Refusing the Right of First Refusal

How an ambiguous legal definition is endangering nonprofits' control of dozens of affordable housing developments in the final years of their tax credit agreements.

By **Brandon Duong** - October 16, 2020

Aswan Village, the development at the center of a major lawsuit between OLCDC and HallKeen Management. Photo courtesy of OLCDC.

For the past five years or so, dozens of nonprofits across the country have found themselves embroiled in costly litigation spawned from the ambiguity of the Low-Income Housing Tax Credit program's right of first refusal provision. At stake is whether they can, as is standard, take ownership of the properties and maintain their affordability as investors exit, without having to pay market prices.

A recent court victory for the Opa-Locka Community Development Corporation (OLCDC), a nonprofit affordable housing provider in Florida, may set a useful precedent in clarifying that provision. But the road there wasn't easy, and a legislative fix will probably still be needed.

LIHTC and the Right of First Refusal

The LIHTC program is the largest funding source for affordable housing in the United States. According to the U.S. Department of Housing and Urban Development (HUD), it created over 3.2 million affordable housing units from 1987 to 2018. The federal government allocates tax credits to each state based on population. Developers can then apply for these tax credits to build affordable housing. However, most nonprofit developers are not required to pay taxes. So instead of utilizing it themselves, they sell the tax credits to investors who are often large financial institutions. In return, the LIHTC developer gets a large lump sum that they can use to cover the costs of construction.

The LIHTC program requires that affordability be preserved in these developments for 30 years. Investors that do not comply could have their tax benefits recaptured by the IRS, although enforcement of this provision typically ends in year 15. Investors can utilize the tax credits in the first 10 years, but ownership of LIHTC properties typically changes in year 15, when the investor will no longer be at risk for tax credit recapture.

LIHTC deals are limited partnerships. When an investor pays for the tax credit, they become a limited partner, meaning they invest money into a project but do not oversee the day-to-day management of the property. The nonprofit developer uses the money it makes from the sale of those tax credits to finance the costs of construction. The nonprofit becomes the general partner, which oversees the daily operation of the property and has unlimited liability for the financial wellbeing of the partnership.

Integral to this transition is something called a right of first refusal (ROFR). According to the Internal Revenue Code (IRC) Section 42(i)(7), nonprofit general partners have a right of first refusal which allows them to purchase a LIHTC property that they manage for a price equivalent to the outstanding debt plus exit taxes. This provision allows nonprofits to gain ownership of LIHTC properties as their investors exit and preserve their affordability because they can pay predictable, usually below-market, price. A report on transfer disputes from the Washington State Housing Finance Commission notes that "for years the vast majority of LIHTC projects involving nonprofits have in fact been transferred to the nonprofit partner at the end of the 15-year compliance period as a matter of course."

However, there has been contention around the definition and triggering conditions of the LIHTC program's ROFR provision. The right of first refusal is not unique to the LIHTC program. It is also used in common real estate transactions, especially between tenant entities and landowners. This common right of first refusal is often triggered by an enforceable, bona fide offer of purchase from an unrelated third party. When this offer is made, tenants are given the opportunity to match the offer price of the third party and buy the property for themselves. The right of first refusal in the LIHTC program differs in that the price is not based on a third party's offered price but on the sum of the property's outstanding debt and taxes. This has raised confusion about whether a third-party offer is necessary to trigger the right, and what constitutes such an offer, because it is unclear if the LIHTC program's ROFR refers to the common ROFR, or if it is something unique.

The Rise of Aggregators

This ambiguity made LIHTC deals fertile grounds for predatory entities known as "aggregators," which buy investor interests in LIHTC developments that they expect could fetch a significant price on the market. They then dispute the transfer of property to the general partner in year 15, knowing that nonprofits are not likely to have the resources for a costly court battle to defend their ROFR. According to the report by the Washington State Housing Finance Commission on this growing problem, aggregators' tactics can include "disputing the conditions and scope of transfer rights; delaying, obstructing, and disagreeing with related valuations; refusing consent to refinancing, either outright or by placing significant conditions on consent; disputing fee calculations; arguing over typographical errors; and asserting alleged breaches of partnership duties from many years prior, including by arguing that rents should have been set higher to maximize profits."

According to David Davenport, the attorney representing the Opa-Locka CDC in its legal battle over ROFR, this tactic has grown more prevalent over the past five years. "I've been involved in litigation . . . involving more than 100 low-income housing projects in three dozen or more lawsuits in about 20 states," he says.

Greg Griffin, vice president for Enterprise Community Asset Management, says that much of the litigation entangling nonprofits around the country centers on whether a bona fide, competing third-party offer of purchase is required to trigger the nonprofit's right of first refusal. Some limited partners can and have used the argument that they are required to challenge the nonprofit's right of first refusal and then leverage a higher price. "Requiring a bona fide third-party offer possibly could just eliminate the ability to ever trigger it," says Griffin. "The argument could be made that why would someone make an offer when a nonprofit already holds a right to purchase it at this below-market price?" In this case, if there are no third-party offers, "aggregators could argue that . . . the nonprofit cannot trigger the right of first refusal, [and they] have to pay fair market value for the property or it has to be sold to another third party at fair market value." Enterprise adds that all of the limited partners that it works with in its syndication expect to transfer their LIHTC properties to nonprofit owners at year 15.

For the nonprofits that find themselves in these situations, the fallout can be dramatic. The Tenants' Development Corporation (TDC), a nonprofit housing provider in Boston, for example, is in the midst of a costly court battle with an aggregator named Alden Torch Financial. Anita Huggins, the assets manager at TDC, says that as her organization approached year 15 on a 185-unit LIHTC development called South End Tenant Housing II, TDC ran into complications with Alden Torch. Like many aggregators, Alden Torch was not TDC's original limited partner, but had bought the limited interests after the original LIHTC investors had used up all the tax credits and sought an exit from the deal.

"We received a letter from them, saying they wanted us to put the property on the market," recalls Huggins. TDC did so, and then notified Alden Torch that they would be exercising their right of first refusal. "They then sent a notification rescinding their direction to put the property on the market," Huggins says. "So we said, 'Nope sorry it's too late, we're in this process.' We had about eight offers to purchase the property. We accepted one of the offers, and then . . . were able to exercise our right of first refusal." In response, Alden Torch placed a restriction on the city registry saying that TDC did not have clear title to the property. That was when the Tenants' Development Corporation sued Alden Torch. Hours later, Alden Torch followed with a lawsuit saying that TDC did not have a right of first refusal. *Shelterforce* reached out to Alden Torch but they did not respond.

The costs of such litigation can add up. Downtown Action to Save Housing (DASH), an affordable housing nonprofit in Bellevue, Washington, spent $300,000 on litigation against Boston Financial, an aggregator that bought the limited interests in Heron Run, a senior living facility, from Midland Financial in 2014. DASH was in a slightly different situation from TDC and OLCDC in that in addition to having a right of first refusal in its limited partnership agreement, it also had a buyout option that allowed it to purchase the limited interests directly from its partners. However, Kim Loveall Price, vice president of community development at DASH, characterized the relationship between the two organizations as poor, saying that when year 15 approached on a LIHTC property, Boston Financial would include the value of the property in the price of its limited interests, making them much higher than what is normal in LIHTC transactions.

There were conflicts on multiple properties. For the first property, Evergreen Court, DASH paid $75,000 for a buyout. "On the second deal, which was also a very low-income senior project, Ashwood Court, they were trying to do a forced sale because they didn't feel like we had this right of first refusal," explains Loveall Price. "They said, 'We can force the sale,' and we got scared. So we made them an offer. We actually had to take out a loan from the housing authority for $300,000 to pay them. We didn't want to lose the property." It was only when the Boston Financial demanded a buyout payment of $1 million for another property that the organization realized it could not afford to continue paying those kinds of prices, and sued Boston Financial. *Shelterforce* reached out to Boston Financial for comment but received no reply.

The costs extended beyond the financial realm. In tax credit deals, many nonprofit general partners plan to recapitalize the project in year 15. The nonprofit typically re-syndicates and refinances the property to do capital improvements after the tax credit investor has departed from the deal. "We ended up missing three rounds to re-syndicate the property," says Price. That money was critically needed for renovations. Several senior units had to have their access to a communal deck blocked because it was in such bad shape, but the organization did not have the funds to repair it. "We calculated that I had about a $400,000 lost opportunity," says Price. "At the end of the day, it's so frustrating to me because I have low-income seniors living in these properties, and we had to board off their deck. It's just wrong."

The Opa-Locka Community Development Corporation had similar experiences. "Thus far, we've identified over a million dollars of lost opportunity costs," says Davenport. "The lost opportunity cost is the $1 million-plus of proceeds that would otherwise have come to OLCDC that have continued to accrue to HallKeen for the last year or so."

Additionally, while the lawsuit was still in progress, OLCDC was unable to meet the requirements of an RFP issued by Miami-Dade County where qualifying companies could participate in any RFPs dealing with county-owned land for affordable housing, including all 7,000 units of public housing as well as acres and acres of other properties. "A key component of qualification was cash flow and cash on hand," says Willie Logan, executive director of OLCDC. "Because we were in the middle of litigation, we got horrible scores because on our balance sheets, we spent so much on legal fees for Aswan. We're locked out of participating in any development for five years." And that wasn't the only blow. "We had preapproval for two lines of credit," adds Logan. "All of that was frozen because of the depositions. There was a potential to make millions of dollars. We didn't apply for a tax credit because we didn't have time. It froze a lot of financial capital activity and the executive team and energy of board members. It took 18 months of our lives."

Aswan Village

The conflict between OLCDC and HallKeen over Aswan Village Apartments, a 216-unit LIHTC property in Opa-Locka, Florida, shows that the problems with differing interpretations of the ROFR can go beyond aggregators buying up limited partner interests.

Originally, Bank of America was the limited partner/investor in Aswan Village, while OLCDC and the Bank of America Community Development Corporation together composed a managing member entity, in which Bank of America CDC was the general partner and OLCDC was the administrative partner. According to a spokesperson for HallKeen Management, BoA was impressed with HallKeen's work managing and leasing what had been an underperforming mill complex in Lawrence, Massachusetts, and from 2010 to 2011 "offered to sell certain property interests to HallKeen, in each case subject to approval from local stakeholders and existing partners. All properties discussed were struggling in some respect with leasing, management, or other challenges."

One of those properties was Aswan Village. In 2014, Bank of America

CDC sold its general partner interests to HallKeen, making it a co-general partner with OLCDC. HallKeen created a subsidiary, HK Aswan, for the purpose. Later in the year, Bank of America sought to exit the deal entirely as an investor and transferred its limited-partner interests to HallKeen Management as well.

According to OLCDC, the conflict started in January 2019 when HK Aswan hired several brokers to investigate property values and recruit potential buyers to take over its interests in Aswan Village. About three months later, an affordable housing developer, investor, and operator called Lincoln Avenue Capital drafted a nonbinding letter of intent to buy Aswan village for $21 million. HallKeen signed it and passed the letter to OLCDC to sign. Instead, OLCDC invoked its right of first refusal and moved to buy the property for the price stipulated by law—Aswan Village's outstanding debt plus taxes. When HallKeen refused to sell under those terms, OLCDC filed a lawsuit, stating that HallKeen was trying to prevent OLCDC from exercising its right of first refusal and had attempted to sell Aswan Village for a market price in violation of the contract.

HallKeen argues that OLCDC acted in bad faith and that the court decision backing OLCDC contradicts how Florida law defines the right of first refusal. It argues that common right of first refusal hinges on meeting the bona fide and enforceable offer price of a third party, which the nonbinding letter did not constitute.

However, OLCDC argues that the ROFR in the LIHTC program isn't a common ROFR. In an open letter, 20 housing nonprofits agree. Virtually all LIHTC deals include a price equation equal to the assumption of property debt plus taxes, they point out, which is different from a common ROFR where the price is based on whatever price a third party offers. This, they say, proves that the ROFR referenced in LIHTC deals is not the same as the common ROFR, and therefore does not require a bona fide, enforceable purchase offer from a third party for a nonprofit to trigger it.

On July 7, the 11th Judicial Circuit in Miami-Dade County agreed with those nonprofits and ruled that a nonprofit's right of first refusal under LIHTC is not contingent upon the receipt of any third-party offer to buy the property, and that all that is required to trigger the ROFR is for the limited partner to display an intent to sell the development. Since OLCDC's contract with HallKeen did not have any further conditions under its Section 42 right of first refusal, the ruling found that the owner did not have to enter into an enforceable purchase agreement before OLCDC's ROFR was triggered. On Oct. 6, the 11th Circuit Court of Miami-Dade County denied a motion for reconsideration filed by HallKeen Management.

Implications of the Florida Ruling

While this ruling only directly affects properties in Florida, it will still have a resounding effect on rulings across the country, as judges in other jurisdictions may look to the 11th Judicial Court to help inform their own decisions should similar cases arise in their jurisdictions. Court rulings on the right of first refusal in LIHTC deals have been mixed. In 2018, the Massachusetts Supreme Judicial Court in *Homeowner's Rehab, Inc. v. Related Corporate V SLP, L.P.* ruled that a bona fide offer was not required to trigger the right of first refusal. On the other hand, the U.S. District Court in Washington ruled the opposite in 2019 in *Senior Housing Assistance Group v. AMTAX Holdings 260, LLC*, finding that that the right of first refusal requires "a bona fide offer from a third party, acceptable to the property owner," among other requirements.

HallKeen filed a request for reconsideration on July 30, arguing that the finding will have a negative effect on affordable housing financing. "Aswan Village was distressed and underperforming," says a HallKeen spokesperson. "HallKeen saw potential for the property and we felt like we could bring management, expertise and capital to help turn it around, irrespective of tax credits. Our agreement and collaboration with the OLCDC was specifically conditioned upon sharing cash flow and equity. Absent the potential upside, there would have been little incentive for HallKeen to participate. If this court decision were to stand, it could severely limit these types of successful collaborations where companies like ours help nonprofits turn around distressed properties."

We asked Scott Hoekman, president and CEO of Enterprise Housing Credit Investments, which syndicates LIHTC transactions, if collaborations between for-profit and nonprofit housing organizations could be hurt by this court case. He didn't think so. "For-profit and nonprofit partners collaborate every day in developing and operating housing credit properties, including working through all manner of challenges," he said. "For such partnerships to be successful, they do not require for-profit partners to subvert the nonprofit's rights under the Section 42 ROFR."

Priya Jayachandran, president of the National Housing Trust, similarly disagreed with HallKeen's statement. "There are plenty of collaborations between for-profit syndicators and nonprofit owners," she said. "It's been the case for as long as the ROFRs have existed. Just because the court upholds it doesn't mean that it's tamping down interest. The vast majority of for-profit syndicators and investors honor and uphold the ROFR."

Kiera O'Rourke, the advocacy and policy manager at OLCDC, also criticizes HallKeen's assertion that the court decision would limit collaboration between investors and nonprofits: "Court decisions that uphold the contractually bargained-for ROFR will have absolutely no effect whatsoever on the availability and cost of equity capital for the LIHTC program. Tax credit investors understand when they commit equity capital to this program that their investment is undertaken for a financial return that is based on the tax subsidies in the program, not based on an expectation of residual value. They understand that the ROFR will work as Congress intended to transfer full ownership to the nonprofit general partner."

David Davenport added, "The Court's order also found that HallKeen paid somewhere between $250,000 to $400,000 when they entered the deal in 2014, and the records examined during the litigation and provided to the Court demonstrated that: (1) this price was paid because OLCDC's ROFR did not allow for HallKeen to share in equity after the end of the Compliance Period if exercised by OLCDC, and (2) HallKeen's purchase price in this amount was based on cash flows and fee streams (not equity sharing or potential). . . . One practical way to think about this is a rhetorical question: do we really think that Bank of America would have sold the right to access millions of dollars of equity a few years later at the end of the Compliance Period for less than $400,000 if there really was a right to share in the equity?"

Fixing the Problem

Davenport says that while state agencies have few options to influence current litigation, there are effective measures they can take to prevent litigation from being weaponized against LIHTC developers by aggregators in the future. Last year, the Washington State Finance Commission, for example, made changes to their tax credit application process by requiring a disclosure about whether anyone involved in the deal has been involved in litigation focused on affordable housing. For those that have been involved in past litigation, the commission can take the details into consideration as they decide whether to approve the tax credits.

Additionally, the commission is implementing a process for interest transfers. If a limited partner wishes to transfer interest in a low-income housing tax credit partnership to a third party, they must have the commission's consent to do so, so that the commission can, similarly, check for evidence of troubling past litigation by the potential purchaser.

The big underlying problem enabling aggregators, however, is the ambiguity of the LIHTC right of first refusal itself. Policy change to clarify it is necessary to protect nonprofits from costly litigation. The Affordable Housing Credit Improvement Act is one policy that

Enterprise's Griffin says would be extremely helpful in clarifying transfers of ownership. Reintroduced by Sen. Maria Cantwell, D-Wash., in 2019 to the Senate Finance Committee, the act would make the LIHTC right of first refusal into a purchase option, eliminating any perception of requiring a third-party offer. The bill has tremendous bipartisan support, with one third of all members in the House of Representatives co-sponsoring the bill.

Griffin also believes the Save Affordable Housing Act, introduced by Rep. Joe Neguse, D-CO, would help the situation. As it stands, rent and income restrictions stay with a LIHTC property for at least 30 years. However, there's a loophole in the tax credit provisions that allows a LIHTC property owner to ask the state to find a buyer at qualified contract price, and if the state fails to do so, then those extended-use restrictions are removed, allowing the owner to increase the rent or sell to someone who will. The National Council of State Housing Agencies found that this loophole is leading to the premature loss of over 10,000 affordable units each year, and as of 2017, approximately 50,000 units had already been lost nationwide. Ellen Lurie Hoffman, the federal policy director of the National Housing Trust, says that many aggregators turn to this process after they have successfully challenged a general partner's right of first refusal, making the asset they've just gotten control over more profitable. The Save Affordable Housing Act would eliminate that loophole. The two bills also enjoy bipartisan support in both the Senate and the House of Representatives, as well as from major affordable housing groups including the Stewards of Affordable Housing for the Future, the National Low Income Housing Coalition, the National Housing Trust, and Enterprise Community Partners.

Bold action must be taken to preserve our nation's affordable housing stock. Litigation over the right of first refusal, especially in cases involving aggregators, poses a serious threat to nonprofit housing providers. Without action, the issue will only worsen. A 2012 report released by HUD states that more than 20,000 LIHTC properties —which represent over 1.3 million housing units—will have reached year 15 during 2010-2024, meaning more will be vulnerable to predatory practices by aggregators or costly legal battles. While the report predicts that most units will remain affordable, the experiences and testimony from housing organizations struggling through costly litigation illustrates how the affordability of thousands of units can and has been endangered. As long as the right of first refusal remains unclear, year 15 will be a breeding ground for misunderstandings and lawsuits, and enable the profit-seeking behavior of aggregators that will continue to cause tremendous harm nonprofits and the communities they serve.

"These are the most low-income people you will ever meet," says Loveall Price of the residents in the LIHTC development she manages. "They share food at the end of the month, like half open milk, because they just don't have any money. And I paid those [aggregators] $300,000 of my cash to get rid of them. Everybody's not in it for the same thing that we all are, so be willing to stand up and advocate for your people."

Brandon Duong

Brandon Duong is an associate editor for *Shelterforce.* He recently received a master's degree from the Urban Planning & Policy program at the University of Illinois at Chicago. In the past he has also been an ESL instructor at the Vietnamese Association of Illinois, a volunteer in the Police Accountability Group of A Just Chi, a graduate assistant at the Great Cities Institute, and a slam poet.