Legally Speaking: Evolution of the Aggregator's Playbook

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Current Trends in Year 15 Exit Disputes

Federal tax credits under the Low Income Housing Tax Credit program continue to be one of the most important tools for developing affordable housing in the country. These tax credits are the primary economic incentive for private-sector investment in affordable housing and have spurred, on average, the development of over 100,000 units annually.

Organizations seeking LIHTC—known as "tax-credit investors"—usually acquire them in one of two ways. First is by direct investment into a limited partnership or LLC—referred to as a "project partnership"—formed by an affordable housing developer to own and develop a LIHTC project. Second is by investing with a syndicator, who will, for an upfront fee, invest that capital into a fund, which in turn owns interests in one or more project partnerships, either directly or through layers of subsidiaries. Regardless of the structure used, the tax-credit investor's aim is the same: acquire virtually all tax credits allocated under the LIHTC program, among other tax-based benefits available from the project partnership (including depreciation and taxable losses), in exchange for a passive investment of capital.

In exchange for the development and stewardship of the LIHTC project and partnership for the statutory 15-year Compliance Period, the developer ordinarily receives the majority of cash-based benefits available from the LIHTC project, including distributable annual cashflow and any built-up equity in the project. Accordingly, once the tax credits are secured and the 15-year Compliance Period ends (Year 15), the developer typically has various options to exit the investor from the partnership by acquiring the LIHTC project or the investor's interests in the project partnership for a price based upon the investor's minimal cash-based economic rights. This longstanding and well-documented economic sharing arrangement—with tax benefits going to investors and cash benefits going to developers—has been honored by the original parties to these partnerships for decades, serving as a cornerstone for the immense success of the LIHTC program.

Many developers, however, are discovering that the original investor or syndicator with whom they negotiated has exited the deal following receipt of the tax credits and has been replaced by an "Aggregator." As the Delaware Chancery Court recently recognized, aggregators engage in "a now-nationally-familiar pattern of tactics" at or around Year 15—referred to as the "Aggregator's Playbook"—intended to upend the agreed-upon economic arrangement and extract unintended cash payouts from project partnerships at the expense of the developer, the partnership and the LIHTC project's low-income residents. Some original investors have begun to follow suit. As evidenced by the continuing influx of new litigation around the country, this trend plaguing the LIHTC industry shows no signs of slowing, and aggregators' counsel are beginning to deploy a program-damaging narrative that describes the program as providing "benefits typical of a real-estate investment" that happens to carry tax benefits along with it.

The Aggregator's Playbook in Action

Aggregators commonly seek to extract unintended value from a project partnership by inflating the price associated with the developers' Year 15 purchase option and attempting to monetize the investor's capital account. For example, aggregators in four different cases in state and federal courts in New York and Florida relied upon this tactic. Despite the applicable contracts requiring that the purchase price equal the small percentage of cash that the parties agreed the investor (now controlled by an aggregator) would receive from a sale of the LIHTC project, and the terms governing the distribution of such proceeds, the aggregators argued that sale proceeds must be treated as liquidation proceeds following the partnership's dissolution, which would create a large payout based upon the investor's positive capital account. They further claimed the tax regulations require this result. But each court addressing this issue rejected the aggregator's contentions and correctly concluded that the sale of the LIHTC project is a separate and distinct event from any subsequent dissolution and liquidation of the project partnership. Sale proceeds were therefore not treated as liquidation proceeds and were instead distributed as the original parties agreed.

In recent disputes in Texas and Illinois, the parties' operative agreements required the developers' option price equal the fair market value of the investor's interest in the project partnership, i.e., as a going concern.

A "going concern" valuation quantifies the benefits an interest-holder could reasonably anticipate from the project partnership in the future, discounted back to present day. But aggregators ignored this agreed-upon valuation methodology, demanding that the interest instead be valued based upon a hypothetical sale of the project, which, under the applicable agreements, requires payments based upon capital account balances. In both instances, an arbitrator and a federal court ruled against the aggregators, adopted the proper going concern valuation methodology and, in the Texas dispute, awarded damages, attorney's fees and costs to the prevailing developer.

Current Trends

Given the growing body of case law rejecting these aggregator tactics, their playbook has evolved. They now commonly attempt to circumvent Year 15 purchase rights and agreed-to economic sharing arrangements altogether. For instance, aggregators try to take advantage of developers' good-faith efforts during early negotiations of a Year 15 exit to manufacture a record they can later use in litigation. They then leverage threats of costly, protracted litigation to force developers to pay large sums to exit the aggregator-controlled investor, effectively depriving developers of their Year 15 exit rights.

Aggregators are attempting to block developers from exiting investors by leveraging rights to consent to the appraiser or appraisal required to determine the exit price. They will withhold consent unless the developer agrees the investor's capital account is to be monetized, regardless of the operative agreement not requiring such. Furthermore, where a nonprofit developer or sponsor holds a "minimum purchase price" right of first refusal under 26 U.S.C. §42(i)(7) (§42 ROFR), aggregators will frequently purport to withhold consent to any sale of the project (even when they have no such right) and will claim the nonprofit's §42 ROFR cannot be triggered as a result, and thus must be abandoned.

The U.S. Court of Appeals for the Sixth Circuit overturned a trial court decision that enabled an aggregator to effectively block a nonprofit's §42 ROFR from being triggered. The Sixth Circuit recognized that the tax credits alone provide "a significant return on investment that makes the arrangement attractive and worthwhile to the [tax-credit] investor." It further found that exiting the investor after the Compliance Period is "crucial to the efficacy of the LIHTC program." Accordingly, the Sixth Circuit rejected the aggregator's attempt to block the §42 ROFR.

Aggregators are increasingly claiming or threatening to remove developers from project partnerships before the developer's Year 15 exit rights are ripe or exercised. They perform a "deep dive" into the project partnership's business records over the entire 15-year Compliance Period, searching for any technical breach of the operative agreements. They then exaggerate the alleged breach to claim a right to remove the developer and attempt to force the developer to forfeit its Year 15 exit rights. But, as courts in Florida and Washington found, the purported breaches tend to be "baseless" or mere "foot fault[s]," and thus are intended only to deprive the developer of their rights.

In sum, aggregators are continuously changing how they attempt to undermine Year 15 exit rights. Therefore, the sooner a developer recognizes an aggregator has acquired interests in their project partnership and identifies the specific tactics being used, the better position they will be in to preserve their Year 15 exit rights.

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