

Perspectives

on Affordable Housing & Community Development



Our Real Estate practice provides legal services to real estate professionals across the globe.

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California's New Affordable Housing Lender

The California Tax Credit Allocation Committee's Call to Action

by Gary P. Downs

The American Recovery and Reinvestment Act of 2009 ("ARRA") instantly made the California Tax Credit Allocation Committee ("CTCAC") one of the biggest lenders in the world by providing CTCAC with more than \$700 million to boost the affordable housing industry. This boost in funds was disbursed through two programs created under ARRA: (1) the Section 1602 Program ("Exchange Program") and (2) the Tax Credit Assistance Program ("TCAP"). In late January, just as CTCAC was ordering the first batch of checks from the California State Controller, CTCAC awarded the final dollars under the ARRA programs. Fortunately, Congress is close to extending the Exchange Program for another year. Unfortunately, without the extension of TCAP, there will be a sharp decrease in available funds for the new fiscal year. Tax credit agencies will most likely tie such available funds to 9% tax credit projects only. This article discusses the past, present and future of TCAP and the Exchange Program in California.

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California's New Affordable Housing Lender

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The Past

Early after the passage of ARRA, CTCAC aggressively pursued guidance for implementations of TCAP and the Exchange Program from the U.S. Department of the Treasury and the U.S. Department of Housing and Urban Development ("HUD"). The Treasury and HUD provided guidance that allowed CTCAC to set up one of the more complex funding programs found in the country. In an effort to provide as much flexibility as possible, CTCAC reviewed each project individually to determine which of the ARRA programs would provide the most appropriate funding. Although TCAP and the Exchange Program have many similarities, the programs trigger different federal requirements that produce vastly different effects. Projects utilizing TCAP funds face federal cross-cutting requirements. For instance, a project receiving TCAP funds must pass a National Environmental Policy Act review and pay Davis Bacon prevailing wages. CTCAC's policy of flexibility allowed all projects the opportunity to compete for either gap or cash-in-lieu financing; choosing to apply for gap rather than cash-

in-lieu financing gave projects a leg up in the competition. A gap application allowed projects to score higher under the leverage point category. Finally, CTCAC allocated \$100 million to bridge the unfunded commitments of the California Department of Housing and Community Development ("HCD") that arose due to California's economic woes. In the end, more than \$130 million was spent to bridge such unfunded commitments.

CTCAC held two rounds of competition for bond projects and one for 2009 9% projects. CTCAC awarded funds to only 34 of the 45 projects that entered the first round of bond competition. Scoring for the competition was based on the original CTCAC reservation application and emphasized the type of development and low award request compared to budget and affordability. The second round of competition for bond projects and the first round of competition for 2009 9% projects proved noncompetitive as CTCAC awarded funds to all the projects that applied.

The Present

Since all of the \$700 million provided by ARRA has been awarded, CTCAC is presently funding the initial draws on a number of projects and underwriting and

preparing documents for the remainder. However, some projects have yet to accept the awards. A few projects have rejected the awards primarily due to the inability or disinclination to meet the federal requirements or the state prevailing wage requirements that ARRA funds trigger. All rejected award funds are returned to CTCAC and then can then be re-awarded. CTCAC is reporting that if there is ARRA money left over, it will be used to bridge unfunded HCD commitments.

Once awards are accepted, the loan process involves preparation of due diligence binders, California Housing Finance Agency underwriting, document preparation and funding by the California State Controller in the form of checks. Title companies are treating these checks like cash. CTCAC is doing a good job addressing reasonable comments from the developer and other lenders. CTCAC is also flexible on pay-in timing and amounts. This flexibility is critical for many projects that must deal with challenging source availability during construction.

Unfortunately, the affordable housing industry has not worked through all important state and federal issues. It is reasonably clear that ARRA funds awarded to a project will be exempt from federal taxation. Taxability for state income tax purposes remains unclear for many states, including California. However, California's Treasurer may be prepared to introduce legislation clearing this issue in favor of non-taxability. The Treasurer is waiting to hear the final word from the IRS regarding whether the awards are taxable on a federal level. Most practitioners are taking the position that ARRA funds, whether contributed by the state as forgivable loans or grants, produce a capital account for the project owner's partners. In a transaction where the tax credits are fully replaced by ARRA funds, the lion's share of tax losses are not allocated to a tax credit investor, but are available to be taken by the project's sponsors. The addition of the ARRA amounts to partner capital accounts make those losses significantly more valuable.

From the Chair

James M. Rishwain, Jr.



Welcome to Pillsbury's annual newsletter, *Perspectives on Affordable Housing & Community Development*. This year the affordable housing sector continues to suffer from the collapse of the tax credit market and reduced lending by traditional sources. More than ever before, our clients' needs are evolving quickly, and we are evolving just as quickly to serve your needs. Pillsbury has become a market leader in helping clients tap the alternative opportunities created by the American Recovery and Reinvestment Act. Our lawyers have also entered the policy debates over funding priorities at the national and local level. We will continue to lobby for new programs, advocate for tax credit secondary market transactions, structure creative workouts and address unique client issues and concerns. The marketplace may be full of ambiguity, but we at Pillsbury are unambiguously committed to being a market-leading law firm in affordable housing and helping our clients remain strong and successful.

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Refinancing Distressed Loans

Issues and Choices Arising in the Current Economic Climate

by James M. Grosser and Marta K. Porwit

An extended period of economic decline has affected the financial viability of many affordable housing projects. Construction delays, which in an up market may present significant, but manageable, problems, can result in far greater challenges in a down market. In particular, borrowers that secured permanent financing commitments during better times can expect to face great difficulty in securing replacement financing if construction delays result in the expiration of permanent loan commitments. As credit terms stiffen, delayed projects can develop yawning gaps in their sources and uses. Increasingly, lenders find themselves with difficult

choices, as borrowers seek to modify existing financing agreements. While negotiation may be the best way for some lenders to maximize their prospects of full repayment, increasingly, borrowers and lenders must confront the possibility of foreclosure, enforcement actions on guarantees and bankruptcy.

When choosing a path between negotiation or foreclosure, the lender's maximum recovery will be the dominant concern. Lenders typically prefer to avoid foreclosure, especially for projects that have not achieved construction completion. As such, a lender in a default context

generally will be amenable to negotiating a forbearance agreement with the borrower as an alternative to immediate foreclosure. However, in cases of extreme project or developer distress, foreclosure may be the lender's only feasible option.

Having served as legal counsel to the range of parties involved in affordable housing projects (e.g., developers, syndicators, direct investors, fund investors and lenders), Pillsbury is well positioned to guide borrowers and lenders through the various pitfalls that may threaten to derail a successful distressed loan refinancing or modification.

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Refinancing Distressed Loans

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Address the Fundamentals—Solid Project Management

When a loan default stems from construction delays, the lender's first step, even before commencing refinancing negotiations, is likely to be a site inspection. This inspection, the purpose of which is to evaluate the condition of the project and to ascertain the percentage of construction completion, often sets the tone for negotiations. A borrower without an adequate plan to remedy construction delays and/or concerns regarding the condition of the project will encounter an uphill battle when seeking a loan modification agreement. A borrower demonstrating consistent progress and superior construction quality stands on firmer ground. In the case of a pure construction loan, the borrower must also have a solid plan for securing permanent take-out financing. Due to the toughening of credit terms in recent years, the amount of permanent financing a project can support is likely to have decreased. Accordingly, borrowers may need to fill the resulting gap either with personal funds or with subordinate debt from government programs or other lenders.

Affordable housing projects with low-income housing tax credits present additional wrinkles. Construction delays may present risks relating to the satisfaction of placement in service deadlines imposed by the Internal Revenue Code and/or the tax credit allocating agency. In some cases, it may be necessary for a developer to obtain a new credit allocation. These factors will affect a lender's willingness to forbear in the exercise of its default rights. On the other hand, a lender considering foreclosure is well advised to evaluate the borrower's recordkeeping to ensure that the project is on track to qualify for a sufficient amount of low-income housing tax credits to ensure the project's viability. Lenders must exercise due diligence to avoid foreclosing on a

project only to learn later that the project does not qualify for low-income housing tax credits.

Ability to Offer Sufficient Collateral

A borrower's ability to repay a loan remains the most important factor in a lender's decision to modify existing loan documentation. Whether a borrower requests forbearance or refinancing, a lender is likely to insist on additional collateral or guarantees to mitigate the financial risk. A borrower able to pledge additional collateral or guarantees sufficient to meet the lender's requirements will be much better positioned to reach a satisfactory agreement. A prudent borrower should take a broad and creative approach when identifying potential sources of additional collateral.

While a borrower may feel its negotiating power lies strictly in its creditworthiness, collateral and ability to meet its financial obligations, lenders will often evaluate more personal details, as well, such as a borrower's actions and statements and the "tone" of negotiations.

In a Tough Market It's Not Just All Dollars and Cents

While a borrower may feel its negotiating power lies strictly in its creditworthiness, collateral and ability to meet its financial obligations, lenders will often evaluate more personal details as well, such as a borrower's actions and statements and the "tone" of negotiations. By adopting an unyielding and relentless approach to the bargaining process, a borrower risks alienating the lender and frustrating its own refinancing efforts. A borrower must make a realistic assessment of its bargaining position, and must be prepared to

make concessions and share good or bad news openly.

Bankruptcy of the Borrower

A lender considering foreclosure should keep in mind the possibility that the borrower will declare bankruptcy. A bankruptcy filing by the borrower will result in an automatic stay, preventing the foreclosure from proceeding until the stay can be lifted. Lenders are well advised to develop a bankruptcy strategy before posting the loan for foreclosure. Factors to consider in the formulation of a bankruptcy strategy include identification of other creditors of the borrower to determine whether the lender can block the confirmation of a bankruptcy plan, and the selection of a qualified appraiser to testify in bankruptcy court regarding valuation issues. The valuation of low-income housing tax credit projects presents unique issues, so the lender must select an appraiser with the relevant experience.

Conclusion

Given the severity of the current financial crisis, negotiations over the refinancing of a distressed loan can be challenging. By keeping the above-described factors in mind, borrowers will be better positioned to successfully refinance a distressed loan and avoid foreclosure. Lenders, on the other hand, will need to do their due diligence before settling on forbearance or foreclosure as their best option. Pillsbury has extensive experience in helping borrowers and lenders facing distressed loans, and remains dedicated and available to assist in a variety of issues that arise in financing affordable housing projects.



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Will the Sun Set on the New Markets Tax Credit?

Updates on Recent NMTC Allocations and Legislation

by Michael A. Peers

On October 30, 2009, the Community Development Financial Institutions Fund (“CDFI Fund”), a branch of the U.S. Department of the Treasury, announced that 99 community development entities (“CDEs”) had been selected to receive allocations of new markets tax credits (“NMTC”) through the 2009 allocation round (“Round Seven”) of the NMTC program. Enacted in 2000 and launched in 2003, the NMTC program’s intent is to spur private investment and economic growth in low-income communities (“LICs”).

The NMTC program attracts private sector investors to low-income areas by offering them a 39% federal tax credit over seven years—a 5% credit in each of the first three years and a 6% credit in each of the last four years. The investor receives the credit when it provides a

Qualified Equity Investment (“QEI”) in a CDE. The CDE in turn uses the QEI to make loans or invest in businesses and projects in LICs.

In Round Seven, 249 CDEs applied for allocations, requesting a total of approximately \$22.5 billion in allocations. The CDFI Fund made allocation awards totaling \$5 billion—or 22% of the total amount requested by the applicants. The 99 allocation recipients were provided with allocation awards ranging in size from \$4 million to \$125 million. Mission-driven organizations received 40% of the Round Seven allocation awards while CDEs affiliated with for-profit parents received 42% of the total, and public bodies were awarded 18% of allocation authority. 24 CDEs received their first NMTC allocation and awards, totaling \$858 million.

With each NMTC allocation round, the CDFI Fund becomes increasingly sophisticated in identifying NMTC applicants that show a strong potential and lasting commitment to stimulating economic growth in LICs. It has become customary for applicants to commit to standards that greatly exceed the basic NMTC program requirements. For instance, CDEs that are awarded NMTC allocation authority are required to invest substantially all (generally 85%) of their QEIs in LICs. In Round Seven, 96 of the 99 NMTC recipients indicated in their NMTC application that they would invest at least 95% of their equity investment dollars into qualified LIC investments. Additionally, 95 of the 99 NMTC recipients indicated in their NMTC application that they would invest in more areas of higher economic distress than are minimally required under NMTC program rules. As the CDFI Fund refines the program criteria, and competing CDEs independently impose higher investment standards, the NMTC allocation awards become more competitive with each round.

Since its inception in 2000, Congress has consistently supported the NMTC program, making it one of the largest community development programs in the federal government. The most recent extension of the NMTC program occurred in fall 2008, when Congress passed the Renewable Energy and Job Creation Act of 2008 that included an NMTC extension through 2009. In February 2009, Congress passed the American Recovery and Reinvestment Act, which included a provision for \$3 billion in additional NMTC allocation authority to be divided equally between 2008 and 2009, increasing the overall allocation authority for 2008 and 2009 to \$5 billion.

As it stands now, the NMTC program expired on December 31, 2009. The New Markets Tax Credit Extension Act of 2009 (H.R. 2628/S. 1583) was introduced in the House on May 21, 2009, by Representatives Richard Neal (D-MA) and Patrick Tiberi (R-OH) and in the Senate

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Will the Sun Set on the New Markets Tax Credit?

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on August 5, 2009, by Senators John Rockefeller (D-WV) and Olympia Snowe (R-ME). This legislation seeks to extend the NMTC Program for an additional 5 years with \$5 billion in annual NMTC allocations. The legislation would also authorize investors to use their NMTC investments to offset the alternative minimum tax ("AMT"). On February 1, 2010, President Obama released the fiscal year 2011 proposed budget to Congress, which includes an extension of the NMTC program through 2011 with an allocation amount of \$5 billion for each of 2010 and 2011. The proposal would also permit the NMTC to offset the AMT.

While this legislation has yet to pass through Congress, the CDFI Fund is confident that the NMTC program will be extended. On August 3, 2009, the CDFI Fund solicited comments concerning the NMTC allocation application, the application review process and 10 specific questions about topics related to the application such as award caps, threshold requirements and minority-entity participation in the NMTC program. By the close of the comment period on October 2, 2009, the CDFI Fund received 21 comments from different organizations, trade associations and individual commentators. At the New Markets Tax Credit Coalition's December 10, 2009 Conference, CDFI Fund Director Donna J. Gambrell, stated that the CDFI Fund has "been reviewing these comments diligently, with a goal of including what we can as part of the 2010 application round." Director Gambrell also stated that she anticipates that the 2010

NMTC round will open in the spring of 2010 with allocations being awarded in December.

Pillsbury will continue to monitor the progress of the proposed legislation and any changes to the NMTC allocation application. Pillsbury has advised CDEs, equity investors, lenders and developers in structuring and closing many NMTC transactions. We have experience in various aspects of the ever-evolving NMTC program, including allocation applications, project developments, syndication, leverage financing, asset management and regulatory compliance.



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East Lexington Apartments

East Harlem Lexington Partners, L.P., an affiliate of Allied Pacific Development, has purchased a nine-building affordable housing development in East Harlem, known as Met Paca I and Met Paca II, for \$26.9 million. The sale was the largest recorded in Upper Manhattan in 2009, according to Massey Knakal Realty Services. The 229-unit housing complex will operate under a Section 8 rent subsidy. The properties encompass several addresses, including a series on East 118th Street, East 119th Street, East 122nd Street and Lexington Avenue. Pillsbury represented East Harlem Lexington Partners, L.P., in the acquisition of the real estate and in connection with the financing obtained from Freddie Mac.



Over-Income Tenants

by Christian D. Dubois

As many affordable housing projects have struggled to maintain revenues in the face of decreased occupancy, we have seen an increasing focus on how to handle over-income tenants. Situations where initially qualifying low-income tenants experience an increase in household income pose potential risks to project compliance and, somewhat paradoxically, risks of reduced rental receipts. Project managers must carefully develop procedures for handling over-income tenants to minimize rent loss while avoiding noncompliance with regulatory requirements.

The starting place for any discussion of over-income tenants is the Next Available Unit Rule (“AUR”) as set forth in Section 42(g)(2)(D) of the Internal Revenue Code for low-income housing tax credit (“LIHTC”) projects and in Section 142(d)

(3)(A) of the Internal Revenue Code for tax-exempt bond-financed projects. When a household’s annual income exceeds 140% of the initial qualifying level (170% for deep rent skewing), the household is identified as over-income. Under the AUR, an over-income unit continues to qualify as long as all subsequent vacant units in the same building of comparable size or smaller are rented to qualifying households. If the owner fails to rent the next comparable or smaller unit to qualified households, it brings all larger over-income units in the building into noncompliance.

Until recently, the AUR was applied on a project-wide basis for LIHTC projects and on a building-by-building basis for tax-exempt bond-financed projects; however, under the Housing Assistance

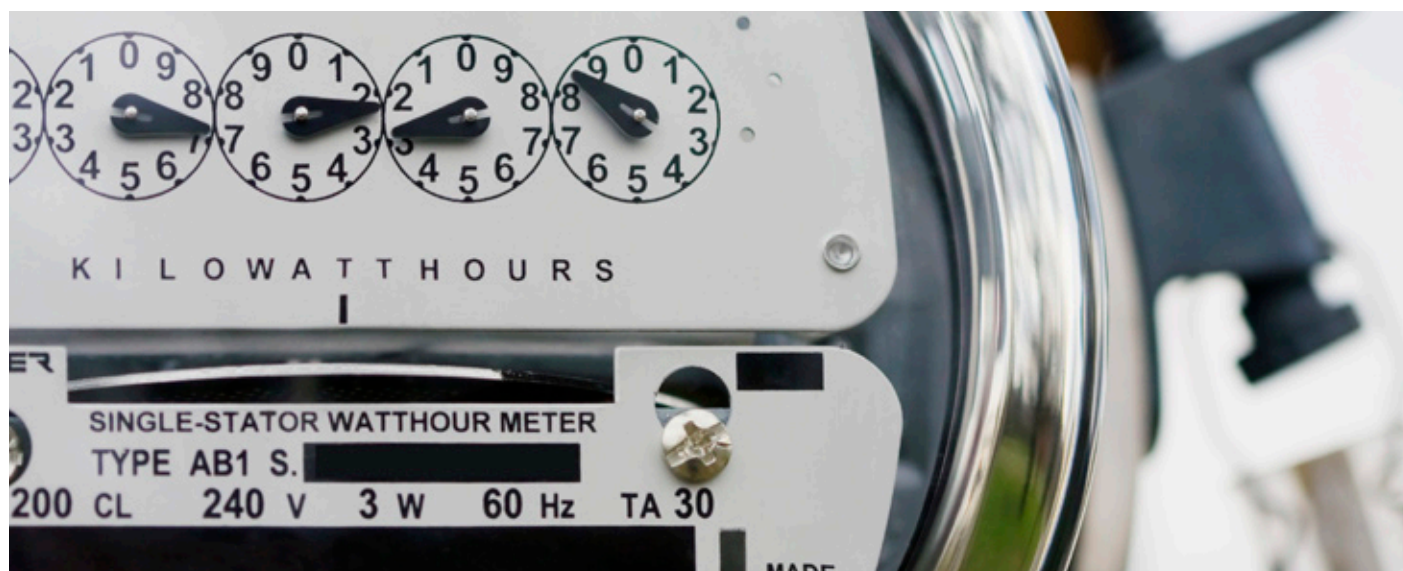
Tax of 2008, the AUR is now applied on a building-by-building basis for LIHTC projects as well. The application of the AUR on a building-by-building basis is helpful to mixed-income project planners, particularly in projects where each building is assigned specific affordability requirements. Typically, conversion of an affordable unit to a market rate unit will occur less frequently now that vacated units outside of a building with an over-income tenant do not require conversion to an affordable unit. Under the old rule, an over-income tenant in one building of a LIHTC project might trigger application of the AUR in another building, while the over-income unit would also need to remain affordable to meet specific building affordability requirements. Now the conversion does not take place until a unit becomes available in the same building, after which time the over-income unit can be converted to a market rate unit.

Compliance with the AUR has become more difficult. According to recent informal guidance provided by the Internal Revenue Service, non-renewal or termination of a tenant for the sole reason of increased income will be considered a violation of LIHTC program compliance, subjecting projects to the possibility of credit recapture. As a result, project managers need to be careful not to establish a practice of non-renewing or terminating tenant leases on the basis of increased income. The Internal Revenue Service apparently bases this guidance on its interpretation of the AUR as a protective measure for tenants, as well as project owners. Details are not available at this time, but formal guidance is expected in the upcoming months. Until such guidance is issued, project managers should consider alternative procedures, such as negotiated relocation of over-income tenants from affordable units to market rate units or off-site.



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Energy Update

by Christian D. Dubois

The American Recovery and Reinvestment Act of 2009 (“ARRA”) provided an enticing interim measure to address shrinking demand for energy tax credits, called the Section 1603 Program. Although the program has the potential to be a helpful tool in facilitating green building, its short lifespan and limitations on qualifying entities may be a significant hurdle to its effectiveness.

In July of 2009, the IRS issued guidance for the Section 1603 Program, available at <http://www.ustreas.gov/recovery/docs/guidance.pdf>. Section 1603 allows grant payments in lieu of tax credits from the energy production and investment programs under Internal Revenue Code Sections 45 and 48. The payment amounts are typically 30% of the basis of the energy property. Section 1603 funding is available primarily for energy property placed in service in 2009 and 2010, with applications due by October 1, 2011.

Section 1603 funding is not available to projects owned by nonprofits, government agencies and entities controlled by nonprofits or government agencies. To address this prohibition, the IRS allows use of a for-profit “blocker” taxable C corporation

as an intermediary. With the prevalence of nonprofits in low-income housing deals, particularly in California, it may be difficult in practice to set up a transaction to include such a “blocker” and qualify the project for other subsidies, such as property tax abatement.

Unfortunately, the problem of the blocker requirement is not eliminated through a lease pass-through structure. In recent years, Pillsbury has assisted several low-income housing projects in monetizing Section 48 credits through this type of structure. The typical setup has included an “Energy LLC” affiliate of the project owner’s general partner, which leases the solar equipment from the project owner for a fixed rent payment, sells electricity back to the project owner for a variable energy payment (often based on market electricity costs), takes the energy credits for itself and includes as an income item 50% of the pass-through credits. Because Section 1603 requires that both the lessor and lessee be eligible to receive Section 1603 payments, the lease pass-through structure does not obviate the need for a blocker intermediary above the project owner.

The Energy LLC lease pass-through structure was designed, in part, to avoid the 50% tax credit basis hit to project owners caused when energy credits are taken on bond-financed projects. Under ARRA, this basis hit was eliminated. As a result, the lease pass-through structure will likely be a good fit only for projects where Section 1603 funding is unavailable and there are sufficient energy credits to justify the costs of negotiating and documenting the structure.

Senators Dianne Feinstein (D-CA) and Jeff Merkley (D-OR) have introduced a bill to extend the Section 1603 Program for an additional two years through 2012. We are hopeful that the Section 1603 Program will be extended and that whatever legislation is adopted will remove the blocker requirement to allow greater access to this important funding resource.



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Developments at HUD

by Irene C. Kuei and Noa L. Clark



The U.S. Department of Housing and Urban Development (“HUD”) continues to play an active role in spurring economic and affordable housing development. In mid-January of this year, HUD announced that it is awarding \$2 billion in American Recovery and Reinvestment Act funding to states, local governments and nonprofit housing developers under its Neighborhood Stabilization Program. HUD continues to propose new rules to streamline the use of its programs.

Lifting the Tax Credit Equity Requirement

To facilitate the use of historic tax credits, new markets tax credits and low-income housing tax credits (“LIHTC”) with Federal Housing Administration (“FHA”)-insured loans, in October 2009, HUD proposed a rule to eliminate the long-standing requirement that borrowers of FHA-insured loans escrow all, or substantially all, of the tax credit proceeds expected to be realized in the transaction at the time of the initial endorsement of

the loan. This proposed rule alleviates the burden in many instances of having to obtain bridge financing in deals that have deferred equity pay-ins, which are increasingly common. HUD, however, may still require escrowing tax-credit proceeds for other purposes, such as working capital. In addition, the proposed rule adds LIHTC, historic tax credits and new markets tax credits to the list of funding types that, where approved by the FHA, do not need to be fully disbursed before disbursement of the FHA mortgage proceeds. Overall, these changes signal HUD’s continuing goal of encouraging the use of FHA-insured loans for multifamily and mixed-use projects using LIHTCs, historic tax credits and new markets tax credits.

HUD Properties Eligible for Weatherization Assistance Program

On January 25, 2010, the U.S. Department of Energy published a final rule amending the eligibility provisions for multi-unit buildings under the Weatherization Assistance Program (“WAP”). Under the

rule, certain multi-unit properties that appear on a list published by the DOE and that participate in an assisted or public housing program, the LIHTC program or the U.S. Department of Agriculture Rural Housing Service’s Multifamily Housing Program, will meet certain WAP eligibility criteria without submitting additional eligibility verification. We expect this new rule to streamline and enhance the application process for WAP.

Updated FHA Multifamily Rental Closing Documents

To bring the FHA multifamily rental project closing form documents up to date, HUD issued a comprehensive set of revised closing documents for public comments on January 21, 2010. HUD expects the revised closing documents to be consistent with current real estate and mortgage lending laws and practices and expects that all parties involved in these transactions will benefit from the revisions. The multifamily closing documents can be found on HUD’s Web site at <http://www.hud.gov/offices/hsg/mfh/mfhclosingdocuments.cfm>.

Pillsbury will continue to stay apprised of HUD developments throughout 2010, and we are happy to help navigate and answer questions regarding HUD’s policies and procedures.



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Legislative Outlook for 2010

by Kimberly C. Moore



The new year brings a mix of renewed optimism and tempered expectations, some new ideas and a few old ones. The affordable housing industry as a whole spent considerable time in 2009 on the interpretation and implementation of two programs created under the American Recovery and Reinvestment Act of 2009: (1) the Section 1602 Program (“Exchange Program”) and (2) the Tax Credit Assistance Program (“TCAP”), programs created to jumpstart an otherwise stalled affordable rental housing industry. The Exchange Program permits eligible state housing tax credit agencies to “exchange” up to 40% of a state’s 2009 low-income housing tax credit (“LIHTC”) ceiling and 100% of certain LIHTCs carried forward

or returned to the agency for a cash payment to finance construction or acquisition and rehabilitation of a qualified low-income building. TCAP was created to address funding gaps and involves HUD grants to agencies, which in turn provide subawards for projects that received LIHTC in fiscal years 2007, 2008 and 2009. The U.S. Department of the Treasury announced on December 22, 2009, that it has provided more than \$4 billion in grant funding to 50 agencies through the Exchange Program.

While the Exchange Program and TCAP have provided critical funding for projects otherwise facing budget gaps, the programs have not made, nor were they

Shiloh Arms

Pillsbury and its client, Allied Pacific Development (“APD”), are proud to have worked on Shiloh Arms Apartments, which is the first project to have closed in California with the American Recovery and Reinvestment Act of 2009 (“ARRA”) funds administered by the California Tax Credit Allocation Committee (“CTCAC”). Pillsbury, APD and CTCAC worked closely together in navigating through regulations governing the new program created by ARRA and administered by CTCAC. Shiloh Arms is a 106-unit multifamily housing project located in Sacramento, California. As a 4% rural project, obtaining the necessary financing for the project proved to be difficult but not impossible. In addition to the ARRA funds, the project was financed by tax-exempt and taxable bonds issued by the Housing Authority of the County of Sacramento, as well as a redevelopment agency loan provided by the Redevelopment Agency of the County of Sacramento Housing and Redevelopment Agency.



intended to make, tax credit investments more attractive to equity investors. According to a recent report prepared by the Harvard University Joint Center for Housing Studies, the \$0.85 offered by the Exchange Program may actually be forcing some investors out of markets instead of bringing them in at market rate prices. The report concludes that additional changes are needed to reinvigorate the affordable housing industry and cites legislative proposals that have been advanced by the industry, including the five-year carryback proposal, making the LIHTC refundable and extending the Exchange Program through 2010. The report also discusses several fresh ideas, including expanding the coverage of the Community Reinvestment Act and allowing Fannie Mae, Freddie Mac and Troubled Asset Relief Program recipients to use LIHTC to offset dividend payments that are owed to the Treasury.

On December 9, 2009, the U.S. House of Representatives passed the Tax Extenders Act of 2009 (H.R. 4213), which includes one of the proposals advanced by the industry: extension of the Exchange Program for an additional year. The House also passed the Jobs for Main Street Act on December 16, 2009 (H.R. 2847), which includes \$1 billion for the National Housing Trust Fund, \$65 million for project-based voucher or rental assistance and \$1 billion for public housing grants. Both bills have been sent to the Senate for consideration. In a joint statement released on December 22, 2009, Senators Max Baucus (D-MT) and Chuck Grassley (R-IA) sent a letter to Senate Majority Leader Harry Reid (D-NV) and Minority Leader Mitch McConnell (R-KY) regarding their intent to take up expiring tax provisions in early 2010. Pillsbury will continue to monitor national legislation and industry proposals as they develop in 2010.



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An Update from Pillsbury's Affordable Housing Team

A Full-Service Reminder

In the last several months, Pillsbury's Affordable Housing team has provided an increasing amount of assistance to its developer clients in anticipated disputes arising from delayed equity contributions, partner bankruptcy filings and debt service shortfalls resulting from reduced project cash flows. We have also spent more time with our clients developing alternative sources of financing and providing other client services for matters of peripheral focus in better economic times. As a result, our team has had the opportunity to work closely with our experienced attorneys across the spectrum of practices within our firm and has been reminded of the breadth of services Pillsbury offers.

Over the past year, clients have engaged Pillsbury on several occasions to address tax credit adjuster disputes and disputed or delayed capital contributions from investor limited partners. At various points in our negotiations, we have brought in our experienced team of litigators to prepare for the possibility of trial. In other deals where investors or their affiliates have filed or threatened to file for bankruptcy, we have worked with our experienced bankruptcy attorneys to determine the best course for our clients to maximize their claims and their returns on such claims. In some cases we have facilitated the transfer of an investor's interest in a partnership so that the project could move forward without further funding delays.

As financing and credit markets stalled, our team worked with clients to take advantage of programs such as the Exchange Program and Tax Credit

Assistance Program under the American Recovery and Reinvestment Act of 2009. These deals required the analysis of our low-income housing tax experts to determine how best to structure joint venture agreements that, unlike traditional deals, did not include a silent tax credit equity partner.

For some of our clients, 2009 was a time for internal housekeeping while markets settled. Our experienced in-house attorneys were able to handle such matters as filing and protecting trademarks and other intellectual property, reviewing and drafting employment contracts and assisting with insurance disputes.

Like most of our clients, we are optimistic that 2010 will bring about an increased number of successful affordable housing transactions; however, 2009 was a strong reminder that Pillsbury's capabilities extend well beyond closing deals.

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The HFA Initiative: Has the Ship Sailed?

What You Still May Need to Know

by Irene C. Kuei

Affordable housing developers spent much of their time in 2009 wrestling with the Section 1602 Program (“Exchange Program”) and the Tax Credit Assistance Program (“TCAP”) under the American Recovery and Reinvestment Act of 2009. In California, the Exchange Program and TCAP proved to be a success and jump-started many stalled low-income housing tax credit projects. However, the attention received by the bond-financing programs at various state and local housing finance agencies (“HFAs”) paled dramatically in comparison. As developers struggled to move along their stalled 2007 and 2008 projects with the assistance of the Exchange Program and TCAP, little or

no attention has been paid to the bond-financing programs. The California HFAs and the California Debt Limit Allocation Committee saw a significant drop in the demand for new issuance of tax-exempt multifamily housing bonds in 2009.

On October 19, 2009, after months of negotiation between various arms of the federal government and the HFAs, relief finally arrived as the Obama administration announced the HFA Initiative to help HFAs get back into the lending game. The HFA Initiative created two programs—the New Issue Bond Program (“NIBP”) and the Temporary Credit and Liquidity Program (“TCLP”), both under the

authority of the Housing and Economic Recovery Act of 2008.

NIBP

The NIBP was designed to provide a temporary market for new single-family and multifamily housing bonds that the HFAs issue to finance new mortgages. Under the NIBP, the Treasury will purchase Fannie Mae, Freddie Mac, Ginnie Mae and FHA securities backed by new HFA bonds.

HFAs are to pay fees to the government-sponsored enterprises and the Treasury, intended to cover the cost of financing the new bonds as well as the risk posed by

the individual HFA, based on its rating. Generally speaking, the interest rate on the new bonds will be equal to a short-term Treasury interest rate for the period during which the proceeds are held in reserve before being drawn down by the HFAs to originate mortgages. The NIBP was only available for a short two-month period, which ended on December 31, 2009. More than 90 state and local HFAs representing 49 states participated in the NIBP for an aggregate total new issuance of \$15.3 billion. In California, the few lucky in-the-know developers and HFAs acted swiftly after the program announcement and were able to submit the applications prior to the program deadline. Among the successful California NIBP applicants are: California Housing Finance Agency ("CalHFA"), which received a NIBP allocation of \$585 million for multifamily debt; Association of Bay Area Governments, which received approximately \$66 million for multifamily debt; and California Statewide Communities Development Authority, which received \$230 million for multifamily debt.

TCLP

The TCLP was announced alongside the NIBP and was administered by Fannie Mae and Freddie Mac. Under the TCLP, the Treasury has agreed to purchase a participation interest in the temporary credit and liquidity facilities provided to HFAs under the program, providing a credit and liquidity backstop. The TCLP will provide HFAs with temporary credit and liquidity facilities to help the HFAs maintain their financial health and preserve the program infrastructure.

In California, TCLP will provide substantial aid to CalHFA. CalHFA has about \$3.6 billion in variable rate demand obligations ("VRDO") outstanding in a debt portfolio of more than \$8 billion. CalHFA's variable rate debt traded poorly as financial crises eroded confidence in its liquidity banks and its bond insurers. According to *The Bond Buyer*, a national trade newspaper which focuses on the municipal bond industry, at its worst point last fall, investors placed about \$1 billion in VRDOs to

CalHFA's standby bond purchase agreement banks, forcing the agency to pay penalty rates and to plan for the possibility of accelerated repayment. The variable rate market has improved since then, but CalHFA continues to pay more than the SIFMA Municipal Swap Index rate for a portion of its VRDO portfolio, as well as large premiums to renew liquidity facilities. According to Tim Hsu, CalHFA's deputy director of financing, the TCLP should resolve the problems in the variable rate portfolio for three years.

Both the NIBP and TCLP have provided temporary relief to the multifamily housing bond market, but more needs to be done. The programs could have been more successful but for their short duration and the lack of publicity. Many developers are still scratching their heads wondering what the NIBP and TCLP were about and how they actually worked. In California, for example, only a few lucky in-the-know developers that were already working on transactions involving Freddie Mac, Fannie Mae, Ginnie Mae and FHA financing were able to benefit from NIBP. These developers will each save approximately 50 or 60 basis points in interest rate through their participation in NIBP and will earn out more in debt proceeds. Many more developers missed the opportunities to participate in the program due to its short duration even though their projects involved Freddie Mac, Fannie Mae, Ginnie Mae or FHA financing. Many of these developers did not have the time or the knowledge of the programs due to the lack of publicity.

Much emphasis was placed on the Exchange Program and TCAP in 2009. At the time of writing this article, Congress is close to extending the Exchange Program for another year in 2010, but not TCAP. While this is not a final determination, the California Tax Credit Allocation Committee ("CTCAC") has indicated that without the extension of TCAP, there will be a sharp decrease in available funds for 2010, and the limited funds that are available will likely tie only to projects awarded 9% low-income housing tax credit. The result of CTCAC's decision will be

tremendously detrimental to the already struggling California HFAs. In the era before the Exchange Program and TCAP, 4% tax-exempt bond-financed projects were responsible for the production of a majority of the affordable multifamily housing units. Unless the California HFAs and other participants of the bonds market take more immediate action to encourage Congress to do more for the HFAs and the multifamily housing bonds industry, we will see many 9% deals, but few or no 4% deals in California in 2010.



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California's New Affordable Housing Lender

(continued from page 2)

The Future

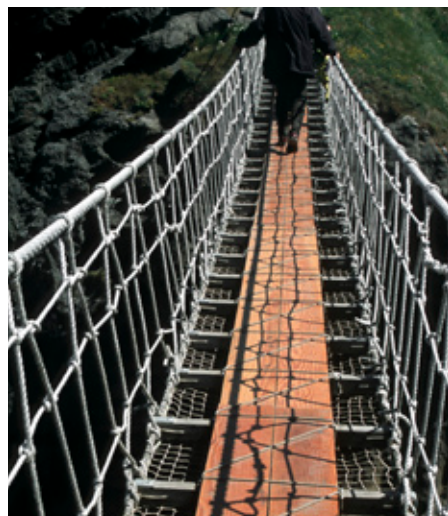
The expected extension of the Exchange Program will provide significant funds. CTCAC plans to amend its regulations and currently expects to allocate exchange funds as gap financing for 9% projects. This means that bond projects requiring tax credit equity as a source will not be feasible. In essence, the funding decrease weans the industry off of the direct subsidy. Now more than ever, the industry must redouble its efforts to redevelop demand for tax credits.

Pillsbury is heavily involved in the formulation of regulations for various ARRA programs and represents various parties in a large number of projects receiving ARRA funds. Pillsbury is prepared and available to advise on these and any other affordable housing matters.



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Mind the Gap

Bridging the California Housing Department's Unfunded Commitments

by Gary P. Downs

Surprising almost all observers, the California Department of Housing and Community Development ("HCD") Proposition 1C programs remain unfunded. In December 2008, the Public Management Investment Board ("PMIB") announced that HCD could no longer write unconditional commitments to its awardees. This means that Infill Infrastructure Grants, Transit Oriented Development, Multifamily Housing Program and many other program awardees received commitments that are conditioned on the availability of funds. These HCD programs are typically funded through California public bond sales, which have stopped as a result of the current economic environment and cost to the state. While awardees prior to the December announcement are treated differently from those following the announcement, most awardees face uncertainty of funding and need to bridge the HCD commitment to induce other lenders and investors to close funding transactions. Governmental agencies and private lenders have developed, and continue

to develop, programs to bridge the HCD commitment gap.

Pre-PMIB Announcement Awards

HCD committed approximately \$1.2 billion in awards prior to the December 2008 PMIB announcement. Technically, these commitments are unconditional. California funded \$560 million to the HCD programs from the few bond financings recently accomplished by the state. While HCD has committed the entire \$560 million to pre-PMIB announcement transactions pursuant to a first-come-first-served policy benefiting HCD construction funding programs like the Infill Infrastructure Grant program, politics also play a part in determining which projects receive funding. For instance, the California Tax Credit Allocation Committee ("CTCAC") has persuaded HCD to give priority to projects utilizing its tax credit allocations. As of the publication of this newsletter, approximately \$660 million of HCD commitments remain unfunded.

Post-PMIB Announcement Awards

All awards granted after the PMIB announcement received commitments conditioned on California bond funding. For the most part, these awards are too large for project sponsors to bridge funding gaps without significant help from outside sources. CTCAC created a "Backfill" money pool with funds received under the American Recovery and Reinvestment Act of 2009 ("ARRA") to bridge the funding gaps. Projects competed for the funding under CTCAC Regulations. CTCAC Backfill money was unavailable for the Infill Infrastructure Grant program, as CTCAC reasoned that the program did not directly fund housing. The CTCAC Backfill program provides the advantage of funding what would otherwise have been a permanent HCD funding source with construction period funding. This allows sponsors to decrease the amount of their construction loan, which is significantly more costly than the no interest rate Backfill money. Many pre-PMIB and post-PMIB announcement projects have received Backfill awards. Although all

CTCAC ARRA funding has been awarded, any unused awards will likely go into the Backfill pool to help alleviate the pressure on HCD and state bonding.

CTCAC continues to work with HCD on post-PMIB projects also that it is also funding through its 9% program or with ARRA money. If the projects do not have a Backfill award, CTCAC is advocating prioritizing these projects, essentially swapping out the conditional commitment for a firm commitment from HCD.

Other Bridge Programs

Certain private lenders have developed loan programs to act as bridge financing until California funds its commitments. However, at the time of publication of this newsletter, the developing loan programs are few and maintain limited funding. One significant affordable housing bank lender is working with the state to create a standby bond purchase arrangement, which would allow the lender to buy tax-exempt California general obligation bonds to replace HCD Proposition 1C funds at the time when HCD funding would have occurred. The proceeds from the general obligation bond sale will fund the HCD commitment to the project identified by the lender. The bonds would then be prepaid from future California bond sales that would have funded the HCD commitments. This would allow the lender and others to make senior loans with the assurance that if HCD does not fund its commitments, the lender can fund by buying tax-exempt California general obligation bonds. Pillsbury is optimistic that this program, although not entirely worked out, has legs and will ameliorate the HCD funding crisis.

We continue to closely monitor these developments in an effort to provide the best and most up-to-date solutions for our clients.



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Changes to Tax Credit Joint Venture Structures

by H. Carl Moultrie III

The economic crisis and the changes in law intended to help the low-income housing tax credit ("LIHTC") marketplace have resulted in changes to deal structures and investor requirements. The most obvious change has been the significant decrease in credit prices. New sources of funding, such as the new Tax Credit Assistance Program ("TCAP") and the Section 1602 Program ("Exchange Program") created under the American Recovery and Reinvestment Act of 2009, are beginning to fill the funding gap caused by this decrease. In addition to new issues resulting from the implementation of such programs, developers have faced new investor requirements, including heightened guarantee and reserve requirements and an emphasis on investor rights to freely transfer their interests.

Credit prices, which rose to more than \$1 per credit dollar in 2007 have now decreased to the range of \$.60 to \$.70 per credit dollar, but over the past quarter have started to creep upward in some areas. TCAP and Exchange Program funds come with certain costs, such as agency fees and requirements not previously imposed. As agencies have only recently begun closing deals involving such funds, there is a learning curve for the agencies as well as the other parties. In our experience, agencies have been using the same base form documents for TCAP and Exchange Program deals. Due to the additional responsibilities assumed by agencies as a result of such programs, agencies have begun imposing certain asset management and monitoring fees on projects. In many instances the fees are annual, resulting in a reduction of distributable cash flow.

Many agencies have further attempted to impose regulatory limits on the investor's ability to remove and replace the general partner/manager of the investment entity or the property manager and the ability of the parties to amend their governing documents.

Tightening investor underwriting standards are reflected both in the terms related to guarantees and in increased reserve requirements. Previously there was more flexibility with respect to the length and amount of developer guarantees. Today, guarantees typically appear to be for a minimum of 5 years, and there is a general reluctance to include caps on the guaranteed obligations. There is a trend toward maintaining operating reserves of greater than 6 months of expenses and increased replacement reserve requirements that may exceed \$400 per unit per year for some projects.

Finally, investors have become more insistent on having the ability to freely transfer their interests in the investment vehicle. This is due in part to the elimination of

the recapture bond requirement pursuant to the Housing Assistance Tax Act of 2008, which facilitates a secondary market for LIHTC investments. However, as lenders have also been tightening their requirements, the relaxation of transfer requirements has been at odds with lenders' requests for restrictions on transferability.

As more deals close in 2010, we anticipate that the challenges involved with TCAP and Exchange Program financing will settle, and developers, lenders and investors will find more common ground with respect to fundamental business terms. Pillsbury will closely monitor the changes and the challenges related to the use of TCAP and Exchange Program funds and is available to assist and advise on these matters.



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9TH ANNUAL

Developers' Roundtable

Thursday, February 25, 2010

Peninsula Beverly Hills

9882 South Santa Monica Boulevard
Beverly Hills, California 90212

Registration / Networking	12:00–1:00pm
Roundtable Discussions	1:00–5:30pm
Cocktail Reception	5:30–7:30pm

RSVP by Thursday, February 18

Sherry Tyler at slt@housingadvisors.com
*Space is limited. Please register early.
Invitation is not transferable.*

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Northwood Place

Last year Pillsbury highlighted Northwood Place as an upcoming 32-unit affordable housing project in Ketchum, Idaho, a small town immediately adjacent to the Sun Valley ski resort. Pillsbury and our client, Allied Pacific Development ("APD"), are pleased to announce that financing for Northwood Place closed in November 2009. The project is a joint venture between APD and the Ketchum Community Development Corporation, and was the first project in Idaho to take advantage of TCAP and Exchange Program funds under the American Recovery and Reinvestment Act of 2009 ("ARRA"). Project participants faced the challenge posed by fast-changing deal terms as the Idaho Housing and Finance Association moved quickly to draft its forms to effectuate the nascent TCAP and Exchange Programs. With eco-friendly materials and sensitive design considerations throughout, the environmentally conscious design of Northwood Place incorporates two major renewable resource components: (1) a ground source geothermal exchange system for snowmelt and common area heating; and (2) 3,000 square feet of roof-mounted photovoltaic panels that will generate electricity to offset common area electrical usage. In addition, as much as 75% of the total contracted revenue of the approximately \$6 million construction contract has been locally assigned. Northwood Place is expected to be ready for occupancy in the fall of 2010. As shown (upper right), construction is already well under way.



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