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Manufactured triggering of right of first refusal upheld

Affordable housing advocates laud judge's ruling

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The general partner of an affordable housing development could solicit a third-party offer to purchase the development and trigger its right of first refusal without breaching its fiduciary duty to the development's limited partners, a judge in the Suffolk Superior Court's Business Litigation Session has decided.

Looking solely at the option agreement between the parties, each side could make a plausible argument that its interpretation was correct, Judge Janet L. Sanders explained. Under the option agreement, the nonprofit sponsor of the development had a unilateral right to acquire the property at a market rate but would pay a lower price if a third party's offer triggered its right of first refusal.

The limited partners argued that the general partner had no authority to solicit an offer on the sponsor's behalf if they didn't consent to a sale. Sanders acknowledged that, if the court allowed the right of first refusal to be activated artificially, the section of the agreement authorizing a market-rate offer would seem to serve no purpose.

But the flip side was also true, according to Sanders.

"If the General Partner could not solicit or even entertain a third party offer without the Limited Partners' consent, then the Limited Partners could simply withhold their consent — not an unreasonable position to take, since they know that they could get a higher price if [the sponsor] was forced to purchase their interest outright," she wrote.

To interpret the option agreement, Sanders looked to the partnership agreement, the parties' intent when they executed the two contracts and the "backdrop" of the Low Income Housing Tax Credit program, under which the agreements were negotiated.

The 19-page decision is *Homeowner's Rehab, Inc., et al. v. Related Corporate V SLP, L.P., et al.*, Lawyers Weekly No. 12-143-16, and can be found at masslawyersweekly.com.

McKenna

Contracts are key

Whether the decision in her clients' case impacts other LIHTC projects remains to be seen, said the plaintiffs' counsel, Karen E. Friedman of Boston.

"I really do think it depends on the contract documents," the Lurie Friedman attorney said. "The majority of our argument was that our partnership agreement did not give the limited partners the ability to block a sale pursuant to the right of first refusal and the option agreement."

The defendants' counsel, Dennis E. McKenna of Boston, said that the position his clients have maintained has been consistent: The agreements are clear and unambiguous and do not permit the nonprofit to force a sale of the property through the exercise of the right of first refusal. While the nonprofit could make a market-rate offer on the property, the right of first refusal would only kick in if the owner "formed a specific intent to sell" and the partnership then received a bona fide offer, the Riemer & Braunstein attorney said.

McKenna's clients appealed Sanders' ruling, and he said he was heartened that the judge had taken the "fairly rare" step of granting a stay, which may suggest the existence of a legitimate issue for the Appeals Court to resolve.

If there was anything surprising about the decision, said Boston attorney Kenneth B. Gould, it was that it wound up in litigation at all. The Lawson & Weitzen attorney explained that the deal embodies a "very typical, common structure" with an exit strategy that was likely the result of a lot of negotiating.

The lesson is that attorneys have to take care in drafting their agreements, according to Gould.

"It is possible to build some residual value [of the property] into the exit strategy, but it doesn't look like that was part of the deal here," Gould said.

But he added that the tax benefits are enough of an incentive to fund affordable housing, he said.

"That's what [the investors] are paying for, not the residual value," he said.

Sanders aptly expressed concern about imposing too high an exit cost on the nonprofit, he added.

"By the time the [15-year compliance] period ends, the property may need work, there may have been code changes and a need to bring the property up to code," or the property may just be "tired," Gould said. Any increase in the exit cost ultimately adversely affects the tenants of the affordable units, he added.

Gould said he didn't see bad faith in the nonprofit going out and soliciting a third-party offer. If anything, he said, the bad faith may have been on the other side, with the investors trying to block the transfer of the property to the nonprofit and thwart the parties' intent.

Nixon Peabody's Jeffrey Sacks said the decision is "critical" to preserving §42 LIHTC projects developed by nonprofit owners as affordable housing.

"If this case had gone the other way, a nonprofit would have lost control of the property, and it would have been sold to the highest bidder," he said.

An indication of the important role the LIHTC plays in addressing the state's affordable housing shortage can be found on a recent Department of Housing & Community Development fact sheet, which shows that during its 30-year history, the LIHTC has led to 822 tax-credit projects in Massachusetts, creating 58,855 affordable units and raising $5.03 billion in equity from the private sector.

According to Sacks, this case is "definitely not an outlier." He pointed to a pending bipartisan bill cosponsored by Sens. Maria Cantwell, D-Wash., and Orrin Hatch, R-Utah, which would convert rights of first refusal into options to purchase at a favorable price.

Deal is struck

In July 1997, nonprofit sponsor Homeowner's Rehab, Inc., general partner Memorial Drive Housing, Inc., limited partner Centerline Corporate Partners V L.P. and special limited partner Related Corporate V SLP L.P. came together using the LIHTC to redevelop and rehabilitate the property at 808-812 Memorial Drive in Cambridge, which is now home to 211 affordable apartment units, 89 market-rate units, commercial space and a 262-space parking garage.

The LIHTC program provides equity investors with 10 years' worth of tax credits, which will be clawed back if the affordable units are not maintained as such for a 15-year "compliance" period, which in this case expired on Dec. 31, 2012.

The partnership agreement provided that, in exchange for their $6.9 million capital contributions, the limited partners would acquire a 99.98 percent interest in the partnership. General partner Memorial Drive was to have "full and complete charge of the management of the business of the partnership in accordance with its purpose."

It was envisioned, however, that one day HRI would acquire the partnership's interest in the property in one of two ways. The first was an "absolute, exclusive, and continuing" right of first refusal, under which it would pay the least of three prices, generally the "Section 42 price," as defined by 26 U.S.C. §42(i)(7). HRI would be on the hook for the principal still owed on the mortgage plus all federal, state and local taxes attributable to the sale, but nothing more.

Alternatively, HRI could unilaterally make its own offer, acquiring the property for its fair market value, accounting for the restrictions encumbering the property.

This property on Memorial Drive in Cambridge is home to 211 affordable apartment units.

As the deal was coming together, the firm of Reznick, Feder & Silverman provided a memo which indicated that the limited partners could expect to net $3.3 million over their $6.9 million capital contribution. In fact, by the end of the compliance period in 2012, the limited partners had received approximately $7.5 million in tax credits and had taken advantage of over $24 million in tax losses.

Once the compliance period had ended, the executive director of both HRI and general partner Memorial Drive, Peter Daly, proposed acquiring the limited partners' interest in the property, but for the "Section 42 price" rather than the restricted market price.

The limited partners resisted, saying the Section 42 price would only be available if the partnership were willing to sell to a third party. Absent their consent, the limited partners maintained that Memorial Drive could not solicit or entertain outside offers.

With no agreement in sight and with the expiration of the right of first refusal looming at the end of 2016, on the advice of counsel Daly reached out to a fellow Boston nonprofit affordable-housing organization, the Madison Park Development Corporation, which agreed to offer to purchase the partnership's interest in the property for $42.175 million.

Daly believed this would trigger the right of first refusal. He issued a "disposition notice" as required, but Centerline balked, reiterating its belief that the general partner had no authority to sell or accept any offer on behalf of the partnership without the special limited partner's consent.

Undaunted, HRI tried to move forward with the purchase via the right of first refusal, agreeing to assume the mortgage debt secured by the property, which exceeded Madison Park's offer and the Section 42 price.

With no sign that the limited partners would accept those terms, HRI and Memorial Drive filed suit in Suffolk Superior Court's Business Litigation Session seeking declaratory relief. In their counterclaim, the defendants alleged breaches of fiduciary duty and the covenant of good faith and fair dealing. They also sought removal of Memorial Drive as general partner and an injunction against the sale of the property.

On Sept. 13, 2016, Sanders allowed the plaintiffs' motion for summary judgment in its entirety, including judgment on the defendants' counterclaims. The defendants filed a notice of appeal and on Oct. 18 were granted a stay restraining and enjoining the plaintiffs from selling or transferring the property. The time period for the plaintiffs to exercise their rights under the right of first refusal and option agreement will be tolled while the litigation is active.

Getting what they bargained for

The tax credits the LIHTC program provides to affordable-housing developers are useless to a tax-exempt organization. Instead, in these deals equity investors typically take a 99-percent initial partnership interest in a project, retaining that interest through the end of the 15-year compliance period to reap the full benefit of the tax credits.

For the developer, "the real incentive lies in its ability to acquire the [project] back from the partnership at the end of the 15 year compliance period" and continue to operate it as affordable housing, according to Sanders.

The transfer of the property typically involves "little cash," the judge noted. Instead, the developer often simply relieves the investors of the outstanding debt on the property.

Sanders noted that the partnership agreement "expressly recognized that one of the primary purposes of the Partnership is to provide affordable housing," which she considered in interpreting its provisions.

The defendants argued that since a sale to a third party cannot be *consummated* without the limited partners' consent, the general partner could not solicit or accept a third-party offer without its consent, either. But Sanders found nothing in the partnership agreement that would preclude Memorial Drive from doing what it did.

In essence, the judge concluded that the investors would be getting what they bargained for, given that the partnership agreement speaks to the nonprofit being able to purchase the property for the "minimum price consistent with the requirements of [26 U.S.C.] Section 42(i)(7)." MLW