Beware the Aggregator

Avoiding bad investor exits

By David Davenport

Created by the Tax Reform Act of 1986, the Low Income Housing Tax Credit (LIHTC) has become the most important resource for creating and maintaining affordable housing in the United States. The LIHTC program provides state and local allocating authorities the equivalent of approximately $8 billion in annual budget authority to issue tax credits for the acquisition, rehabilitation or new construction of rental housing targeted to lower-income households. Because the LIHTC program brings real estate developers and tax credit investors together to achieve the laudable purpose of providing affordable housing and has helped to finance nearly 2.4 million units of affordable housing since 1986, the program is a great illustration of how the public and private sectors can come together to address important social needs.

Experience has shown that the vast majority of relationships that are formed between real estate developers and tax credit investors are good, long-term relationships, generally guided by reasonableness and fairness, and governed by complex partnership agreements. These "project partnerships," in general, include a general partner entity (often a subsidiary of the developer), who operates and manages the partnership; and a limited partner entity (the investor), who generally plays a passive role in the operation of the partnership, possesses certain negotiated rights regarding management, and receives the vast majority of the tax credits during the first ten years of the partnership's operation of its affordable housing development. The limited partner entity, often a partnership itself, and commonly referred to as the Upper Tier Partnership, is typically comprised of a general partner who manages or controls the tax credit investment and a limited partner who actually made the capital investment for the tax credits.

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Enter the Aggregator

I am a Shareholder with the law firm of Winthrop & Weinstine, P.A, which is located in Minneapolis, MN; and I am a trial lawyer. Over the last several years, I have seen significant changes take shape in the industry, and participants, usually real estate developers, find themselves in project partnerships where their limited partner tax credit investor is now managed or "controlled" by what has become known within the industry as an Aggregator.

An Aggregator—unlike a typical syndicator or investor that developers have worked with for years—is usually an organization that has acquired limited partner interests in the project partnership or may have obtained control of the Upper Tier Partnership through ownership of its general partner entity long after the creation of the original project partnership. In other words, the Aggregator is someone new to the general partner; who was not part of the initial transaction that lead to the partnership or the development; and, as experience has shown, views the partnership and its development as a financial instrument rather than a real estate investment. Thus, once the project partnership's tax credits have been fully allocated and realized due to the developer's successful operation of the development, and the development reaches the end of the Compliance Period (i.e., year 15) such that recapture of the tax credits is no longer a possibility, the Aggregator aggressively seeks to dispose of the limited partner's interest in the project partnership. And, in my experience, the Aggregator often casts reason, fairness, good faith, and legal principles aside because it is not an industry participant interested in developing more affordable housing; rather, it hopes to extract more financial return from the development than the tax and other benefits it purchased.

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In my work with developers on a variety of year 15 issues and concerns, I have seen this happen many times. For instance, a few years ago, I represented a nonprofit organization who was a general partner in a project partnership and had negotiated for, and received, a right of first refusal to purchase the development at the end of the compliance period for the statutorily discounted price of debt plus taxes. The partnership agreement, like the right of first refusal, was entered into in 1999. Fifteen years later, when the nonprofit went to exercise its right, the Aggregator rejected the exercise and claimed that the document giving rise to the right had been invalid from its inception. Upon investigation, the nonprofit realized that the right of first refusal document had an error in it because it identified a for-profit affiliate, rather than the nonprofit as the entity possessing the right. Thus, according to the Aggregator, because the contract had a provision stating that the right would expire if the nonprofit lost its nonprofit status during the compliance period, the nonprofit never actually had the right at all. On its face, the Aggregator's position was entirely unreasonable, but it provided a platform for the Aggregator to create controversy and argue for a sale of the development based upon a fair market value rather than debt plus taxes. Fortunately, but after being in litigation for more than a year, we obtained a court order to reform the right of first refusal, correct the error, and allow for the nonprofit to move forward as the party with the right of first refusal.

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Additionally, I have represented several real estate developers involved in refinance disputes that arise when project partnership debt is scheduled to mature around year 15 and the limited partner tax credit investor refuses to consent to the refinance, or contrives arguments that consent is needed to refinance when, in reality, it is not based on the operative partnership agreement. In these cases, large positive capital accounts generally exist and the Aggregator, who may also have rights to substantial deferred asset management fees, posits that refinancing at year 15 is simply not allowed, under any circumstances; unless, for instance, the proceeds from a refinance are used to acquire the tax credit investor's "interests" in the project partnership for a price determined by the Aggregator. In expressing the perceived value of this interest, the Aggregator may condition its price to the balance of a positive capital account or to a 99 percent distribution of the proceeds from a hypothetical sale of a development since the partnership agreement (for tax reasons) made the limited partner a 99 percent owner of the project partnership. To create leverage, and where consent to refinance is needed, the Aggregator may withhold consent, even as the project partnership's debt is scheduled to mature and default is imminent. Fortunately, I have been able to help real estate developers navigate these situations and obtain court orders to allow for refinances without consent from the tax credit limited partners. Most recently, last November, following a bench trial, my developer client was successful in proving that the Aggregator had acted unreasonably and in violation of the partnership agreement and an implied duty of good faith and fair dealing (which exists in all contracts).

Property Raids

Lastly, recent experience suggests that efforts to remove developers from their posts as general partners in project partnerships may be on the rise and become more common. In fact, in helping clients address a recent property raid—where six people (including two security guards and a locksmith) showed up unannounced at 9:30 on a Monday morning at a senior housing development with the intent to physically "take over" the property—we learned that the raid was only one out of approximately 20 removal raids that had been orchestrated over the last four years. We also learned that the raid followed a standard protocol and was coordinated by an employee whose job duties include initiating and overseeing raids intended to remove general partners from project partnerships.

In sum, while adversarial relationships are not the norm in the LIHTC industry, the presence of the Aggregator has created conflict unlike that which we have seen in the past. TCA