest (through periodic payments and the performance of critical covenants, or otherwise)

Tax credit documentation checklist

In a LIHTC workout, a lender should require the borrower to provide it with copies of the following documents that are necessary for a subsequent owner of the property to claim remaining tax credits:

- Initial Application for credits
- Tax credit award letter
- Cost certification (and related audit)
- Original tenant files (and related audit)
- Tax eligibility letter
- Form 8609 (IRS LIHTC Allocation and Certification)\
- Any Form 8823s (IRS notice of non-compliance)
- Annual certifications of continuing program compliance
- Annual tax returns/audits
- Tax credit administrator and/or HUD inspection reports with findings and documentation of resolutions

Unlike tenant and vendor files, many of these documents may not be maintained on-site at the property. As a result, a lender may have difficulty obtaining them following a foreclosure or in the event that discussions with the borrower deteriorate.

What factors should a lender consider in developing its long-term strategy?

In the event that the underlying causes of the borrower's financial distress cannot be resolved, the lender will need to decide whether it is in its best interest to negotiate with the borrower to restructure the loan, to foreclose on the project, or to attempt to sell the loan. This decision hinges on a number of factors and requires the lender to consider its negotiating leverage (see the prior section on negotiating leverage) and to weigh the advantages and disadvantages of the various outcomes. The following is a series of questions that the lender should consider in order to assess the various outcomes:

- Where is the project in the cycle of tax credits?
- Are there any remaining equity installments due from the limited partners/tax credit investors?
- What is the value of the remaining tax credits?
- Are the tax credits 4% credits (in which the lender actually holds tax exempt bonds) or 9% credits?
- And if the credits are 4% credits, what are the bond transfer restrictions?
- Is the property in compliance with the LIHTC restrictions?
- Does the lender have all of the necessary tax credit documentation to deliver to a purchaser of the property?
- What is the recapture exposure of the tax credit investor(s)?
- Is the project a HUD Section 8 project? If so, what are the HUD regulatory restrictions and has the lender subordinated to such restrictions?
- Is the property more valuable as a rent-restricted or a market-rate property?
- How does the "decontrol period" impact the value of the property?
- Have guarantees of the debt burned off?
- Is there an interest rate swap associated with the loan? If so, which party is "in" and which party is "out" of the money? If the borrower is "out" of the money, how will a swap termination be paid?
- What are the risks, if any, to the lender if its OREO group takes title to the property?
- How will the lender market the property following a foreclosure or through a receivership?

The importance of these questions will be evident in the following sections, in which we will address the advantages, disadvantages and challenges presented by the various long-term restructuring/exit scenarios available to the lender.

LIHTC exit strategies: Loan sale

Because there is currently a very robust market for distressed debt, a lender's first option for dealing with any non-performing loan is often to look to sell the loan. This section addresses the unique considerations and difficulties involved in the sale of a loan secured by an LIHTC project (referred to herein as an "LIHTC loan").

The difficulties involved in the sale of an LIHTC loan are tied to two features of such loans. The first feature is the highly specialized nature of the affordable housing business and the limited market for such projects (and consequently for LIHTC loans secured by such projects). This feature pervades all LIHTC loans. The second feature relates to the way the loan is structured and comes into play only with respect to LIHTC loans secured by projects involving so-called 4% credits.

Limited market for potential purchasers

Affordable housing is a highly specialized industry, particularly when LIHTCs are involved. As such, there are very few, if any, financial buyers of distressed LIHTC loans (i.e. buyers who are making a financial play that they can collect more from the borrower than they are required to pay for the loan). Typical distressed debt investors simply don't have the time or inclination to understand the complexities of affordable housing and, therefore, are generally interested in loans secured by more common types of real estate or other collateral.

This means that the pool of potential buyers for LIHTC loans will likely consist only of strategic buyers (i.e. buyers who are interested in purchasing a loan in order to gain a strategic advantage with respect to an ownership interest in the property itself). Unfortunately, the pool of strategic buyers is also quite limited. Many developers of market-rate properties are simply unwilling to wade into the waters of affordable housing. Although an LIHTC property can be converted to a market-rate property under certain circumstances (such as following a foreclosure), the value of a property as a market-rate property is most often significantly less than its value as an LIHTC property because of the additive value of the tax credits that are available only if the property continues to be operated as an LIHTC property. Moreover, the ability to convert an LIHTC property to a market-rate property is often constrained by market factors. Thus, the sale of an LIHTC loan (or the sale of the LIHTC property itself) to a buyer that anticipates converting the property to a market-rate property is generally unlikely to be a lender's best option.

In short, the pool of potential purchasers for an LIHTC loan is typically limited to other affordable housing developers. Not only is this pool quite shallow, but there are few such developers who have experience in buying distressed debt and are interested in taking on the headaches associated with a failed LIHTC project.

9 percent credits vs. 4 percent credits

There are two different types of federal LIHTCs: 9% credits and 4% credits. Financing for a project involving 9% credits is structured like any other conventional construction or construction-to-permanent financing. In other words, a loan will be made directly by the lender to the borrower and the loan will be secured by a mortgage on the 9% LIHTC property. On the other hand, financing for a project involving 4% credits will be structured through bonds issued by a local public authority. The bonds will either be sold directly to the lender or will be sold to third-parties and credit enhanced by a letter of credit issued by the lender. The bonds and/or borrower's reimbursement obligation under the letter of credit will then be secured by the 4% LIHTC property.

The sale of an LIHTC loan secured by a 9% LIHTC property is relatively straightforward. There are comparatively few restrictions on the transfer of such a loan and the lender can simply transfer its interest in the loan and the loan documents to the purchaser. However, the sale of an LIHTC loan secured by a 4% LIHTC property is much more complicated.

With respect to bonds that have been purchased by the lender directly from the authority, the governing bond documents will typically restrict any re-sale of the bonds to a particular class of purchasers. Such restrictions typically limit the sale of bonds to (a) a "Qualified Institutional Buyers" (QIBs) as defined in Rule 144A under the Securities Act of 1933, as amended, (b) "Accredited Investors", as defined in Rule 501(a)(1)-(3) of Regulation D under the Securities Act of 1933, as amended, or (c) some combination or subset of (a) and (b). In addition, the governing bond documents will include various documentation requirements for a transfer of the bonds, such a requirement that the purchaser execute a letter of representation certifying that it meets the transfer restrictions and making certain other required representations.

Only very sophisticated institutional organizations, such as banks, qualify as QIBs. As such, a provision in the governing bond documents restricting transfers to QIBs will significantly limit the number and types of potential purchasers. A restriction on transfers to Accredited Investors opens up the market to a broader class, including certain high net worth or income individuals, but is still quite restrictive.

With respect to bonds which were previously secured by a letter of credit, and which are now held by the lender following a draw under the letter of credit and an optional or mandatory tender of the bonds, the operative bond documents may either prohibit a transfer of the bonds or may require certain additional documentation from the purchaser given that the bonds contemplate that holders will have the security of the letter of credit which is no longer available. Moreover, if the bonds have been redeemed and the lender is selling its rights under a letter of credit reimbursement agreement, various other complications come into play.

Given the obstacles associated with the sale of an LIHTC loan, is it still a viable alternative?

Because of the small market for potential purchasers and the various restrictions and complications concerning transferability, it is extremely difficult to sell an LIHTC loan. However, it is not impossible and the obstacles to such a sale can be overcome in certain circumstances. Based on our experience, we have the following observations concerning the sale of an LIHTC loan:

- It is extremely difficult to sell an LIHTC loan through typical distressed debt markets.
- Strategic buyers are the best prospects for purchasing an LIHTC loan.
- Strategic buyers are most likely to be identified through industry sources.
- The sale of an LIHTC loan is more likely to occur when the borrower is cooperative and participates in the process.
- Negotiations concerning the sale of an LIHTC loan are complicated and will involve issues unique to the particular transaction.
- When bonds are involved, the issuing authority is sometimes willing to waive or modify transfer restrictions to enable a sale of the bonds to an identified purchaser that would not otherwise qualify.

LIHTC exit strategies: Right-sizing the loan

The most logical long-term solution for a distressed and over-leveraged LIHTC project is a negotiated re-structuring or "right-sizing" of the debt owed to the lender. Such a right-sizing may be accomplished by a repayment of debt by the borrower and investors, a forgiveness of debt by the lender or a combination of both. While in theory this is the most logical solution, just like any settlement, it depends upon the parties' assessments of their respective alternatives and their leverage for negotiating a deal that they believe is acceptable.

To better understand the key leverage points in negotiating a restructuring, readers should review the previous section, "What are the unique dynamics of a low-income housing tax credit workout?" The primary issues include:

- How much debt reduction is necessary in order to reduce the debt to a level that the project will support? Note that in that if there is an interest rate swap in place, a right-sizing will likely trigger a swap modification fee (which in today's interest rate environment may be significant).
- Does the limited partner have unfunded capital contributions that can be paid into the project
- Does the limited partner have an incentive and an ability to invest additional capital into the project? As we previously noted, a limited partners' incentive to invest additional capital is largely a function of the value of future unearned tax credits on the project and the investor's risk of recapture for tax credits already taken.
- Does the general partner have the incentive and ability to invest additional capital into the project?

- What are the lender's options and does it have an economic incentive to participate in a re-margining by writing down a portion of its debt?

As an alternative to the lender writing down a portion of its debt, the debt may be bifurcated into an A Note (in an amount that the project can support) and a "soft" B Note (such as a note payable from the project's excess cash flow or a sale of the project). This structure is likely to be more palatable to the lender than completely writing off a portion of its debt because it preserves the entire debt in the event that the economics of the project significantly improve or the borrower sells the project.

An A Note/B Note restructuring may seem like a logical and relatively simple solution. However, such a restructuring can present various challenges, including the following:

- The tax exempt status of the interest on the B Note may be adversely affected.
- A restructuring of a loan secured by a project involving so-called 4% LIHTCs may require a "reissuance" of the bonds, which will necessitate the involvement of bond counsel and will be more complicated and expensive than a restructuring of a typical loan.
- A restructuring will likely trigger a termination of any associated interest rate swap, which can result in significant swap modification fees.

LIHTC exit strategies: Foreclosure

A lender's ultimate remedy for dealing with a distressed and over-leveraged LIHTC project is to foreclose on the project. Foreclosure is the primary unilateral remedy that may be undertaken by a lender and will generally be the remedy against which a negotiated restructuring will be measured and evaluated.

Impact of foreclosure on the LIHTC property and its tax credits

A foreclosure typically terminates the LIHTC Land Use Restriction Agreement (LURA) containing the rent and occupancy restrictions on the property, subject to the new owner's compliance with a "decontrol period." The decontrol period is a three-year period during which any owner of the property is prohibited from (i) evicting or terminating the tenancy of any low-income tenant other than for good cause, or (ii) increasing the rent for any such tenant above the rent-restricted rate established by the state housing agency. Unfortunately, if there is no LURA in effect for the property, any remaining tax credits will be disallowed. As such, a lender will need to decide whether to preserve or reinstate the LURA, thereby maintaining the right to claim any remaining tax credits, or to terminate the LURA, thereby allowing

the property to be converted to a market-rate property (subject to compliance with the decontrol period).

Although it is possible to structure a foreclosure in a way that preserves the existing LURA (particularly in a judicial foreclosure state), a lender will typically foreclose away the LURA and then agree to encumber the property with a new LURA if it desires to maintain the property as a LIHTC property (thereby preserving the right to receive remaining tax credits associated with the property). We will address the mechanics of reinstating a LURA in the final section of this booklet.

Estimating a lender's recovery upon foreclosure and other factors for a lender to consider in deciding whether to foreclose

The lender's primary focus in evaluating its foreclosure option should be on how much the lender anticipates that it will receive for the property upon its ultimate disposition. As we have previously discussed, any guarantees of the indebtedness will likely have burned off and the lender's only recourse will be to the project itself. As a result, the lender's recovery will solely depend on the amount the lender receives from a sale of the project. Since this will typically occur after the lender has purchased the property at foreclosure, the lender must also consider any carrying costs associated with holding the property until its disposition and any exposure it may have for operating the property prior to its sale.

Determining the anticipated net realizable value of a property starts with obtaining a valuation of the project by a qualified appraiser. We have previously discussed the valuation of LIHTC projects in a previous two-part section in this booklet. Suffice it to say that the valuation of an LIHTC property is more art than science and some appraisals are better than others. However, as with any appraisal, a lender should not necessarily assume that it will be able to realize the full appraised value of the property at or following foreclosure. Rather, the lender should carefully consider the relevant market of potential purchasers for the property, how it intends to reach those potential purchasers and how such potential purchasers will value the property and any remaining tax credits.

One good place to start in evaluating the prospects for a sale of the property is to ask the following two questions based on the property valuation report or appraisal:

- Does the valuation report indicate that the property is more valuable as an LIHTC property or as a market-rate property?
- If the project is more valuable as an LIHTC property, how much of its value is attributable to its bricks and mortar vs. its remaining tax credits?

If the valuation report indicates that the property is more valuable as a market-rate property or there is very little value attributable to tax credits

(for example, because the project is at the end of the LIHTC lifecycle), the lender's best strategy may be to permit the LIHTC LURA to terminate upon foreclosure, thereby opening up the market of potential purchasers to operators of market-rate properties. Prior to embarking on such a strategy, however, the lender should assess the impact of the "decontrol period" on marketability of the property. In addition, the lender should assess the impact of any senior encumbrances on the property. For example, if the project is a HUD Section 8 project, the lender may have subordinated its mortgage to HUD regulatory restrictions that are very similar in scope to the restrictions contained in the LIHTC LURA, thereby precluding a conversion of the property to a market-rate property.

On the other hand, if the valuation report indicates that the property is more valuable as an LIHTC property and a significant portion of its value is attributable to tax credits, the lender will most likely want to preserve or reinstate the LURA and sell the property to an LIHTC-purchaser so as to obtain the incremental value of the tax credits. Prior to embarking on this strategy, however, a lender should carefully consider the marketability of the tax credits by asking:

- Is the property fully compliant with all LIHTC restrictions?
- Does the lender have all of the necessary tax credit documentation to deliver to a purchaser?
- Will a prospective purchaser of the property be able to utilize or re-syndicate the tax credits?
- Are there a sufficient number of years remaining in the LIHTC lifecycle to warrant a re-syndication of the tax credits?

Hopefully, the lender's appraiser will have addressed each of these issues and provided the lender with an in-depth market survey for a re-sale of the tax credits. If not, the lender should address each of these issues internally and with competent counsel.

Reinstatement of a LIHTC LURA following foreclosure

In the previous section, we discussed the lender's remedy of foreclosure. A foreclosure typically extinguishes the LIHTC Land Use Restriction Agreement (LURA) that contains the rent and occupancy restrictions on a LIHTC property, thereby disqualifying the property from receiving any remaining tax credits. However, in many cases this is not the lender's desired outcome. Rather, the lender would like to preserve the property as a LIHTC property and take advantage of the value of any remaining tax credits. The lender usually accomplishes this result by either reinstating the existing LURA following the foreclosure sale or encumbering the property with a new LURA.

How is a LURA reinstated?

The process for reinstating a LURA following foreclosure varies from state to state and property to property. In some cases, the appropriate state housing agency will want to record a document that reinstates the same LURA that was terminated by the foreclosure. In other cases, the state agency will prefer to negotiate and record an entirely new LURA. The lender and its counsel should work with representatives of the designated housing finance agency on a mutually acceptable process. We recommend that the lender or its counsel contact the appropriate state agency and discuss a reinstatement of the LURA prior to beginning the foreclosure process. State housing agencies are generally extremely cooperative in working with a foreclosing lender to preserve the property as an LIHTC property.

How long does a lender have to reinstate a LURA following foreclosure?

Section 42 of the Internal Revenue Code is not entirely clear on the issue of how long a lender has to reinstate a LURA. One part of Section 42 suggests that the LURA must be reinstated prior to the end of the calendar year in which the foreclosure sale takes place. See 26 U.S.C. § 42(h)(6)(A) ("No credit shall be allowed by reason of this section with respect to any building for the taxable year unless an extended low-income housing commitment is in effect as of the end of such taxable year."). However, a different part of Section 42 suggests that the lender has one year to reinstate the LURA, even though the LURA may not be in effect as of the end of a calendar year. See 26 U.S.C. § 42(h)(6)(H) ("If during a taxable year, there is a determination that an extended low-income housing agreement was not in effect as of the beginning of such year, such a determination shall not apply to any period before such year and subparagraph (A) shall be applied without regard to such determination if the failure is corrected within 1 year from the date of the determination.").

Each state housing agency with which we have discussed this issue has agreed with our conclusion that the better reading of Section 42 is that the lender has one year to reinstate the LURA. Nevertheless, since it is the IRS that will ultimately decide whether the credits are allowable, the more conservative approach is to reinstate the LURA prior to the conclusion of the taxable year in which the foreclosure takes place (unless there is a good reason to delay doing so).

What is the impact of a reinstatement of the LURA?

A lender's decision to reinstate (or preserve) the LURA should not be taken lightly. Once a LURA is reinstated following foreclosure, the reinstatement is permanent and the lender cannot decide at some later point to terminate it.

A reinstatement of the LURA will preserve the right of future owners of the property to claim tax credits for periods following the foreclosure, provided that the property is operated in compliance with the LURA. Under Section 42 of the Internal Revenue Code, tax credits allowable during a year in which the foreclosure takes place are to be allocated between the prior and new owners of the property based on the number of days during the year in which the property (or interest) was held by each. See 26 U.S.C. § 42(f)(4).

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February 2021