CASE LAW UPDATE

Year-15 Disputes in the Low-Income Tax Credit Program

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Introduction

The American Bar Association's *Journal of Affordable Housing and Community Development Law* published two articles focused on "Year 15" litigation and property interest transfer rights in the Low-Income Housing Tax Credit (LIHTC) industry in its June 2022 issue.[1] Since then, two of the cases discussed therein have changed course, resulting in a dramatic impact on the litigation landscape and on the outcome of several other cases.

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1. *Compare* David A. Davenport & Samuel T. Johnson, *Year-15 Disputes in the Low-Income Tax Credit Program, Aggregators, and Their Playbooks*, 31 J. Affordable Hous. & Cmty Dev. L. 1, 59–85 (2022) [hereinafter *Aggregator Year 15 Disputes*], *with* Steven F. Griffith, Jr. et al., *Preserving the Low-Income Housing Tax Credit Public-Private Partnership: Investor Perspectives on Year-15 Exit Disputes*, 31 J. Affordable Hous. & Cmty. Dev. L. 1, 35–58 (2022) [hereinafter *Investor Perspectives*].

Additionally, a Delaware Chancery Court has issued an important new decision.

In the first case, commonly known as *Pathway*, the Sixth Circuit reversed a lower federal district court and preserved a non-profit organization's Section 42(i)(7) Right of First Refusal (§ 42 ROFR).[2] In the second case, commonly known as *St. Mary's*, a federal district court in New York State granted reconsideration of its prior decision on an important Year-15 issue, rejecting the notion that capital account balances alter carefully negotiated contract language and issuing a decision in accord with several other similar cases.[3] As for the Delaware Chancery Court, in a case commonly known as *JER Hudson*, this "precedential" decision represents a candid rebuke and detailed analysis of the "Aggregator" problem that threatens the efficacy of the LIHTC program.[4] This article discusses these cases.

I. The *Pathway* Decision

Pathway clarifies that (1) Congress intended for tax credit investors to exit LIHTC partnerships at the end of the Compliance Period, after they receive the primary benefit of their bargain: tax credits (*not* back-end residual property value); (2) Congress specially fashioned the § 42 ROFR to facilitate this exit; and (3) the private agreements of parties incorporating this congressionally sanctioned § 42 ROFR must be interpreted in accordance with this congressional intent. *Pathway* followed a district court decision that effectively nullified a non-profit's § 42 ROFR,[5] despite the fact that the non-profit, Presbyterian Village North (Presbyterian), had previously owned and operated the 150-unit senior-focused property at issue as subsidized housing and had only utilized the LIHTC program for rehabilitation of the property, partnering with Pathway Senior Living of Michigan (PSL) to do so.[6] As is common practice for utilization of the LIHTC program for rehabilitation, (i) the property was transferred to a newly created partnership; (ii) Presbyterian and PSL secured tax credits under the LIHTC program (Housing Credits); and (iii) they then "withdrew from the Partnership," leaving affiliates as nominal owners but the general partners of the partnership, which would ensure the tax credit investor's "receipt of

2. SunAmerica Hous. Fund 1050 v. Pathway of Pontiac, Inc., No. 19-11783, 2021 WL 391420 (E.D. Mich. Feb. 4, 2021), *rev'd and remanded*, 33 F.4th 872 (6th Cir. 2022) (concerning the 26 U.S.C. § 42 right of first refusal for qualified non-profits (the § 42 ROFR)). The authors of this article are part of the law firm that represented a party in this decision.

3. Saugatuck, LLC v. St. Mary's Commons Assocs., L.L.C., No.19-cv-0217 (SJF)(SIL), 2022 WL 3699484 (E.D.N.Y. Aug. 26, 2022). The authors of this article are part of the law firm that represented a party in this decision.

4. JER Hudson GP XXI LLC v. DLE Invs., LP, 275 A.3d 755, 772–73 (Del. Ch. 2022) (discussing the Aggregator problem; collecting cases; citing Wash. State Hous. Fin. Comm'n, Nonprofit Transfer Disputes in the Low Income Housing Tax Credit Program: An Emerging Threat to Affordable Housing, at 1, 5 (Sept. 2019)).

5. This district court decision was referenced in the June 2022 Issue.

6. *Pathway*, 33 F.4th at 875–76.

its expected tax-related benefits,"[7] while retaining for Presbyterian and PSL the full operational control previously held.[8] But all along, the intent was for Presbyterian to reacquire the property through its § 42 ROFR for the minimal debt-plus-taxes price, as is well-understood in the LIHTC community.[9]

However, as the end of the Compliance Period approached, SunAmerica chose to adopt a different approach. Consistent with other Year-15 dispute tactics, "[i]n late 2017—about a year before the end of the LIHTC Compliance period—Presbyterian expressed its desire to acquire the Property. [But] SunAmerica responded that it would prefer to hold off discussions concerning the sale of the Property until the Compliance period lapsed."[10] While Presbyterian waited, its general partner affiliate, "PV North," discussed the § 42 ROFR with an outside organization who later offered to purchase the property, triggering the ROFR.[11] "[T]he General Partners [then] told SunAmerica that they had received a bona fide offer, and thus Presbyterian could exercise its [§ 42 ROFR.]"[12] Instead of honoring Presbyterian's § 42 ROFR, SunAmerica responded with a lawsuit.[13]

A. The District Court's Decision.

At summary judgment, the district court found the "bona fide offer requirement" for Presbyterian's § 42 ROFR was not met because "the offer was solicited for the purpose of triggering the ROFR, and because the offer was not legally enforceable."[14] After analogizing to the traditional common law meet-and-match right of first refusal,[15] the district court felt the triggering mechanism required the general partners hold a *genuine, specific intent* to sell the property *to the third-party offeror*, as opposed to a desire to sell generally.[16] The district court also believed that the general partners "breached their fiduciary duties to [the tax credit investor]" because the general partners desired to accept the offer to sell for the purpose of triggering Presbyterian's § 42 ROFR.[17]

B. The Sixth Circuit's Reversal and Remand.

The Sixth Circuit reversed both findings and remanded, holding instead that the bona fide offer requirement only requires the general partners' "*general intent* to sell the property" after receiving an offer and that "*the*

7. Id.
8. *Id.* at 876.
9. *Id.* at 874–75.
10. *Id.* at 877.
11. *Id.*
12. *Id.*
13. *Id.*
14. *Id.* at 878.
15. *Id.* at 878–79.
16. *Id.* at 878 ("[T]he General Partners needed to manifest a true intention to sell.").
17. *Id.*

intent to sell to the nonprofit if the ROFR procedure is invoked . . . *does not defeat the . . . required intent* to sell the property."[18] The Sixth Circuit also distinguished the bona fide offer requirement used in the traditional right of first refusal context, which "operates to protect the holder from being forced to match an outlandish offer,"[19] determining instead that the § 42 ROFR "*must be understood in the context of the LIHTC program*."[20] As the court explained, the § 42 ROFR "varies markedly from a ROFR in a 'typical' [meet-and-match] real estate transaction,"[21] because the former "defines *ex ante* the price at which the nonprofit will purchase the project: the [debt-plus-taxes price] . . . ."[22]

The court then dismissed the district court's and SunAmerica's concept of the "bona fide offer requirement," reasoning:

> It cannot be the case that knowledge of the ROFR holder's intention to exercise that right if a third party makes an offer would defeat the willingness to sell. *That conclusion would render the ROFR provision meaningless* because the General Partners' knowledge that the ROFR holder wants to exercise the provision would mean that the General Partners could never manifest a true intention of selling to a third party.[23]

Noting that such a paradox would "contravene Congress's intentions" and "would contravene the Partners' bargained-for exchange under the LIHTC arrangement,"[24] *Pathway* established that "[w]hen interpreting such an ROFR provision, [courts] must account for Congress's goals expressed in LIHTC, including *its intention to make it easier for nonprofits to regain ownership of the property and continue the availability of low-income housing*."[25]

C. Pathway *Solidifies the Roles of LIHTC Program Participants and the Importance of the § 42 ROFR.*

Pathway thus underscores the fundamental mutuality at play in the "bargained-for exchange under the LIHTC arrangement," whereby (a) LIHTC investors seek "to reap the benefits from the housing tax credits, *not from the Property's long-term appreciation gains*" because the "[*tax*] *benefits alone provide the investor with a significant return on investment* that makes the arrangement attractive and worthwhile to the investor";[26] while (b) developers and nonprofits negotiate for the residual value that their extended efforts have

18. *Id.* at 883 (emphasis added).
19. *Id.* at 879 (emphasis added).
20. *Id.* at 880 (emphasis added).
21. *Id.*
22. *Id.*
23. *Id.* at 883 (emphasis added).
24. *Id.* at 881.
25. *Id.* at 882 (emphasis added).
26. *Id.* at 874, 881 (emphasis added).

built up throughout the Compliance Period.[27] In other words, tax credit investors are *not* investing in real estate.[28]

The Sixth Circuit also solidified the importance of the § 42 ROFR, which "operates to protect the incentives of for-profit entities to initially invest in affordable housing projects, while creating a means for nonprofits to regain ownership and continue the mission of affordable housing once those incentives expire."[29] In turn, as *Pathway* clarifies that "*[f]acilitation of the investor exit after the expiration of the fifteen-year compliance period is, therefore, crucial to the efficacy of the LIHTC program*."[30] The court warned that the danger in disrupting this careful balance is that "nonprofits will be less likely to enter a partnership that includes an investor, if doing so entails a serious risk of an ownership battle after the fifteenth year. *Unsurprisingly, industry participants in LIHTC programs have long acted in accordance with that understanding*."[31] *Pathway* thus serves as an extraordinarily important case in Year-15 disputes and has already impacted several other previously pending cases.

D. Pathway's *Impact:* Palm Communities *and Other Settled Cases*

One example is apparent from a recent order granting a stay pending related appeals in a case commonly known as *Palm Communities*.[32] As referenced in the June 2022 Issue, the district court in *Palm Communities* decided—relying upon the now reversed district court in *Pathway*—that a "bona fide offer" requirement could only be satisfied if the general partner held a *specific intent* to "'*actually* desire to accept' a third-party offer . . . ."[33] Accordingly, that court found that the § 42 ROFR was not triggered by the general partner's desire to accept an offer so the non-profit could exercise

27. Jill Khadduri et al., U.S. Dep't of Hous. & Urb. Dev., What Happens to Low-Income Housing Tax Credit Properties at Year 15 and Beyond? 41, 76 (Aug. 2012), https://www.huduser.gov/publications/pdf/what_happens_lihtc_v2.pdf ("[A]s investor competition to purchase LIHTC equity intensified, 'back-end' dynamics moved decidedly in favor of [project sponsors].") [hereinafter Year 15 HUD Report].

28. *But cf. Investor Perspectives*, *supra* note 1, at 38 ("In short, a LIHTC asset is a real-estate investment that happens to also provide affordable housing.").

29. *Id.* at 875.

30. *Id.* (emphasis added).

31. *Id.* (emphasis added) (citing the Year 15 HUD Report, *supra* note 27, and noting that "[b]y far the most common pattern of ownership around Year 15 is for the investor partners to sell their interests in the property").

32. Centerline Hous. P'ship I, LP Series 2 v. Palm Cmtys., No. 8:21-cv-00107-JVS-JDE, 2021 WL 4895746 (C.D. Cal. Sept. 2, 2021). The authors of this article are part of the law firm that represented parties in the case.

33. Palm Cmtys. v. Centerline Hous. P'ship I, LP Series 2, 8:22-cv-00296-JVS-JDE, 2022 WL 6672470, at *4 (Sept. 28, 2022) (discussing a summary judgment order in *Palm Communities*). The authors of this article are part of the law firm that represented parties in the case.

its § 42 ROFR.[34] The court—like the district court in *Pathway*—relied upon this conclusion, in part, to find the general partner breached its fiduciary duty to the investor limited partner by intentionally triggering the nonprofit partner's § 42 ROFR.[35]

Following the Sixth Circuit's reversal in *Pathway*, however, and while *Palm Communities* was on appeal to the Ninth Circuit (the Appeals), a subsequent case closely related to *Palm Communities*, involving the same parties and the same LIHTC property, was proceeding before the same judge, whereby the court stayed those proceedings pending the Appeals because, in part, the court had "*relied on the same legal standard in the now reversed decision* of *SunAmerica Hous. Fund 1050 v. Pathway of Pontiac, Inc.*, No. 19-11783, 2021 WL 391420, at *3 (E.D. Mich. Feb. 4, 2021) . . . ."[36] The court reasoned that "[i]t follows that if [it] were to deny a stay but later be reversed on appeal on the breach-of-fiduciary issue, then significant judicial time and resources spent furthering th[e] litigation will have been wasted."[37] Soon thereafter, the same parties filed a joint notice of settlement in the Appeals, notifying the Ninth Circuit that a binding agreement had been reached, which provides, *inter alia*, for the dismissal of the Appeals with prejudice.[38]

Two other cases also settled in *Pathway*'s wake: *Wesley Hous. Dev. Corp. of N. Va. v. SunAmerica Hous. Fund 1171*,[39] and *Riseboro Comm'y P'ship Inc. v. SunAmerica Hous. Fund No. 682.*[40] In the former, the nonprofit received an assignment of the limited partners' interests in the affordable housing property and a $1.5 million payment; while, in the latter, the nonprofit received a majority ownership interest in the affordable housing property and $1.2 million, paid over fifteen years, to fund resident services programs.[41]

II. The *St. Mary's* Reconsideration Order

Another Year-15 case referenced in the June 2022 Issue, commonly referred to as the *St. Mary's* case, has also changed course following a motion for reconsideration.[42] *St. Mary's* resolved how to calculate the price for an option to purchase an investor limited partner's interest in a LIHTC partnership

34. *Id.*

35. *Id.*

36. *Id.* (emphasis added).

37. *Id.* at *5.

38. *See* Centerline Hous. P'ship v. Palm Cmtys., No. 22-5277, at Doc. No. 26, No. 22-55637, at Doc. No. 21 (9th Cir., Oct. 21, 2022).

39. Case No. 2021 11960 (Va. Fairfax Cir. Ct. Fairfax, Va. Nov. 14, 2022).

40. 18-cv-7261 (RJD) (VMS), at Doc. No. 68 (E.D.N.Y. June 30, 2022).

41. Beth Healy, *Affordable Housing Case Settled in Michigan Reverberates in Massachusetts*, WBUR (Aug. 22, 2022), https://www.wbur.org/news/2022/08/22/affordable-housing-case-settled-michigan-reverberates. The authors of this article are part of the law firm that represented a party in Wesley Hous. Dev. Corp. of N. Va., Case No. 2021 11960 (Va. Fairfax Cir. Ct., Fairfax, Va. Nov. 14, 2022).

42. Saugatuck, LLC v. St. Mary's Commons Assocs., LLC, No.19- cv-0217 (SIL), 2022 WL 3699484 (E.D.N.Y. Aug. 26, 2022).

pursuant to an option agreement.[43] Under the option agreement, the option price is "the amount otherwise payable to the Limited Partners as if the fee title to the [property] had been acquired under [the option to purchase the property] and the mortgages were satisfied or otherwise paid or assumed" (Hypothetical Sale).[44]

Prior to the *St. Mary's* opinion, the Eastern District of New York adopted a report and recommendation (R&R) that used the limited partnership agreement's (LPA) dissolution and liquidation waterfall (Section 12.4) to determine the option price under a Hypothetical Sale, which would have produced a windfall for the investor limited partner by allowing it to monetize a positive capital account while upending the general partner's bargained-for back-end benefits.[45] Upon reconsideration, however, the court in *St. Mary's* acknowledged that it had not considered another, similar case, commonly known as *Hopkins Court*, recognized the resounding connections between the two cases, and reevaluated its previous contract interpretations in light of *Hopkins Court* to adopt the New York State Appellate Court's conclusion that "the interpretation posited by the [investor limited partner]—'that any sale of the project results in an immediate dissolution of the partnership that would, in effect, predate the sale and require section 12.4(A) to control the distribution of its proceeds – *would impermissibly operate to render portions of the partnership agreement meaningless*.'"[46]

In doing so, *St. Mary's* recognized—as did *Hopkins Court*—that the option price should be calculated by utilizing the LPA provision applicable to the distribution of sale or refinancing proceeds, not the LPA provision applicable to liquidation or dissolution of the partnership. Specifically, the court found the LPA "unambiguously lists 'the sale or other disposition of all or substantially all of the assets of the Partnership' as an event that '*cause[s]* a dissolution'" but *not until after the sale occurs and its proceeds are distributed under the LPA waterfall applicable to sale proceeds*.[47] Put differently, as a matter of order of operations, "the sale and dissolution are two distinct events" according to the LPA's plain language and, therefore, cannot be treated as a singular event.[48] Thus, *St. Mary's* harmonized itself with *Hopkins Court* and held that to determine the option price under a Hypothetical Sale "the parties must first use LPA sections 9.2.B(i)–(ix) [applicable to the distribution of sale or refinancing proceeds] before applying Section 12.4 [applicable to the distribution of liquidation proceeds] to distribute any remaining funds."[49]

The court also discredited another commonly-proffered Aggregator contention, which is that limited partners must receive payment upon exiting a LIHTC partnership for their positive capital account balances.[50]

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43. *Id.* at *2–4, *6–7.

44. *Id.* at *2.

45. *Id.* at *5–6.

46. *Id.* at *7 (emphasis added) (citing and quoting *Centerline/Fleet Hous. Partnership, L.P. – Series B v. Hopkins Ct. Apts.*, 195 A.D.3d 1375, 1375–77 (E.D.N.Y. Aug. 26, 2022).

47. *Id.* at *7.

48. *Id.*

49. *Id.* (also discarding the investor limited partner's argument that Section 12.4 would be rendered superfluous under *Hopkins Court*).

50. *Id.* at *8.

> Specifically, *St. Mary's* rejected this approach by reasoning that although "these arguments may have *surface* appeal, they are unsupported by the LPA's unambiguous language . . . which is devoid of any language that explicitly conditions Section 9.2.B's proceeds-allocation waterfall on a pay-out commensurate with the parties' capital accounts . . . ."[51]

III. The Delaware Chancery Court Decision: *JER Hudson*

As noted earlier, *JER Hudson* is a recent case identifying the Aggregator problem and does so in one of the most detailed opinions on the issue to date. As in *Pathway* and other Year-15 disputes, in *JER Hudson* a "new limited partner repeatedly sought either a sale of the [LIHTC] property or a buyout of its partnership interests at what *it* considered fair market value" after the end of the Compliance Period.[52] After the Aggregator "began agitating for a way to avoid" a non-profit's a § 42 ROFR, "[w]hen the general partner would not go along, the limited partner claim[ed] the general partner's response to the property's disposition to a nonprofit amounted to a breach of fiduciary and contractual duties" that also justified removal.[53] However, the court's exhaustive order found against the Aggregator in every respect.[54]

A. JER Hudson's *Articulation of the Aggregator Problem*

JER Hudson characterizes itself as a "precedential opinion contribut[ing]" to the wider Year-15 litigation context,[55] going so far as to precisely articulate the troubling trend whereby "'certain entities, like Hunt [Capital Partners], are acquiring limited partner interests in LIHTC partnerships—known as 'Aggregators'—who then attempt to extract value out of such interests that were not intended by the original parties to the partnerships.'"[56] The Delaware Chancery Court recognized the threat Aggregators pose to the LIHTC industry and the rigidity of the nation's affordable housing stock,[57] while also summarizing the "'variety of tactics'" that Aggregators utilize:

> When the general partner does not accede to the new limited partner's demands, the limited partner and general partner clash over the general partner's fiduciary duties and the terms of the governing partnership agreement, and litigation follows. In some instances, new limited partners have sought to leverage partnership liabilities in order to secure a profitable buy-out and cash return. In other instances, that tension has come to a head over

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51. *Id.* (emphasis added).
52. JER Hudson GO XXI LLC v. DLE Invs., 275 A.3d 755, 761–62 (Del. Ch. 2022).
53. *Id.* (emphasis added).
54. *Id.* at 762.
55. *Id.* at 761.
56. *Id.* at 772 n.78 (alterations in original) (quoting CED Cap. Hldgs. 2000 EB, L.L.C. v. CTCW Berkshire Club, L.L.C., 2020 WL 6537072, *5, *10 (Fla. Cir. Ct. Nov. 3, 2020) (court trial order)).
57. *Id.* at 772–73 (quoting Brandon M. Weiss, *Clarifying Nonprofit Purchase Rights in Affordable Housing*, 48 FORDHAM URB. L. J. 1159, 1168–69 (2021)).

> the property's disposition through the ROFR. New limited partners have attacked the exercise of the ROFR based on the legitimacy of the triggering offer, whether the partnership was a willing seller, and other mechanical issues. The plaintiffs in those cases have also asserted a general partner breached its fiduciary duties by permitting the exercise of a ROFR or otherwise thwarting the goals of a new limited partner.[58]

JER Hudson thus stands as a contemporary reminder that the Aggregator problem is real and continues to disrupt the delicately balanced relationships central to the LIHTC program's success.

B. JER Hudson*'s Clarification of the LIHTC Program and Participant Expectations*

JER Hudson also offers several notable findings on the LIHTC program, including (i) the importance of § 42 ROFRs; (ii) investor expectations; and (iii) post-Compliance Period property interest transfer rights. As for the importance of the § 42 ROFR, the court reiterated its legislative purpose, which "is designed to facilitate the nonprofit's preservation of [LIHTC property] as continued affordable housing."[59] *JER Hudson* also chastised the common Aggregator-playbook-challenge to § 42 ROFR dispositions, finding that doing so is "not in the 'usual way' or 'ordinary course' of this, or any, LIHTC partnership. Stopping, reversing, or rescinding the Disposition [of the § 42 ROFR] would be outside of the 'usual way.'"[60]

The court also connected the § 42 ROFR to investor expectations, finding that Aggregators who attempt to inhibit the transition envisioned by the ROFR contravene the LIHTC program's intent, as well as the *original* parties' *original* understandings.[61] This is because "[t]he Property has already distributed its allocated tax credits, so retaining investments in a property that is no longer eligible because a limited partner 'believes it would be in its own strategic business interest to do so' would not be 'the usual way.'"[62] *JER Hudson* additionally provides insight into the often opaque multitiered, investor-side structures of typical LIHTC deals, which often involves a middle-tier "fund" that houses partnership-level interests, as is the case in *JER Hudson*. But, even at this level, as the court explained, "[a]fter the Compliance Period expired and the Property was no longer eligible for tax credits, pursuing other sources of value from the Property was not part of the Fund's purpose."[63] Similarly, the court further solidified that traditional investors do not expect residual equity benefits at Year-15 because "Section 42 [of the LIHTC program] advances the deliberate policy

58. *Id.* at 773–74 nn.80–86 (footnotes omitted) (collecting cases).

59. *Id.* at 767 (footnote omitted).

60. *Id.* at 798 (footnotes omitted). The "usual way" relates to the Delaware Uniform Partnership Law and the *ultra vires* doctrine.

61. *Id.* (footnote omitted).

62. *Id.* (footnote omitted).

63. *Id.* (footnote omitted).

choice *to replace* a typical equity investor's expectations of economic cash flow or appreciation from the apartment complex with a comparable or better return on investment almost *solely derived from tax benefits*."[64] Thus, tax credit investors "contemplate[] preserving tax credit value *but do[] not contemplate pursuing equity value after the Compliance Period*,"[65] since, "[a]t the end of the [Compliance] Period, the investor has reaped all the tax credits it can from its investment and typically exits the partnership by selling its limited partner interests, either to the general partner or to a third party."[66]

Conclusion

Pathway and *St. Mary's* mark especially significant changes worthy of attention given that they were discussed in the June 2022 Issue but have since been reversed or wholly reconsidered. *JER Hudson* adds an additional layer to this body of law similarly meriting examination.

64. *Id.* at 766 (emphasis added; footnote omitted).

65. *Id.* at 796 (emphasis added).

66. *Id.* at 771 (footnote omitted) (noting also that the "value of those interests is much lower than it was at the beginning of the Credit Period, as the tax credits have been harvested").