NATIONAL HOUSING TRUST

Right of First Refusal in the Housing Credit Program

The Low-Income Housing Tax Credit (Housing Credit) program is the largest federal resource for creating and preserving affordable housing. The Housing Credit program facilitates partnerships between mission-driven nonprofit organizations and for-profit investors to generate affordable rental housing for low-income families across the country. The program has helped to finance nearly 3.5 million affordable homes since 1986.

In recent years, outside parties motivated solely by profits, have acquired the control of investor partnerships in Housing Credit properties and begun systematically challenging a nonprofit general partner's project transfer rights through the Right of First Refusal. These actions have wide-ranging impacts on the low-income residents who call Housing Credit properties home, in addition to nonprofit general partners who are committed to the long-term preservation of affordable housing communities.

The disruption of the normal investor exit process, with the hope of generating windfall returns, has led to a growing number of troubling legal disputes and litigation that both drains the general partner's resources and threatens the long-term affordability of valuable affordable homes.

WHAT IS THE IMPACT OF THE DISPUTES?

Challenges to general partner's project-transfer rights are focused on the Right of First Refusal (ROFR). The ROFR can be used by the nonprofit to obtain full ownership of a property by purchasing the investor stake once the tax credits have been fully claimed, often at Year 15.

By disputing the transfer of property to the nonprofit general partner through the ROFR, private investors are threatening to extract profits from a mission-driven general partner affordable housing developer/owner *and* the Housing Credit program.

Mission driven nonprofits not only invest in the physical housing but also in supportive services, education / training programs, & partnerships with other local organizations that benefit community members outside of our own properties.

WHAT IS THE RIGHT OF FIRST REFUSAL?

The Housing Credit program, through Internal Revenue Code (IRC) Section 42(i)(7), offers nonprofit general partners a Right of First Refusal (ROFR). The ROFR may be used to obtain eventual ownership of the property at a minimum purchase price equivalent to the outstanding debt plus exit taxes. The provision allows nonprofit general partners to gain ownership of Housing Credit properties after the initial 15-year compliance period of the program. After Year 15, the investor has claimed all Housing Credits though the program's rent restrictions remain for at least an additional 15 years.

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When mission driven developers are forced to spend limited reserves on legal feels or to pay the private investor directly to remove them from the partnership, few resources are left to maintain low rents, provide wrap-around resident or supportive services, or ensure that the properties are maintained as high-quality housing. In these scenarios, it is the low-income renters who are most hurt. Meanwhile, staff resources are diverted to combatting the partnership dispute rather than providing housing services. In some instances, mission-driven owners may be forced to sell the property.

In addition to low-income renters and the financial stability of an individual affordable housing community, the systematic challenges of the ROFR also affects the financial viability of a nonprofit general partner. As property reserves erode, a nonprofit partner experiences higher levels of debt and hits to their balance sheet. Private, profit-motivated investors know that most nonprofit general partners do not have the resources to litigate ROFR contractual issues in court. To avoid litigation, private investors, instead, ask for a profitable cash payment or force the sale of the affordable property in return for leaving the partnership. Further, as real estate prices have soared across the country, these profit-motivated parties recognize their ability to exploit and reap hundreds of millions of dollars of profits from Housing Credit developments through the forced sale of the low-income housing. Depending on the legal fees or payments to be made to the private investor, without adequate property reserves, some owners may have to sell their affordable housing portfolio and exit the affordable housing market all-together, bringing about further housing instability for low-income residents.

These actions are both detrimental to the affordable housing industry and contrary to the original intention of Congress and the Housing Credit Program.

A ROFR is not unique to the Housing Credit program and is often used in common real estate transactions when afforded by a local ordinance. The common law ROFR is triggered by an enforceable, bona fide offer of purchase from an unrelated third party. When this offer is made, the relevant party (often a City, designated development partner, or in rare instances the tenants) is given the opportunity to match the third party's offer price and purchase the property for themselves. In these instances, the purchase price is calculated by the market. The ROFR in the Housing Credit program differs in that the price is set by the federal statute, not market price. This clearly establishes it as separate from the common law ROFR, with the statute listing the ROFR purchase price as the sum of the property's outstanding debt plus taxes, yet disputes still occur. Similarly, limited partners state that they are not required to recognize the rights established in the partnership agreement without a bonafide offer from an unrelated third party. As clearly stated in Section 42(i)(7), a nonprofit partner may hold the right to purchase the building through a ROFR after the close of the building's 15 year compliance period thereby negating any serious or "bonafide" offer to purchase by a third party.

WHAT ARE SOME INVESTOR TACTICS FOR SYSTEMATICALLY CHALLENGING GENERAL PARTNERS' PROJECT-TRANSFER RIGHTS?

- taking position that the Section 42(i)(7) ROFR is the same as a common law right-of-first-refusal, including in the calculation of the ROFR purchase price and a bonafide offer;
- disputing the conditions and scope of transfer rights;
- delaying, obstructing, and disagreeing with related valuations;
- refusing consent to refinance, either outright or by placing significant conditions on consent
- disputing fee calculations;
- arguing over typographical errors;
- asserting alleged breaches of partnership duties from many years prior, including by arguing that rents should have been set higher to maximize profits; and
- alleging breach of fiduciary duty by the nonprofit general partner.

> *For most of the Housing Credit program's history, the vast majority of participating nonprofit sponsors have secured the transfer right, exercised it, and obtained full ownership to continue to operate the property as affordable housing in accordance with their missions.*

National Housing Trust has been a champion of this issue across the country, working alongside state and local Housing Credit allocating agencies, advocates, as well as Congress. As the convenor of an HFA Working Group devoted to ROFR issues, we have developed a toolkit of best practices to protect both existing and future Housing Credit properties and nonprofit owners from disputes related to ROFR. NHT continues to work closely with state and local Housing Credit allocating agencies to strengthen of the nonprofit ROFR, to better serve the needs of affordable housing residents and support quality housing opportunities.

If you are concerned about the loss of affordable housing due to Right of First Refusal disputes, please contact National Housing Trust to support our effort.

FOR MORE INFORMATION:

Courts are Handing Setbacks to Nixon Peabody Clients Seeking Control of Affordable Housing, WBUR (May 2022)

Investors Target Affordable Housing, NPR Here and Now (May 2021)

Local Officials and Congressional Leaders Decry Investors Who Put Affordable Housing At Risk, WBUR (May 2021)

Investors Mine for Profits in Affordable Housing, Leaving Thousands of Tenants At Risk, WBUR (April 2021).

Refusing the Right of First Refusal, Branden Duong from Shelterforce (October 2020).

Nonprofit Transfer Disputes in the Low Income Housing Tax Credit Program: An Emerging Threat to Affordable Housing, Report from the Washington State Housing Finance Commission (September 2019).

Year 15: Facing Off with the Aggregator, David Davenport from Tax Credit Advisor (May 2019).
Beware the Aggregator, D avid Davenport from Tax Credit Advisor (April 2017).