Preservation of Affordable Housing

SJC Homeowner's Rehab Case has Significant Implications for Tax Credit Developers and Syndicators

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The Massachusetts Supreme Judicial Court’s decision this past June in the case of Homeowner’s Rehab Inc., et al. v. Related Corporate V SLP LP, et al. is a triumph of public interest jurisprudence. Just as importantly, within the narrow niche of affordable housing practice, it is a far-reaching decision with significant potential implications on the prospects for preserving as affordable housing the 3 million apartments financed with low-income housing tax credits nationwide.

On its face, it was a simple contract dispute: One partner sought a declaratory judgment against the other partner as to its ability to exercise a right of first refusal (ROFR) to purchase the property and own it outright after 15 years, as negotiated at the inception of the partnership agreement.

Beneath that straightforward surface, however, lay a complex and nuanced struggle of important public interests wrestling with common-law principles. The right of first refusal at issue, which allows for the purchase of a low-income housing tax credit (LIHTC) project by a non-profit at a discounted value, was authorized under Section 42 of the IRS code. The for-profit partner (the LP, originally an affiliate of Related, whose interest was subsequently sold to a third party, who pursued the litigation) sought to use common-law principles and select contract provisions to prevent the non-profit partner (Homeowner’s Rehab, or HRI) from exercising its rights under the contract, rights that were dependent on the statutory scheme created in Section 42.

The SJC, on its own initiative, transferred the case from the Appeals Court, and issued a decision that crafted a set of fine judicial lines that will support the public’s interest in the preservation of LIHTC properties nationwide. Within the affordable housing LIHTC community, it is the first appellate decision on the subject. And while it is not controlling precedent in other states, it represents helpful thinking and language that may influence other courts, and will affect contracting behavior.

History of the Case

HRI and the LP were partners in a low-income housing property (808 Memorial Dr. in Cambridge) purchased and preserved as affordable housing using the LIHTC. HRI sponsored the project in furtherance of its mission, and the LP invested capital in return for tax benefits, including LIHTCs. As part of its agreement, the LP gave HRI the ROFR — a right to purchase the property at the end of the 15-year “compliance” period at a discounted price that is authorized under Section 42(i)(7) of the IRS code. At the end of the compliance period, HRI sought to exercise the ROFR. The LP claimed that, under common-law principles (and pursuant to the general provisions of the partnership agreement), the LP’s consent (which it had no desire or obligation to give) was needed prior to its exercise. HRI sought a declaratory judgment in Superior Court that it had taken all necessary action to exercise the ROFR. The Superior Court agreed, and the LP appealed.

The importance of the case to Massachusetts was evidenced by the number and breadth of amicus briefs filed in favor of HRI: four Massachusetts-based housing non-profits (including one by Preservation of Affordable Housing Inc., associated with the authors); three Massachusetts-based associations of distinctly different real estate and community-interest groups; three Massachusetts-created “quasi” governmental entities involved in the production and preservation of affordable housing, as well as the Massachusetts Department of Housing and Community Development (the state agency that allocates tax credits and oversees the LIHTC program).

Three amicus briefs were also filed on behalf of the LP, all of which seemed to have been attracted primarily by the “first impression” nature of the case (none of them represented a similarly situated party).

The Decision

The decision is notable in two respects: The first is that it made important points on issues related to the exercise of a 42(i)(7) ROFR (with the caveat that it only decided the language of the agreement that was in front of them); the second is that it deliberately read the agreements in a way that supported and was favorable to the public policy underlying the LIHTC statutory scheme.

Regarding the exercise of the ROFR, the court resolved an important ambiguity as to what kind of offer was necessary to trigger a 42(i)(7) ROFR. In the common-law context, where there exists a long and sordid history of specious offers at inflated prices that unjustly undermine the intended preemptive nature of rights of first refusal, there is a judicially imposed requirement that a qualifying offer be a “bona fide” offer. But, as the court noted, in the LIHTC ROFR context, the existence of the non-profit’s right to buy the property at a statutory discounted price will likely significantly dampen the interest of otherwise “bona fide” offerors. The court established that, in the 42(i)(7) ROFR context, any enforceable offer from a third party was sufficient to trigger the ROFR. Typically, an enforceable offer is merely one from a party financially capable of exercising it if accepted — a substantially lower bar than a “bona fide” offer. In the underlying case, HRI had solicited and received an offer from Madison Park CDC, a mission-aligned (and capable) local non-profit developer and owner/operator of affordable housing. The court explicitly noted that there was nothing in the agreements that precluded HRI from soliciting and obtaining such an offer.

The court also deftly drew a fine line between a partnership’s ability to decide to accept an offer from a third party (which it deemed did not require the LP’s consent), and its ability to actually accept a third-party offer (which it deemed would require the LP’s consent). In the underlying agreements at issue, the trigger for exercising the ROFR was having received an offer that the partnership had decided to accept. As the court noted:
In drawing this fine line, the court drew its scalpel-like distinction directly from the public policy underlying the ROFR, noting that:

“The decision to accept does not constitute an acceptance of the offer — it need not be communicated to the third party — but a decision must be made.”

In this case, the court noted that the ROFR, using the language of a right of refusal, is a statutory creation; and while “not completely unanchored from its common-law reading,” it is different in many material ways, and should not be read so as to “contravene the purpose of § 42 (i)(7).”

The court noted that the ROFR, reading the contract as a whole and considering the overall purpose of the partnership in order to get to a decision that was consistent with both contract law and the original expectations of the parties. The court’s opinion was broadly and explicitly informed by deep dives into legislative intent and public purpose, including legislative history (noted above), as well as noting that the LIHTC is currently the largest source of affordable housing production and preservation in the country. Generally, the court decided each question of law in a manner that promoted the original legislative intent — to preserve affordable housing by allowing below-market acquisitions by nonprofits, without negative tax consequences. The ROFRs at issue are common to many LIHTC transactions — and the language in the individual agreements has a wide range of clarity and sophistication. National non-profits, such as Preservation of Affordable Housing (POAH) and The Community Builders (who filed a joint amicus brief on behalf of HRI), have ROFRs maturing on hundreds of properties over the next five years. Far beyond its precedential value, this case will have significant impact in favor of the nonprofit sponsors in negotiating the disposition of those properties and their continued preservation as affordable rental housing.

In addition, as the court noted, Massachusetts has a very distinct and real housing affordability problem. One indicator is the amount of income a family must earn in order to afford the rent on an average three-bedroom apartment: $75,000, according to a recent study by the National Low Income Housing Coalition — which also determined that Massachusetts was the sixth-most expensive housing market in the country. Another indicator of the scale of the local problem was the number of amicus briefs supporting HRI, mostly from non-profit or quasi-governmental organizations whose work is dedicated to creating or preserving affordable housing. A third indicator can be seen in the underlying facts of the case: the economic pressures caused by rising market values of housing in Massachusetts. The subject property, 808 Memorial Dr. in Cambridge, is a mixed-income development overlooking the Charles River — a very high-priced rental area, and the market-rate units have had quite significant rent increases over the 15-year period. Presumably, that increased value made it economically worthwhile for the LP to litigate to avoid the ROFR in the hopes of obtaining a higher purchase price under the alternative Fair Market Value option.

All in all — this decision is a trifecta win: a big win for non-profits in the Massachusetts affordable housing community, and for non-profits in the industry nationally — with enormous beneath-the-surface impact on the negotiations between non-profits and the limited partners that have invested in their tax credit projects; a big win for states and local governments that have invested in affordable housing — as projects with existing investments will be preserved at lower cost; and a big win for the affordable housing legal community — as the case represents a veritable treasure trove of helpful language directing courts to find, cherish and preserve the public part of public-private partnerships.

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