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# LIHTC-Related Bankruptcies

By Robert E. Richards, SNR Denton US LLP

This article provides an overview of how bankruptcy or insolvency may affect a low-income housing tax credit (LIHTC) investment (or series of investments) and some of the key issues that may arise. The possibility of a future bankruptcy may also affect front-end structuring or out-of-court modification proposals.

As a general matter, there may be a bankruptcy of the LIHTC development itself, of one or more of the entities up the ownership/management chain or, for guaranteed deals, guarantors or sureties. Some but not all of the involved entities may file. If a guarantor or surety is a state-regulated insurance company, it is ineligible to file for bankruptcy and would need to go through a state insurance rehabilitation/liquidation, although related entities may be eligible to file bankruptcy.

## Project Level Bankruptcy

For the reasons to be discussed, restructurings, foreclosures or deed-in-lieu transactions are more common than actual project bankruptcy filings. A Chapter 11 proceeding is generally used for an attempted reorganization or going concern sale and usually has existing management in control as a debtor-in-possession, while a Chapter 7 proceeding is a straight liquidation run by an independent trustee. Chapter 7 would be more common for project level entity bankruptcies.

The bankruptcy case of a project level entity is in some ways like a typical single asset real estate bankruptcy. The current holder of the first mortgage loan on the project is looking to get paid, typically through lifting the automatic stay to complete a foreclosure process, and may not care about ongoing LIHTC tax compliance or even the current use or the building itself (if a fair market redevelopment would generate higher proceeds). Subdebt, if any, is often subject to an intercreditor or subordination agreement with the senior mortgage lender. To the extent permitted under the intercreditor agreement, subdebt is interested in preserving the possibility of a future recovery on its debt (especially if the subdebt is held by a private commercial party). The current owner

Limited partners or members whose equity position may otherwise be considered out of the money may be willing to play a more active role in the case because of future tax credits and/or potential recapture on past tax credits and are also interested in proper records and reporting for tax compliance purposes continuing throughout the case.

of the project may be pursuing a refinancing, seeking to renegotiate or simply buying time. It may threaten or propose a plan in which it seeks to have the bankruptcy court stretch out the loan amortization or write the secured claim amount down to current real estate values without the lender's consent under the cramdown power of Section 1129(b) of the Bankruptcy Code.

The LIHTC laws, however, add additional dynamics to these real estate cases. Limited partners or members whose equity position may otherwise be considered out of the money may be willing to play a more active role in the case because of future tax credits and/or potential recapture on past tax credits and are also interested in proper records and reporting for tax compliance purposes continuing throughout the case. Subdebt may be subject to a recharacterization as equity attack, especially if its terms are less commercially reasonable than a bankruptcy judge is used to seeing. However, if the unsecured claims in the case consist only of some small project-related trade debt, there may not be a lot of incentive to pursue recharacterization.

Among the key powers of a bankruptcy court that may drive a bankruptcy filing are:

1. the automatic stay that prevents the appointment of a receiver or completion of a foreclosure sale process (at least for a while),

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2. the possibility of obtaining use of rents, refunds and other cash collateral over the secured lender's objection,
3. the possibility of debtor-in-possession financing being authorized over the secured lender's objection,
4. the ability to reject burdensome unexpired leases or executory contracts,
5. the possibility of discharging unexpected tort, environmental, construction defect or other claims where applicable, and
6. the possibility of confirming a Chapter 11 plan modifying the secured creditor's rights without its consent.

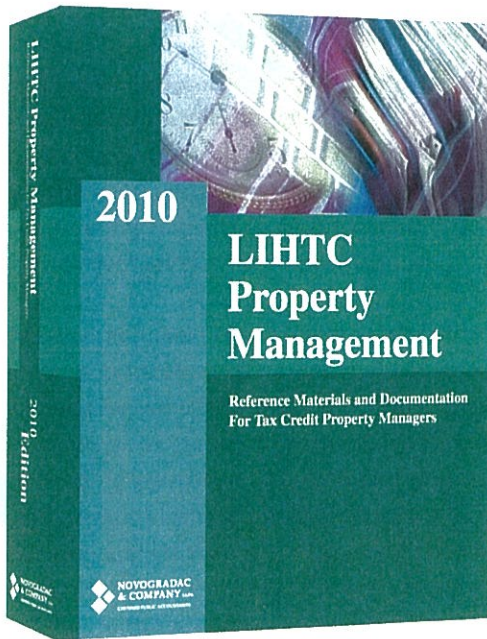
Note, however, that the automatic stay is generally limited to entities that file; it does not protect guarantors, sureties or equity pledgors that have not filed. Also, a contested bankruptcy is time consuming and expensive, including likely expert witness fees. It is hard to sustain such a case and convince a bankruptcy judge to let the project emerge from bankruptcy successfully if the project continues to operate at a loss after the filing or is otherwise losing value, or if the secured creditor is

significantly under water and likely to remain so for the foreseeable future.

There is significant risk that unsecured contractual rights, such as rights to replace management and rights of first refusal, puts, calls or options, may not be specifically enforceable in a bankruptcy case. Claims for breach of such contractual rights may be treated as unsecured claims. Unsecured claims often receive pennies on the dollar and even that reduced recovery may in some circumstances be paid in non-cash consideration, such as notes and/or reorganized stock and/or be paid over time. Any direct rights against third parties, such as guarantors, sureties or letter of credit issuers, are generally not limited by the claims treatment in a bankruptcy case.

General partners may be liable for partnership debts in certain circumstances but often the general partner is a corporation with few assets. Bankruptcy law addressing limited liability companies and their managers and members is relatively undeveloped. The LLC statutes themselves generally envision the LLC being treated

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## COMPLIANCE MADE EASY

The 2010 edition of the LIHTC Property Management Handbook



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like a corporation without recourse to members or managers as a contractual matter. Fiduciary, good faith/fair dealing and other duties, however, may be argued as alternative theories.

As part of any out-of-court modification or workout in which a future bankruptcy is still possible, the lender or other parties may want to consider protections (if they can be obtained) such as an acknowledgment as to the validity, priority and amount of their claims and liens, a provision that the automatic stay will be lifted in any subsequent bankruptcy filing or such a filing would be a bad faith evasion of the workout (to the extent enforceable on such provision), lockboxes for rent, additional collateral or credit support and/or springing guarantees from solvent related parties.

### Other LIHTC Related Entities

Actual filed bankruptcy cases of other LIHTC related entities have been relatively few. Related entities could include the primary and any secondary guarantors (for guaranteed deals) and/or entities that have a direct or ownership interest in the project (or, often, a series of LIHTC projects), provide asset management services and/or serve as the managing member. Sometimes entities have multiple roles. An important fact is whether the guarantor and/or investor hold cash or other collateral to secure claims or reimbursement obligations.

One such case involves Ambac Assurance Corp. where the segregated "bad" assets are in an ongoing state rehabilitation proceeding, while the remaining "good" assets of that insurance company are outside of any proceeding. (Wisconsin Circuit Court in Dane County, Case No. 10 CV 1576. Filings available at [www.ambacpolicyholders.com](http://www.ambacpolicyholders.com).) Other potential large insolvencies of major players in the LIHTC space, including AIG and Fannie Mae, have been avoided.

Key issues (largely unresolved) in such cases may include where applicable:

1. the ability to discharge or reject certain obligations in bankruptcy while maintaining residual or other rights or interests,
2. the ability to sustain the bankruptcy case or reorganize where the entity's only asset is an indirect economic interest and it has only one material creditor,
3. fixing or estimating the amount of indemnity or guarantee claims based on future events and trends,
4. attempts to argue in collateralized deals that the ex-

- isting collateral is excessive and that collateral can be stripped down to a lower amount with excess collateral being made available for general creditors,
5. the attempted assignment or sub delegation of asset management,
6. proposed sales of assets free and clear of liens, claims and "interests" under Section 363 of the Bankruptcy Code,
7. the consent and related rights as to assignments or changes of control,
8. the potential substantive consolidation of entities into each other,
9. the cancellation of indebtedness income and other tax considerations, and
10. the impact of bankruptcy and any related settlements on non-filing third parties, especially if proposed releases or exculpations are not consensual.

### Conclusion

Because of the additional dynamics of future tax credits and potential tax recapture and additional asset management responsibilities, there are likely to be more out-of-court workouts and/or ultimate consensual transactions in bankruptcy for LIHTC transactions than in a typical non-LIHTC transaction involving direct or indirect interests in real estate. There is little guidance as to how many of the issues listed above would be resolved if fully litigated in an LIHTC bankruptcy context. ❖

*Robert Richards is a member of SNR Denton's corporate reorganization and bankruptcy practice and practices in the areas of bankruptcy and insolvency related transactions and litigation. His practice includes Chapter 11 representations, foreclosures, workouts, deeds-in-lieu and transaction structuring, including various kinds of real estate interests and property uses. He can be reached at (312) 876-7396 or [robert.richards@snrdenton.com](mailto:robert.richards@snrdenton.com).*



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