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Replacing a General Partner

By Sean B. Leonard, SNR Denton

The economic turmoil gripping the country over the past few years took a toll on many projects financed with the proceeds of low-income housing tax credits. The fallout left many project-level general partners, often through no fault of their own, in default under the project partnership's limited partnership agreement and/or governing loan documents. As a result, limited partners are now, more than ever, finding themselves negotiating the orderly exit of defaulting general partners, and the admission of replacement general partners. This article is the third in a series of articles discussing the removal of a general partner and associated issues; it examines a number of key considerations for limited partners when negotiating the admission of a replacement general partner.

To extend the analogy created by my colleagues in the prior articles, if the decision to remove a general partner is akin to a divorce, and the treatment of fees payable to the removed general partners and its affiliates is akin to the settlement, then replacing the general partner is akin to finding and courting a new spouse.

Replacing a general partner can be a daunting and time-consuming task for all parties involved. The most immediate objective for a limited partner upon the removal of a defaulting general partner is the stabilization of the project to prevent further damage. In many instances, this requires the limited partner to assume the general partner's ownership interest and duties, a position most limited partners would like to avoid. Once the project is stabilized, the limited partner must then establish a strategy for the project's long-term survival. Once a survival strategy has been determined, the limited partner must find an acceptable replacement general partner. Once a replacement general partner has been identified, an often long and involved negotiation, due diligence and closing process will follow.

Despite the effort and time it may take to bring a replacement general partner into a partnership, the admission of a new general partner can be a positive turning point in a project's lifecycle. An energized and experienced general partner with strong financial resources can turn around a project in short order. At a minimum, a capable and financially strong replacement general partner can get the project through the compliance period without losing tax credits to recapture, which should be the limited partner's ultimate goal in the replacement process.

The ideal replacement general partner will have an impeccable reputation in the industry, years of positive experience managing projects, preferably in the same market, and the financial resources necessary to operate the project to its highest performance and get the project through the tax credit compliance period without recapture.

Consents

Perhaps the biggest hurdle that can occur with the admission of a replacement general partner is the pursuit of consent requirements. Any number of parties to the transaction could have consent rights to the admission of a replacement general partner—investors, lenders, the U.S. Department of Housing and Urban Development (HUD), credit agencies and even co-general partners. The limited partner should conduct a thorough analysis of any required consents early

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in the replacement process, and undertake obtaining them as soon as possible. A general partner's reputation and experience can be a key component in obtaining any necessary third-party consents (lenders, HUD, credit agency) to the replacement. A positive past experience with the proposed general partner can quicken and simplify a third party's consent review.

Guarantees

Negotiations with replacement general partners almost always start with the general partner guarantees. Ultimately, the limited partner will want the replacement general partner to assume the guaranty of all of the obligations of the general partner under the project partnership agreement. Depending on where the project is in its life cycle, the limited partner will want these guarantees to include: guaranty to complete construction of the project, a guaranty to fund operating deficits arising at the project, and a guaranty against lost tax credits.

There are other general partner obligations (environmental indemnity, representations and warranties, repurchase, etc.) to be guaranteed, but the aforementioned guarantees will usually drive the negotiation.

In order to ensure that these guaranteed obligations will be met, the limited partner should insist on a guarantor with strong financial resources. The limited partner should conduct a thorough due diligence investigation of a potential guarantor's financial resources. Once the limited partner is satisfied with the guarantor's finances, it should include in the guaranty documentation a covenant of the guarantor to maintain a certain net worth and level of liquid assets. In addition, the limited partner should also maintain the right to receive the guarantor's financial information—such as audited financials or tax returns—on a regular basis to ensure the guarantor will maintain a strong financial position in order to fulfill its obligations.

Reserves

Often, at the time a replacement general partner comes on board, the project and the partnership have outstanding and overdue financial obligations to meet. Among these unresolved obligations there may be outstanding capital needs (for example, roof repairs or replacements, repaving or re-lining of parking lots, or overdue paint jobs), delinquent real estate taxes, late mortgage payments and third-party payables (for example, painters, landscapers, utilities, etc.). The limited partner will want the replacement general partner to absorb these expenses in consideration of admission to the partnership. Conversely, the replacement general partner will usually want to come into the partnership with a clean slate, i.e. it will want the limited partner to resolve all of these financial obligations before being admitted. An often acceptable compromise will be for the parties to "share the pain," so to speak, and split the

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expenses. The limited partner should be prepared for comprehensive negotiations on the source of these reserve fundings. To protect against future deficits and capital expenditures, the limited partner will want to establish reserves to be funded by the general partner and, of course, the general partner will want to fund these reserves from cash flow. In the worst case, the limited partner should be prepared to inject some capital to fund reserves, require the general partner to put capital into reserves, and beef up the cash flow waterfalls to fund reserves from project operations.

Exit Strategy

The admission of a replacement general partner is also a great opportunity for the limited partner to negotiate a favorable exit strategy. The limited partner could obtain the right to put its interest to the general partner for some negotiated price, or—if the project appears to have no residual value—for some nominal price. In the latter scenario, the limited partner will likely consider it a major achievement to get the project through the compliance period without recapture. At this stage, the limited partner will happily hand the keys over to the general partner and walk away. Under the worst of circumstances, the limited partner may even look for the option to put its interest to the general partner at the end of the tax credit period but prior to the end of the compliance period. This option has been made more attractive with the elimination of the recapture bond requirement under Section 42. In this case, the limited partner must require that the guaranty of recapture continue beyond its exit.

Special Requirements

The ideal general partner may also be required in order to fulfill a special requirement. For example, a number of credit agencies will require that a replacement general partner be a nonprofit entity if the LIHTCs were allocated under the nonprofit set-aside. This can be an especially challenging search in certain markets. Limited partners that find themselves searching for nonprofit general partners in certain real estate markets may be required to make concessions in the negotiation process.

Even under the worst of circumstances, the admission of a replacement general partner can be a positive moment in the lifecycle of a project, benefiting the project, its tenants, the community, the limited partner, its investor and the replacement general partner. So long as the limited partner has a clear and realistic picture of what it is trying to achieve, the limited partner could find itself in a better position, with a valued partner, strong guarantees, a clear exit strategy, and the likelihood of a continued tax credit stream to its investor.

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