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LIHTC exit strategies: Foreclosure

Note: This post is part of a continuing series on the Credit Report Blog on the subject of workouts and bankruptcies involving low-income housing tax credit (LIHTC) projects.

A lender's ultimate remedy for dealing with a distressed and over-leveraged LIHTC project is to foreclose on the project. Foreclosure is the primary unilateral remedy that may be undertaken by a lender and will generally be the remedy against which a negotiated restructuring will be measured and evaluated.

Impact of foreclosure on the LIHTC property and its tax credits

A foreclosure typically terminates the LIHTC Land Use Restriction Agreement (LURA) containing the rent and occupancy restrictions on the property, subject to the new owner's compliance with a "decontrol period." The decontrol period is a three-year period during which any owner of the property is prohibited from (i) evicting or terminating the tenancy of any low-income tenant other than for good cause, or (ii) increasing the rent for any such tenant above the rent-restricted rate established by the state housing agency. Unfortunately, if there is no LURA in effect for the property, any remaining tax credits will be disallowed. As such, a lender will need to decide whether to preserve or reinstate the LURA, thereby maintaining the right to claim any remaining tax credits, or to terminate the LURA, thereby allowing the property to be converted to a market-rate property (subject to compliance with the decontrol period).

Although it is possible to structure a foreclosure in a way that preserves the existing LURA (particularly in a judicial foreclosure state), a lender will typically foreclose away the LURA and then agree to encumber the property with a new LURA if it desires to maintain the property as a LIHTC property (thereby preserving the right to receive remaining tax credits associated with the property). We will address the mechanics of reinstating a LURA in our final post in this series.

Estimating a lender's recovery upon foreclosure and other factors for a lender to consider in deciding whether to foreclose

The lender's primary focus in evaluating its foreclosure option should be on how much the lender anticipates that it will receive for the property upon its ultimate disposition. As we have previously discussed here, any guarantees of the indebtedness will likely have burned off and the lender's only recourse will be to the project itself. As a result, the lender's recovery will solely depend on the amount the lender receives from a sale of the project. Since this will typically occur after the lender has purchased the property at foreclosure, the lender must also consider any carrying costs associated with holding the property until its disposition and any exposure it may have for operating the property prior to its sale.

Determining the anticipated net realizable value of a property starts with obtaining a valuation of the project by a qualified appraiser. We have previously discussed the valuation of LIHTC projects here and here. Suffice it to say that the valuation of an LIHTC property is more art than science and some appraisals are better than others. However, as with any appraisal, a lender should not necessarily assume that it will be able to realize the full appraised value of the property at or following foreclosure. Rather, the lender should carefully consider the relevant market of potential purchasers for the property, how it intends to reach those potential purchasers and how such potential purchasers will value the property and any remaining tax credits.

One good place to start in evaluating the prospects for a sale of the property is to ask the following two questions based on the property valuation report or appraisal:

- Does the valuation report indicate that the property is more valuable as an LIHTC property or as a market-rate property?

- If the project is more valuable as an LIHTC property, how much of its value is attributable to its bricks and mortar vs. its remaining tax credits?

If the valuation report indicates that the property is more valuable as a market-rate property or there is very little value attributable to tax credits (for example, because the project is at the end of the LIHTC lifecycle), the lender's best strategy may be to permit the LIHTC LURA to terminate upon foreclosure, thereby opening up the market of potential purchasers to operators of market-rate properties. Prior to embarking on such a strategy, however, the lender should assess the impact of the "decontrol period" (see our prior post here) on marketability of the property. In addition, the lender should assess the impact of any senior encumbrances on the property. For example, if the project is a HUD Section 8 project, the lender may have subordinated its mortgage to HUD regulatory restrictions that are very similar in scope to the restrictions contained in the LIHTC LURA, thereby precluding a conversion of the property to a market-rate property.

On the other hand, if the valuation report indicates that the property is more valuable as an LIHTC property and a significant portion of its value is attributable to tax credits, the lender will most likely want to preserve or reinstate the LURA and sell the property to an LIHTC-purchaser so as to obtain the incremental value of the tax credits. Prior to embarking on this strategy, however, a lender should carefully consider the marketability of the tax credits by asking:

- Is the property fully compliant with all LIHTC restrictions?
- Does the lender have all of the necessary tax credit documentation to deliver to a purchaser?
- Will a prospective purchaser of the property be able to utilize or re-syndicate the tax credits?
- Are there a sufficient number of years remaining in the LIHTC lifecycle to warrant a re-syndication of the tax credits?

Hopefully, the lender's appraiser will have addressed each of these issues and provided the lender with an in-depth market survey for a re-sale of the tax credits (which we recommended in our prior post here). If not, the lender should address each of these issues internally and with competent counsel.

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Click here to download a pdf of Mark Bossi's complete LIHTC book, which includes all posts in the LIHTC series.

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