

insights

TYPES NOT MAPPED YET February 04, 2015 | TTR not mapped yet | Mark V. Bossi

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

Note: This post is part of a [continuing series on the Credit Report Blog](#) on the subject of workouts and bankruptcies involving low-income housing tax credit (LIHTC) projects.

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 post, 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 posts we will explore each of the ultimate outcomes of a LIHTC 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 (see [our prior post here](#)), 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:

1. Initial Application for credits
2. Tax credit award letter
3. Cost certification (and related audit)
4. Original tenant files (and related audit)
5. Tax eligibility letter
6. Form 8609 (IRS LIHTC Allocation and Certification)\
7. Any Form 8823s (IRS notice of non-compliance)
8. Annual certifications of continuing program compliance
9. Annual tax returns/audits
10. 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 [our prior post 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 our following blog posts in which we will address the advantages, disadvantages and challenges presented by the various long-term restructuring/exit scenarios available to the lender.

[Mark Bossi](#) is co-chair of Thompson Coburn's Financial Restructuring Group. You can reach Mark at 314-552-6015 or mbossi@thompsoncoburn.com.

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Mark V. Bossi