© 2022 Thomson Reuters. Originally appeared in the Fall 2022 issue of Real Estate Finance Journal.
For more information on that publication, please visit legal.thomsonreuters.com. Reprinted with permission

U.S. Court of Appeals for the Sixth Circuit Gives Statutory Context to Affordable Housing ROFRs

*By Alan S. Cohen, Jessica Ragosta Early and Edward R. Hickey**

The authors discuss the first federal appellate court decision to review a nonprofit's attempt to exercise a right of first refusal to acquire a federal low income housing tax credit project following the end of the 15-year compliance period at a statutory, below-market minimum price.

The federal low income housing tax credit ("LIHTC") program[1] is the largest driver of affordable housing in the country. In an effort to keep LIHTC projects affordable as long as possible, Congress created a safe harbor that allows certain types of entities, including nonprofits whose exempt purposes include fostering low-income housing, to hold a right of first refusal ("ROFR") to acquire an LIHTC project following the end of the 15-year compliance period at a statutory, below-market minimum price ("Nonprofit ROFR").

In recent years, a small subset of for-profit investors[2] have aggressively challenged the validity and exercise of contractual Nonprofit ROFRs - particularly the conditions precedent required to exercise these rights - with a goal of extracting value or proceeds that would arise absent the below-market Nonprofit ROFR. A growing number of lawsuits have sprung up across the country involving such investor challenges, with courts applying wide-ranging standards.

In the first decision by a federal appellate court to review an exercise of a Nonprofit ROFR, the U.S. Court of Appeals for the Sixth Circuit issued an opinion on May 10, 2022,[3] that reversed the U.S. District Court for the Eastern District of Michigan's decision in *SunAmerica Housing Fund 1050 v. Pathway of Pontiac, Inc.,* and remanded the case back to the district court for trial.[4]

THE DISTRICT COURT OPINION

The limited partnership agreement ("LPA") included a fairly typical variant of the Nonprofit ROFR provisions routinely seen in the LIHTC industry. The LPA expressly carved out of the investor's consent rights any consent over a sale of the property pursuant to the Nonprofit ROFR. However, the LPA included a require-

*Alan S. Cohen, a partner in the New York office of Holland & Knight LLP, focuses his practice on all aspects of tax-advantaged real estate investments. Jessica Ragosta Early, a partner in the firm's Boston office, is a member of the firm's Litigation and Dispute Resolution Practice with experience litigating LIHTC partnership disputes. Edward R. Hickey, a partner in the firm's Boston office, is the practice group leader of the firm's Tax Credit Transactions Practice. The authors may be contacted at alan.cohen@hklaw.com, jessica.early@hklaw.com and ted.hickey@hklaw.com.

© 2022 Thomson Reuters

ment that the Nonprofit ROFR could only be triggered "[u]pon receipt of a bona fide offer."

The general partners of the property limited partnership received two non-binding letters of intent ("LOIs") that indicated each offeror's desire to purchase the property upon specified terms. The general partners solicited at least one of the LOIs and did so to trigger their affiliate's Nonprofit ROFR. When the general partners advised the investor limited partner, SunAmerica, that the affiliate was exercising the Nonprofit ROFR, SunAmerica sued.

The LPA required a "bona fide offer" to trigger the ROFR but did not define the phrase.

The district court applied the Michigan common law definition of "bona fide offer," which generally requires that the offeror have a genuine intent and the financial ability to follow through with the offer, and that the offer be binding. In concluding that the offer was not bona fide, the district court relied upon the fact that the offer was solicited by the general partners and was not legally enforceable. The district court also found that the general partners (on behalf of the owner) had no intent to sell to a third party.

Accordingly, the district court granted summary judgment in favor of SunAmerica and ruled that the Nonprofit ROFR was not properly exercised and the general partners breached the LPA and their fiduciary duties.

THE SIXTH CIRCUIT PUTS THE NONPROFIT ROFR IN STATUTORY CONTEXT

Departing from the district court's ruling, the Sixth Circuit concluded that the Nonprofit ROFR was not an ordinary, common-law right of first refusal. Rather, the Nonprofit ROFR must be interpreted in the context of the LIHTC program. Recognizing that "the parties' claims are intertwined with LIHTC - a highly complex, unique federal program," the Sixth Circuit examined the background and Congressional intent behind the program:

> When Congress enacted LIHTC, it was especially concerned about the long-term preservation of the low-income housing developments. Recognizing that nonprofits are generally more likely than for-profit developers to maintain rents at below-market levels beyond the initial compliance period, LIHTC requires state agencies administering the program to award at least 10% of their tax credits to projects that involve nonprofit developers.

The Sixth Circuit also observed that Congress included provisions allowing for a special safe harbor in 26 U.S.C.A. § 42(i)(7) to facilitate the continued participation of nonprofit developers or tenants by authorizing them to negotiate provisions in the partnership agreements to buy the property - and limit the residual interest of the for-profit investors - after the initial 15-year compliance period. The "safe harbor provision operates to protect the incentives of for-profit entities to initially invest in affordable housing projects, while creating a means for nonprofits to regain ownership and continue the mission of affordable housing once those incentives expire." The Sixth Circuit concluded that "[f]acilitation of the investor exit after the expiration of the fifteen-year compliance period is, therefore, crucial to the efficacy of the LIHTC program."

BONA FIDE OFFER

In reversing the district court, the Sixth Circuit noted that the LPA, including the Nonprofit ROFR provision, was replete with references to Section 42 such that the LPA and

© 2022 Thomson Reuters

Nonprofit ROFR provision must be understood in the context of the LIHTC program.

As the Sixth Circuit explained, the bona fide offer requirement for a traditional right of first refusal is meant to protect the holder from having to match (or losing its right because it cannot match) an unreasonable offer that the offeror has no intention or ability to follow through with. But the Section 42(i)(7) price eliminates that risk by providing a specific minimum purchase price, which is generally below market.

The Sixth Circuit concluded that "[t]he ROFR contemplated by § 42 varies markedly from a ROFR in a 'typical' real estate transaction." Thus, the court would not impose a common law definition of "bona fide offer" on a right of first refusal that was created to accord with the LIHTC program. Doing so, the court explained, would render the Nonprofit ROFR meaningless, frustrate the Congressional intent of facilitating transfers of LIHTC properties to nonprofits and frustrate the parties' intent. In a practical example, the Sixth Circuit observed that "[i]n these circumstances, soliciting an offer from a serious buyer that knew the ROFR-holder would exercise its right, as the General Partners did, may well be the *only* way to trigger the ROFR."[5]

Ultimately, the Sixth Circuit concluded that the phrase "bona fide offer" is ambiguous as used in the LPA and remanded the case to the district court for a trial on the issue of "how the term 'bona fide offer' in the LPA is to be formulated to accord with the Congressional expressions of intent in the LIHTC-promulgated ROFR - and whether that condition has been satisfied."

INTENT TO SELL

The parties and both courts agreed that to trigger the Nonprofit ROFR the general partners (not SunAmerica) had to manifest an intent to sell the property. The district court concluded that the general partners must form an intent to sell to a third party. The Sixth Circuit determined that "[b]ased on Congress's intent for the LIHTC program, § 42(i)(7) only requires an intent to sell generally and does not, in and of itself, require the existence of a bona fide offer." But because the language in the LPA expressly required a bona fide offer to trigger the Nonprofit ROFR and because that offer must necessarily come from a third party, the Sixth Circuit agreed that "there must be an intent to sell to a third party" to trigger the particular Nonprofit ROFR at issue.

Nevertheless, the Sixth Circuit determined that a willingness or knowledge of the holder's intent to exercise the Nonprofit ROFR cannot defeat any requisite intent to sell; otherwise, a Nonprofit ROFR could never be exercised and would be rendered meaningless. Thus, the Sixth Circuit concluded that the general partners must have a general intent to sell the property and an offer on the table, "[b]ut the intent to sell to the nonprofit if the ROFR is invoked - the willingness to comply with the ROFR provision - does not defeat the LPA-required intent to sell the property."

Accordingly, the Sixth Circuit held the district court erred when it concluded that the evidence overwhelmingly established the general partners did not have an intent to sell. Notably, the district court relied on evidence that the general partners intended to comply with the Nonprofit ROFR provision, "but pointed to no evidence showing that the General Partners

© 2022 Thomson Reuters

never had an intent to sell or entertain third-party offers."[6]

The Sixth Circuit remanded the issue of the general partners' intent back to the district court for trial and added that "[i]n some sense," the general partners' receipt of two offers and solicitation of at least one of those offers would suggest that the general partners "did intend to sell or entertain third-party offers."

Following remand, the case settled and was voluntarily dismissed before the district court could reconsider the general partners' intent in light of the Sixth Circuit's decision.

PRACTICAL CONSIDERATIONS

The Sixth Circuit's approach to interpreting contractual Nonprofit ROFR provisions to accord with the LIHTC program is a practical, common-sense approach and in line with the similar approach taken by Massachusetts's highest court. As the Massachusetts Supreme Judicial Court explained, "[i]t is difficult to imagine why a third party would make a bona fide offer for the property, knowing that the nonprofit organization has [a Nonprofit ROFR] and is likely to exercise it." However, the Sixth Circuit's decision also leaves key questions unanswered that both transactional lawyers and litigators will need to work through as they draft new Nonprofit ROFR provisions and help resolve disputes over existing provisions.

For example, the Sixth Circuit notes that the facilitation of the investor exit after the expiration of the 15-year compliance period is "critical to the efficacy of the LIHTC program," and while this may be true, the ability to attract investor equity is of paramount importance to the program's continued efficacy. Most, if not all, investors who participate in the LIHTC program condition their investments on the receipt of a tax opinion from qualified counsel covering a variety of issues, including tax ownership of the LIHTC project by the LIHTC partnership through which such investment is to be made. As a general proposition, an option to purchase property for an amount that is less than fair market value on the date of exercise runs afoul of traditional tax principles and calls into question tax ownership. As noted above, Section 42(i)(7) is a tax safe harbor that prevents the Internal Revenue Service from denying any federal income tax benefit merely by reason of the issuance of a Nonprofit ROFR. The safe harbor only provides protection if the right granted is, in fact, a right of first refusal and not a below-market option.

Thus, in order to support the issuance of a tax opinion, Nonprofit ROFRs routinely include provisions intended to help distinguish the right granted from that of an option. For example, the LPA requirement of a "bona fide offer" that was the focus of the Sixth Circuit's analysis was surely included to support the issuance of the tax opinion. Another common approach required by tax counsel to distinguish a Nonprofit ROFR from an option is to require the investor's consent to market and sell the LIHTC project to trigger the Nonprofit ROFR to avoid a situation where the general partner and its affiliated nonprofit can trigger the ROFR without any third-party input. The Sixth Circuit's opinion will be instructive to tax counsel on new transactions but does nothing to eliminate the need to ensure that Nonprofit ROFRs on new transactions can be distinguished from below-market options.

For disputes concerning existing Nonprofit ROFRs, some conclusive direction as to what constitutes a "bona fide offer" or a "general

© 2022 Thomson Reuters

intent to sell" would have been welcomed by many in the industry. Nevertheless, the analytical framework provided by the Sixth Circuit serves as persuasive guidance for other courts to follow in the wake of what had previously been a federal and state court split, with federal district courts applying state common law and state courts interpreting Nonprofit ROFRs in light of Section 42.

The Sixth Circuit's clear articulation that common law meanings should not be impressed on these legal concepts when the result is inconsistent with Congress' intent for the LIHTC Program may go a long way toward resolving some of the lingering disputes surrounding Nonprofit ROFRs that have distracted attention from addressing the growing need for affordable housing that the LIHTC program is intended to address.

CONCLUSION

In summary:

- The Sixth Circuit concluded that the right of first refusal contemplated by the LIHTC under 26 U.S.C.A. § 42(i)(7) "varies markedly" from a right of first refusal in a "typical real estate transaction," such that application of general "common law" definitions of "right of first refusal" and "bona fide offer" would contravene the purpose of Section 42(i)(7).
- Section 42(i)(7) is a safe harbor enacted by Congress that operates to protect the incentives of for-profit entities to initially invest in affordable housing projects, while creating a means for nonprofits to regain ownership and continue the mission of affordable housing once these incentives expire.
- A general partner's intent or knowledge that its nonprofit affiliate will exercise its right of first refusal to acquire an affordable housing property at the Section 42(i)(7) price does not preclude the general partner's formation of any requisite intent to sell the property to a third party, so as to trigger the right of first refusal; otherwise, the right of first refusal would be rendered meaningless.

NOTES:

[1]26 U.S.C.A. § 42.

[2]In most instances, the investors involved in these challenges were not the original tax credit investor or syndicator but were entities that acquired interests in LIHTC partnerships near or upon the conclusion of the 15-year compliance period.

[3] https://www.opn.ca6.uscourts.gov/opinions.pdf/22a0100p-06.pdf.

[4]The state appellate courts to address the issue have so far come out in favor of the nonprofits. See *Homeowner's Rehab, Inc. v. Related Corporate V SLP, L.P.*, 479 Mass. 741, 99 N.E.3d 744 (2018); *Aswan Village Associates, LLC v. Opa-Locka Community Development Corporation, Inc.*, 335 So. 3d 1200 (Fla. 3d DCA 2021). The U.S. Court of Appeals for the First Circuit has interpreted Section 42(i)(7) in determining that a dispute over the exercise of a ROFR covered by the Section 42's safe harbor did not present a federal question for purposes of jurisdiction. *See AMTAX Holdings 227, LLC v. Tenants' Development II Corp.*, 15 F.4th 551, 2021-2 U.S. Tax Cas. (CCH) P 50228, 128 A.F.T.R.2d 2021-6317 (1st Cir. 2021), but no other federal appellate court has opined on the validity of an exercise of such a ROFR.

[5]Emphasis in original.

[6]Emphasis in original.

© 2022 Thomson Reuters