EXPIRING USE RESTRICTED PROPERTIES AND FEDERAL POLICY:
PERSPECTIVES FROM THE OWNERS

by
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Submitted to the Department of Urban Studies and Planning
in Partial Fulfillment of the Requirements for the
Degree of
MASTER OF SCIENCE
IN REAL ESTATE DEVELOPMENT
at the
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ABSTRACT

Two decades ago, the federal government attracted many private developers to the affordable housing market by offering 40 year notes at low rates of interest. In exchange, owners agreed to maintain the properties as low and moderate income housing. The owners also had the right to prepay the mortgages after 20 years and end the subsidized use restrictions. Concern about the potential loss of affordable housing through the prepayment of a large percentage of these notes prompted Congress to enact legislation which regulates prepayment while offering incentives to keep the housing affordable.

While the terms of that legislation are complex, owners basically have three options from which to chose: hold, sell or refinance the property. The option that is chosen is the outcome of a complex decision making process involving: owners, tenants and the government. The process is made more demanding by the fact that the owners are simultaneously developer, property manager, taxpayer and general partner. These intertwining and possibly conflicting relationships have a much greater impact on the motivations of owners to chose one of the three options than the simple motive of maximizing profit.

This study takes a close look at the expiring use issue from the owners’ viewpoint. Interviews with practitioners in the field, as well as the observations of several property owners who have recently been involved in the process of selling or refinancing in the current regulatory environment, have resulted in some general observations about what motivates an owner in the decision making process.

Thesis Supervisor: Langley Keyes
Title: Professor of City Planning
ACKNOWLEDGEMENTS

This report was made possible by the generous contributions of time and expertise of many individuals. I would like to thank owners representatives who took precious time away from their jobs to provide insight from the developers perspective: David Olney, Krupp Company, Arthur Winn, Winn Management, David Gilmore, Druker Company. Additional thanks go to the financial advisors who explained the complexities of subsidized housing and made themselves available for clarification of specifics: Peter Richardson, Boston Financial Group, David Smith, Recapitalization Advisors, Howard Cohen and Kathleen Sheehan at Mintz, Levin, et al. Appreciation is given to Vincent O'Donnell, CEDAC and David Keene, MHFA for providing additional insight on specific cases. The efforts of family and friends who also contributed moral support are gratefully acknowledged.

I am most indebted to my advisor, Langley Keyes, who expended an incredible amount of effort helping me to sort and organize the pieces of a very complex puzzle. It was a lesson in structuring my thought process as much as learning about the topic at hand.

DEDICATION

This work is dedicated to Miriam, for always being ready to share words of encouragement and humor throughout the year, and to Alexander, whose bright new smile has already made this world a better place.
TABLE OF CONTENTS

Introduction ........................................................................................................... 5

Over view of the Available Stock
Brief Analysis of Existing Legislation
Relationship of Owner to Tenant and Government
Three Basic Options Available to Owners

Castle Square: A Triangulated Sale ....................................................................... 32

Georgetowne I & II: Complexities of Refinancing ................................................. 48

Lakeview Towers: Sale Teamwork ......................................................................... 62

Analysis and Conclusions .................................................................................... 74

Description and Motivations of Owner:
Taxpayer
Limited Partner
Property Manager
Personal Decision Maker
Developer
Owner Relationship With Tenants and Current Regulations
Owner Relationship With Government and Current Regulations

Final Comments ..................................................................................................... 91

Bibliography ........................................................................................................ 95

Interviews .............................................................................................................. 98
CHAPTER ONE

INTRODUCTION

In the mid 1980's, the potential loss of rental housing for low and moderate income families insured under sections 221 ((d)3 and 236 of the National Housing Act became a steadily increasing concern. Owners who had financed their properties through the program 20 years earlier, now had the option of prepaying the notes in the late 1980's and early 1990's. This prepayment would have eliminated the restrictions on allowable uses; therefore, the housing became known as "expiring use restricted properties". In response to the perceived risk of owners prepaying, new regulations were enacted which restrict the prepayment of the federally insured mortgages. In exchange, owners would be given a range of incentives to keep the housing affordable. The Emergency Low Income Housing Preservation Act (ELIHPA) was enacted by Congress in 1987 to temporarily restrict prepayment. The Low Income Housing Preservation and Resident Home Ownership Act (LIHPRHA) was passed in 1990. With some modifications, LIHPRHA made permanent the emergency act of 1987.

In essence, the options available to the owners under both acts can be pared down to three choices:
(a) **Do Nothing and Wait**: Leave the current financing and rental stream as they already are.

(b) **Sell the Development**: LIHPHRA closely regulates the sale of the property must be offered to non-profit groups first. The government may allow a potentially higher sale price based on the highest and best use of the property.

(c) **Refinance the Development**: While placing restrictions on the amount of additional debt which can be placed on the property, both LIHPRHA and ELIHPA offer incentives, such as rent subsidies, for the owners to maintain the affordability of the development.

This thesis examines the three primary options available to the owners from the perspective of the owner to determine how decision makers ultimately chose among the options offered under the federal regulations of Title II and Title VI.

Although owners might want to make purely rational financial decisions, they realize that there are political and social aspects which influence the decision. This is especially true when dealing with subsidized housing, with three major groups involved: the owners, the tenants and the government.
In an ideal world of unlimited resources, where the regulatory system is functioning as it should:¹

- Tenants will get what they need. The property will be preserved as affordable.
- Owners will get what they have earned. The property will be recapitalized according to formulas based on the property's fair market value.
- The government will pay the least possible amount. Incentives will be related to the property's true value and the tenant's true need, and the government will have a ceiling on its obligations.

However, in the real world of limited resources, each of the three groups gives priority to its own interests, which often conflict the needs of the others. Conflicts include the owner's goal of maximizing profit and the government's goal of minimizing cost. The tenants goal is to preserve affordability no matter what the cost. From an economic standpoint, it would seem that owners and tenants are aligned against the government: tenants are willing to meet the owners asking price, but the government resists because it wants to keep costs down.

Viewed another way, the three way relationship between owners, tenants and government can be perceived as a series of checks and balances. Hypothetically, unlimited federal

funds would create unlimited upside potential in property values for owners, and the preservation (or creation) of an unlimited number of affordable units for tenants. But in reality, government funds are limited and resources must be maximized, tenants want to preserve their homes, and owners want to maximize profitability.

This relationship among tenants (sometimes represented by community groups), government (federal, state and local) and owners (individual and partnerships) requires that each participant be sensitive to the others. Owners must understand the needs and goals of the tenants and the government. Conversely, it is equally important that government and tenants comprehend the motivations and perspectives of the private owners.

A traditional view of tenant/landlord relationships would lead to the conclusion that tenants actions will react to choices made by owners: If the owner decides to do nothing, and keep the project as it is, there is little tenants can do to change the impact of that decision. If the owner decides to sell the project, tenants can become actively involved, as a reaction to a landlord's decision. And if an owner decides to refinance the project, tenants are not impacted.

However, when public subsidy is added to the equation, the landlord/tenant relationship becomes a triangle among the owner, the tenant and the government. Tenants gain new
stature in determining the fate of the project. Through the enactment of Title II and Title VI, tenant advocates have had a pro-active influence on the process by restricting the parameters of the three options available to the owners. Both ELIHPA and LIHPHRA will be discussed in more detail later, but in essence the two acts provide owners with incentives that primarily encourage (a) sale to a non-profit organization, or (b) refinancing of the property with additional subsidies. The latter choice preserves the affordable use restrictions for at least 20 years (Title II) and possibly 50 years (Title VI). A sale to a recognized non-profit would make the affordability permanent.

This thesis deals with how the theory of prepayment restrictions gets played out in the real world and looks at that game from the owner's perspective. This study is organized as follows: the remainder of Chapter I provides a framework for analyzing the case studies: (1) overview of the stock of expiring use properties, (2) explanation and comparison of the regulations that were enacted, (3) a theoretical evaluation of owner interests and options to hold, sell or refinance. The next three chapters present and analyze the decision making processes of three different owners to see how "theory" gets played out in practice. The concluding chapter will use the case material, supporting literature, and the perspectives of financial and legal advisors experienced with the expiring use issue to analyze
how and why owners are motivated to make the particular decisions they do along the route to choosing among the three options. Final recommendations and observations about the process of selling or refinancing expiring use properties will conclude the report.

The following takes a look at the extent of private investment in expiring use properties:

OVERVIEW OF STOCK

The private sector is involved in a much greater percentage of the low income housing market than many people realize. There are more than 4 million U.S. households which receive rental assistance, in one form or another, from the federal government. However, publicly owned housing accounts for only one-third of these units. The majority involve a partnership with the private housing market.\(^2\)

During the 1980's programs to develop or maintain affordable housing were curtailed or eliminated. Changes in tax laws also eliminated many of the advantages of investing in low income housing. Had the federal government continued to encourage investment in low income housing an "emergency" would not have developed, for new production would have

---

exceeded the small portion of low income housing stock leaving the program each year.¹

A government report in 1988 acknowledged the limited success of the Low Income Housing Tax Credit⁴ to fill the void left by the removal of tax incentives in stimulating investment in subsidized housing. The report quotes one owner of a low income property who commented (before the official enactment of prepayment restrictions):

... our situation can be stated quite simply. Congress originally used the tax laws to attract many like me into low income housing ventures. We would not have been at all interested without the tax advantages, and the knowledge that we could, at the end of 20 years, convert to some form of market rate housing.

The recent elimination of tax advantages [for low-income investors] has, for us at least, guaranteed its conversion. Congress would have to do something pretty spectacular to again make owning and managing such ventures attractive to anyone.⁵

What Congress did was to restrict the prepayment on expiring use properties. The focus is on preserving the existing stock of affordable housing by offering incentives to the owners.

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⁵ Hills, p 3.
The Emergency Low Income Housing Preservation Act (ELIHPA, also referred to as Title II) was passed by Congress in 1987, authorizing the Department of Housing and Urban Development (HUD), to use existing subsidies such as rent supplements and rehabilitation loans to deter owners from prepaying. In 1990, the Low Income Housing Preservation and Resident Homeownership Act (LIHPRHA, or Title VI) was enacted, making the emergency measures permanent. Title VI also included several revisions, most notably, time involved to process the request and extension of the low income use for at least another 50 years.

LIHPRHA emphasizes sale to nonprofit organizations or to those who agree to maintain the properties as low and moderate income properties. In addition, the act provides for tests that (1) limit the amount current owners may receive in incentives (the federal cost limits test), and (2) provide a basis for denying incentives where market conditions do not justify them (the windfall profits test).6

An owner's choice of processing under Title II requires that the "Project must have a better and higher use than as assisted low and moderate income housing".7 Processing

under Title VI requires only that the "Project must have some preservation equity (value above the existing debt) to qualify for Title VI incentives". Owners who filed Title II Plans of Action prior to October 11, 1990 can switch to Title VI processing. Certain other owners (transition rule projects) have the right to process under Title II in the future.

The decision making process becomes more complex upon examination of the various options available under the old law (Title II) and the new law (Title VI). David Smith has provided a comparative chart showing the major differences between ELIHPA and LIHPHRA.

8 Johnson, pp 2-3.
**Comparison of Key Economic Features Between the Old Law and the New Law**

<table>
<thead>
<tr>
<th>Component</th>
<th>Under the Old Law (E L I H P A)</th>
<th>Under the New Law (L I H P R H A)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FEATURES THAT FAVOR THE NEW LAW</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Section 8 provided to which tenants?</td>
<td>Generally only those at or below 50% of area median income (not 50-80%)</td>
<td>Everyone under 80% of area median income</td>
</tr>
<tr>
<td>New rents set at what level?</td>
<td>Section 8 certificates or 30% of tenant income</td>
<td>&quot;Preservation Rent&quot; which is a function of fair market value</td>
</tr>
<tr>
<td>Ceiling on Section 8 rents on refinancing?</td>
<td>Unspecified, but usually limited to 100% of existing FMR's for area, or of submarket if necessary</td>
<td>120% of existing FMR's for area, or of submarket if necessary</td>
</tr>
<tr>
<td>Owner able to realize value higher than residential rental?</td>
<td>Effectively not (rent stream is fixed by availability of subsidy, not value)</td>
<td>Yes, if the owner sells</td>
</tr>
<tr>
<td>How soon can an owner start the process?</td>
<td>12 months before the prepayment date</td>
<td>24 months before the prepayment date</td>
</tr>
<tr>
<td>Higher loan-to-equity ratios for sales to non-profits?</td>
<td>No</td>
<td>Yes, up to 95%</td>
</tr>
</tbody>
</table>

| **FEATURES THAT FAVOR THE OLD LAW** | | |
| Maximum loan-to-equity ratio for Section 241(f) equity takeout loans? | 90% | 70% |
| Method of figuring future rent increases? | Annual Adjustment Factor (so cash flow may rise) | Building-block cost-driven approach (so cash flow won't rise) |
| Future restrictions on cash flow? | No | Generally limited to 8% Preservation Yield |
| Yield on Preservation Equity? | Whatever's left from new rent stream | Fixed at 8% |
| New lock-in period? | Remaining term of the original mortgage (+/- 20 years) | Remaining useful life of the housing (at least 50 years) |

Source: David A. Smith, Recapitalization Advisors, Boston, MA
The Magnitude of the Problem: the GAO Report

Before the prepayment regulations were instituted in 1988, attempts were made to estimate the extent of likely prepayments on a national basis. The United States General Accounting Office (GAO) produced a report during 1989 on the likelihood that owners of subsidized housing stock would seek prepayment of their HUD mortgages.\(^9\) GAO found general agreement in four studies that an estimated inventory of 600,000 units had a maximum of 367,000 units eligible for prepayment. However, the number of units that probably would be lost through prepayment varied from 154,000 to 243,000 units. Although it was unclear if the same measures could be used for estimating the likely demand for assistance under the new incentives [i.e. Title VI], GAO believed it was a reasonable assumption that most owners would now seek preservation incentives. In other words, the study concluded that most owners were more likely to refinance with additional subsidies to support the additional debt or sell to a recognized non-profit group, than to do nothing or try to convert the property to market.

Section 8
Existing/Vouchers
813,000

Exhibit 1-3
Composition of Subsidized Housing

Universe of Subsidized Housing

Public Housing
1,400,000

Privately Owned, Subsidized Housing
1,950,000

Privately Owned, Subsidized Housing

Other
165,000

FmHA 515
305,000

Preservation Analysis Inventory
645,000

Section 8 New/Rehab
840,000

Preservation Analysis Inventory

221(d)(3) BMIR
159,000

Assisted 221 (d)(3)
Market Rate
80,000

Section 236 Program
406,000

Source: National Low Income Housing Preservation Commission Tabulations. HUD Data.
The National Low Income Housing Preservation Commission developed a model to try to predict whether owners would seek to prepay. But the exclusion of noneconomic variables (personal, political and social) that could affect owners decisions severely limited the model's usefulness. Also, inaccuracies in HUD databases, including actual errors about the properties, and a lack of information on the physical and financial conditions of the properties, made it difficult to estimate the ultimate cost of deterring prepayments. If costs were higher than expected, the subsidy funds could be drained.

Today, in a soft real estate market, owners are probably even more concerned about the availability of federal subsidies; owners are maintaining an attitude of "act now" to take advantage of the subsidy programs.

In both strong and weak markets, GAO found that owners had similar reasons for investing or not investing in subsidized housing. The primary reasons owners gave for investing were the financial benefits of a low interest federally insured mortgage, tax benefits, and the public-spirited or charitable desire to help provide housing for low income families. In addition, owners invested to make a profit.

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10 The National Low Income Housing Preservation Commission is a private concern financially supported by the National Corporation for Housing Partnerships and the Ford Foundation. The study cited by GAO is "Preventing the Disappearance of Low Income Housing", Washington, D.C. 1988.
11 U.S. GAO p.31
At the time of the GAO survey, owners in the Boston and Los Angeles markets wished to prepay their mortgages or sell to take advantage of built up equity. Conversely, owners in weak real estate markets like Houston and Denver did not intend to prepay or sell to convert the properties to market rate rentals.

But the perception has changed: research for this thesis identified one Boston based owner who insisted that because there are about 30,000 subsidized units in the Boston area, it was unrealistic to ever believe that most or all of these units would convert to market rate. Another owner, involved in limited partnerships which own 4,500 units in 25 subsidized buildings, said owners are committed to keeping the buildings affordable. "I don't know an owner in the state that owns a subsidized building and plans to prepay the mortgage and kick the tenants out". A cynic might point out that this altruism on the part of owners could very well be due to the fact that conversion of the units to market rate is extremely difficult under current regulations.

The GAO pointed out several reasons owners in high demand, low supply markets like Los Angeles and Boston might want to prepay: (1) the built up value of the properties made selling attractive; (2) the earnings limit of 6% on the

12 Interview: William Stetson, SVP, Beacon Property Management, July 6, 1992
original investment under the HUD programs was much lower than the market return would be; and (3) fears of legislative action to "change the rules" discouraged continued participation in the program. Conversely, low demand, high supply areas like Denver and Houston did not plan to prepay because: (1) declining values eliminated any equity; (2) subsidies which were obtained from related HUD programs provided a steady source of income and helped to maintain low vacancy rates.

The following is a more detailed discussion of GAO findings:

1. INCREASED MARKET VALUE OF PROPERTIES

[Prior to ELIHPA] owners planned to prepay mortgages to gain access to increased property values or built up equity. After prepayment, owners could sell the properties, take out equity loans, or convert their properties to higher market uses. In Boston, the increased values of properties averaged 400% over a 20 year period. The increased market value was so great that including the costs of renovations and upgrades, conversion was still justified.

2. LIMITED RETURN ON INVESTMENT

Some owners complained to GAO that the contractual obligation with HUD limited the rate of return to 6% on original investment. These owners were also being taxed on income which they did not receive. This so called "phantom

14 U.S. GAO p.32
15 U.S. GAO p.31
income" was due to the fact that these older mortgages had exhausted allowable depreciation. Therefore, they were unable to offset rental income in excess of the amounts they were permitted to retain under the limited dividend provisions. The excess income had to be placed in a reserve account\(^{16}\).

3. LEGISLATIVE ENVIRONMENT

Many owners told GAO that they would not invest in subsidized housing because of the uncertain legislative environment [at the time of Title II]. Congress, through ELIHPA, had removed the owner's contractual right to prepay their HUD insured mortgage. One owner indicated that because of this precedent, it would be very difficult to find new private investors for low and moderate income housing.

4. FACTORS WORKING AGAINST PREPAYMENTS

Local political restrictions and concern for tenants facing displacement were cited as reasons why owners would not choose to prepay. One owner in Massachusetts, concerned about future business in the state, chose to sell to a nonprofit organization below the appraised value rather than prepay the mortgages and convert the properties. GAO also noted that any owner choosing to prepay incurred the greater market risks inherent in a competitive rental market. There was a potential for higher vacancies when subsidies were

\(^{16}\) U.S. GAO p.31
lost as well as fluctuations in local housing market conditions.

5. INCENTIVES THAT MIGHT DETER PREPAYMENT

Owners listed a variety of incentives necessary to induce continued ownership of low-and moderate-income housing. These included a rate of return greater than the 6% limit, rent increases to market levels and additional subsidies such as Section 8 LMSA payments (based on the difference between tenant income and fair market rents). Equity take-out loans would be effective in discouraging mortgage prepayments, because capital gains liability is deferred. However the interest on these loans is not necessarily tax deductible. Increased cash flow to meet debt service would be necessary through rent increases and additional federal subsidies.

OPTIONS AVAILABLE TO THE OWNERS

The three basic choices available to owners of expiring use properties include doing nothing, selling to a non-profit or refinancing. But within these basic categories are more specific options. Not all owners examine all possible options. For example, an owner who wants only to get out of subsidized housing is not going to be concerned with retaining management contracts, tax implications between refinance and sale, etc. Rather the
owner will be concerned with the quickest way to get out. Other owners see a menu of five options available to them: sale or refinance under Title II, sale or refinance under Title VI, or do nothing and wait for possible future changes. Unique financial and tax situations will dictate whether they ultimately refinance or sell.

The actual financial analysis of sale verses refinance is complicated by the fact that Title VI encourages sale to a non-profit buyer, therefore incentives to refinance under Title VI are not as advantageous.17 This is one reason why owners who decide to refinance are doing so under Title II. When an owner determines that a sale is the best alternative, Title II is still seen as the least time consuming process; however, an owner may still want to sell under Title VI because the regulations allow a potentially higher appraised value (based on the unencumbered highest and best use of the property). The following flow chart gives some idea of the time involved in a sale - roughly 44 months. A refinance (stay in) would take 21 months, but up to 36 months is allocated.

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THE PREPAYMENT/PRESERVATION PROCESS
Chart prepared by Emily Achtenberg and Brown, Rudnick, Fred & Eger
An owner would probably sift through the three primary options (hold, sell, refinance) in the following manner:

1. Do Nothing and Wait.

Boston Financial Group notes that waiting may provide additional information through the experiences of others. But there is little likelihood that the incentives will increase. There is also a risk that federal funding may eventually run out. An owner should take advantage of possible subsidies (by selling or refinancing) while they are available. Attorney Howard Cohen of Mintz, Levin, et al, agrees that the future will be unlikely to offer better alternatives than exist now.

2. Sell the Development.

Because the property must be offered to non-profit groups first, it is very important to anticipate the capabilities of any potential buyer. In weighing the pros and cons of a sale verses a refinance, Cohen wants an owner to consider numerous factors, including:

-- Do you want to sell?
-- What are the needs of the ownership interests?
-- If you sell can you retain the management contract?
-- What are the tax consequences? The adjusted basis of the investors, passive losses which can offset the gain from the deal, etc., should be considered.
Because the priority purchasers have twelve months to make a bona fide offer, David Smith of Recapitalization Advisors points out the importance of being sure that the buyer is capable of completing the purchase. Things to look for in a non-profit buyer\textsuperscript{18} include, (a) experienced housing and management capabilities, (b) good to excellent relationships at local, state (housing finance agency), and federal (HUD) levels, (c) ability to communicate with tenants, and (d) commitment to get through the long process. An owner who chooses to sell may reconsider if no qualified purchaser comes forward.\textsuperscript{19}

The circumstances when selling may be superior to refinancing include:

A. An owner no longer wants to be in the business of owning and managing affordable housing.

B. The property is worth considerably more than its residential rental value (and processing proceeds under LIHPHRA). For example, if the highest and best use is a condominium, then the appraised value, and the sale price to the non-profit buyer, will be based on the non rental use.

C. The owner will pay little or no tax upon sale due to accumulated passive losses which can be used to offset the gain from a sale.

D. The interest on the refinancing is non-deductible at the individual level. If the owner does not intend to

\textsuperscript{18} Smith, p 2
\textsuperscript{19} Smith, p 6
reinvest the loan proceeds, then a sale would be more desirable.

E. The property is a resyndication with secondary notes that mature soon, and the owner is unable to renegotiate the notes. An owner may be forced to sell in order to retire a secondary balloon note.

Although the potential sale price may be higher due to the appraisal method used to value the property, Boston Financial estimates that processing a sale under Title VI would take two to three years longer than a similar transaction under Title II.

3. Refinance the Development

Boston Financial believes that nationally, most partnerships eligible for Title II incentives are choosing this option because it affords greater benefits to both the General and Limited Partners than the alternatives. GP's can retain control of property management contracts and also receive any residual proceeds from refinancing. The Limiteds receive proceeds from the refinancing and do not incur a current tax liability. Finally, the original 40 year note is not extended.

Howard Cohen states that "If your desire is to pull out cash from the deal as quickly as possible, then a refinancing is the preferred route." An owner will need to


26
get HUD approval of any additional debt and incentives will also be needed from HUD to support the new debt.

Boston Financial points out that refinancing under Title VI includes more restrictive equity take out loan amounts and highly regulated appraisal guidelines. This means that only 70% of the equity can be accessed through a take out loan; the value is based on an appraisal of the property as rental apartments only. The use restrictions must also be extended for an additional 50 years. Under Title II, 90% of the equity can be accessed and there are no restrictions on potential future cash flows. The new lock in period would be the remaining years of the original mortgage (see earlier exhibit, "Old vs. New Law"). Therefore, refinancing under Title II is more desirable. David Smith reminds owners that equity takeout loan interest is generally deductible only by the individual, not the entity. This has specific implications for limited partnerships.

In a refinancing, the remaining 30% of preservation equity that is not taken out will have an annual yield of 8% under Title VI. This so called "preservation yield" under Title II is not a fixed rate, but rather, is based on the remaining income stream after debt service. Therefore, explains David Smith of Recapitalization Advisors, it is possible to take a smaller equity loan and receive a larger

21 Interview: David Smith, Recapitalization Advisors, Boston, Ma, June 18, 1992
dividend over time. But because of the low yield rate (8%), it makes better financial sense to pull out as much equity as possible. Owners do not seem to be considering this option.

As Recapitalization Advisors has explained to owners of expiring use properties, "Stripped to its essentials, the basic trade is to take out 70% of value, tax free (refinance), or take out 100% of value, taxable (sale). Since capital gains rates are currently 28%, 100% taxable is equivalent to 72% tax free or better. Individual tax situations may alter this scenario. It is important to survey the General and Limited Partners at the outset, because the sale or refinance is a huge capital event which will impact the tax returns of the participants for at least ten years"²². Because many of these deals were tax driven, the tax situation continues to complicate the ultimate decision of the owner.

Similarly to Boston Financial, Recapitalization Advisors believes that the only truly viable option, given current regulations, is to refinance, preferably under Title II guidelines. Smith notes that refinancing can occur six to twelve months sooner than a sale. An owner is incapable of quantifying whether or not a sale will actually go through. The time delay involved with a non profit buyer is made even more difficult by not knowing if the tenant or

²² Smith, "Selling...", p 5.
community group will be able to obtain financing and complete the transaction. The following chart compares selling verses refinancing under LIHPHA guidelines.
**Exhibit 1**
Selling versus Refinancing in Preservation Recapitalizations
Point-by-Point Comparison of Factors to Consider

<table>
<thead>
<tr>
<th>Note</th>
<th>Key attribute</th>
<th>Sell to a Preserving Entity</th>
<th>Refinance with the Current Owner</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Valuation method</td>
<td>Highest and best use</td>
<td>Highest rental</td>
</tr>
<tr>
<td>2.</td>
<td>Equity takeout</td>
<td>95%</td>
<td>70%</td>
</tr>
<tr>
<td></td>
<td>loan-to-equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td>Preservation Yield Rate</td>
<td>Reinvest at market</td>
<td>Fixed at 8.0%</td>
</tr>
<tr>
<td>4.</td>
<td>Taxation of recap proceeds</td>
<td>Taxable as passive income</td>
<td>Tax-free but future deductibility complicated</td>
</tr>
<tr>
<td>5.</td>
<td>Lock-in tax from capital account</td>
<td>Triggered on sale</td>
<td>Deferred indefinitely</td>
</tr>
<tr>
<td>6.</td>
<td>Transaction costs</td>
<td>Buyer’s costs may be financed out</td>
<td>Seller pays its own</td>
</tr>
<tr>
<td>7.</td>
<td>Property management</td>
<td>Continuation may not be a condition of sale</td>
<td>Owner's option</td>
</tr>
</tbody>
</table>

Source: David A. Smith, Recapitalization Advisors, Boston, MA
Each of the next three chapters will describe a case study of an expiring use property. The first case deals with an owner who wants to get out of the subsidized housing business. The second case deals with a limited partnership that has decided to refinance. The third case is also a limited partnership, but one which decided to sell to a community group.

It is of critical importance to see how theory is translated to real world decision making. By examining the reasons why owners choose one of the three basic options, it is possible to see the actual impact of current regulations on the decision making process. It will also be possible to see how owners juggle the different roles - property manager, general partner, local developer - and how these roles also influence the choice to hold sell or refinance the property.
CHAPTER TWO
CASTLE SQUARE: A TRIANGULATED SALE

INTRODUCTION

The sale of the Castle Square housing project involved an owner whose primary motivation in selling was to get out of the subsidized housing business. This contrasts sharply with one of the buyers, a private management company with experience in low income housing, that wanted to get involved. Ultimately, the seller, the private management company and the residents perceived the tenant buyer group as the ones who came out ahead. The tenants organization hailed the sale as a long awaited victory for the project residents.

This deal does not come anywhere near the ideal of owner, tenant and government discussed in the introduction. Nor does the transaction fit neatly into an analysis of the three options: hold, sell or refinance the property. Ideally, the owner will seek the alternative that generates the best return, tenants will preserve housing and the government will minimize costs. But with Castle Square, the owner wanted out, the residents wanted retribution and the government (local and federal) stalled the process.

It should not be too surprising that the tenants ultimately were able to negotiate numerous concessions.

LeBlanc, Steven. "Looking Forward To A Done Deal." South End News, June 25-July 1, 1992, Vol 13, No. 21, p.1
The owner of Castle Square focused on selling the project as the way to get out of the subsidized housing business. Therefore, the tone of the negotiations was to do anything to get the deal through. The tenants were empowered with more leverage through the support of municipal and social organizations.

The seller viewed himself as a victim, subjected to the demands of tenants, federal and local agencies. Among the major issues which frustrated the seller were the five years of time involved, the owner's political impotence and radical tenant advocates who encouraged the tenants to make progressively more demands.

On the other hand, the principal of a private management company, experienced with subsidized housing, perceived he could get through the regulatory process and acquire the property in order to resyndicate. Ultimately, he was impressed by the savvy of the tenants, who used him to the fullest, taking advantage of his management expertise, credit reputation and personal finances. Educationally, the buyer would do the transaction again. Financially, he would not get involved. If the sale process backfired like this all the time, there would be no private capital willing to commit to subsidized housing. Then the question becomes: Was Castle Square really a "victory for tenants"?
BACKGROUND

Located at the neighborhood borders of Chinatown and the South End, the Castle Square housing project consists of 500 apartment units, first floor commercial space, an A&P grocery store and a 400 car parking garage. The development's owner, the Druker Company, constructed the property in the mid 1960's and managed the on-going property operations. Castle Square had been financed through the Section 221(d)3 program and was subject to rent restrictions in exchange for a low interest mortgage.

In 1987, Druker began the process of selling the property to a limited partnership controlled by Winn Development Company. The original sale price was set at $21 million. However, the signed deal stipulated that the parking garage and food store remain in the name of Druker. Because of this issue, everything about the sale would eventually change - the sale price, the purchasers and the time involved to actually complete the transaction.

After hearing about the impending sale, Castle Square tenants, concerned about possible rent increases or eviction, became involved. Eventually the Castle Square Tenants Organization (CSTO) became partners with Winn and a syndication as the third partner. CSTO identified a number of issues which had to be resolved before they would agree to the proposed sale: long term affordability, funding for an eventual tenant buyback of Castle Square, the tenant
management role, an acceptable rehabilitation plan and operating budget, a source of technical assistance funds, the disposition of the parking garage, the continuation of the A&P food store, and the financial contribution of the seller to CSTO's preservation effort.24

Negotiations involving the parking garage were further muddled by legal questions. The owner had been leasing the parking to Tufts University. Druker wanted to retain the garage for future redevelopment. But the tenants, who for ten years had not been aware of their rights to use the garage, suddenly had this resource to use as leverage in the negotiations. After years of impasse, where neither the tenants nor Druker would relinquish claims to the parking, the tenants finally gained control of 150 parking spaces, in exchange for Druker's right to future redevelopment of the garage.

According to O'Donnell, the delays resulted in the sale becoming entwined in the prepayment regulatory process. The sale was further affected by the timing of reported HUD scandals, which brought to a virtual standstill the processing of Castle Square. In May 1990, a Project Agreement was executed among CSTO, Winn and Druker, and the Boston Redevelopment Authority (BRA) voted the approvals which were needed to resolve the zoning and land use issues

under its jurisdiction.25

The limited partnership that was created, Trebbershaw consists of Winn and CSTO as general partners and a syndication, using Low Income Housing Tax Credits, as the limited partner. Winn's general partnership ownership will be phased out over the next 5 to 10 years, but the management contract will continue for 15 years. The syndication will be paid off after 15 years, and CSTO will become the sole owner of the development.

By the time the sale occurred in June 1992, the list of participants looked something like this:

<table>
<thead>
<tr>
<th>DEVELOPMENT TEAM</th>
<th>Castle Square Tenants Organization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tenant Partner:</td>
<td>Deborah Backus, Juandamarie Brown, Co-CEOs</td>
</tr>
<tr>
<td>Developer Partner:</td>
<td>Winn Development Company Arthur Winn, President J. Ralph Cole, Hollingsworth B. Wiedemann, Principals</td>
</tr>
<tr>
<td>Tenant Consultants:</td>
<td>Chia-Ming Sze, Architect; CEDAC (Vincent F. O'Donnell), Financial and Regulatory Analysis; CTAC (William Traynor and Lizbeth Hyer, organizational development); Boston Affordable Housing Coalition (Michael Kane), Development Strategy); and Hezekiah Pratt and Associates, Architect</td>
</tr>
<tr>
<td>Attorneys</td>
<td>Greater Boston Legal Services, Jay Rose (CSTO); Brown, Rudnick Freed &amp; Gesmer, Daniel Sullivan, Jeffrey Sacks &amp; Josephine McNell (CSTO); Mintz, Levin, Cohn, Ferris, Glovsky &amp; Popeo, Howard Cohen &amp; Kathleen Sheehan (Winn)</td>
</tr>
<tr>
<td>Rehabilitation:</td>
<td>LEA Associates and Haven Associates, Architects &amp; Engineers; Wolf Construction</td>
</tr>
<tr>
<td>Financing:</td>
<td>Massachusetts Housing Finance Agency, with FNMA Credit Enhancement</td>
</tr>
<tr>
<td>Property Management:</td>
<td>Winn Management Company</td>
</tr>
</tbody>
</table>

25 Achtenberg, p. CSQ 2
DEAL STRUCTURE

In addition to the $17 million acquisition cost of Castle Square, federal and state financing of $16.5 million will be used to update apartments and the exterior. Total funding sources, including equity contributions by Winn and the future limited partners, is in excess of $52 million. During the five years of negotiations, four separate government agencies had to okay the sale, including HUD, the BRA, EOCD, and MHFA.26 According to Vincent O'Donnell27, Director of Development for Massachusetts Community Economic Development Assistance Corporation (CEDAC), the tenant's organization will pay Druker over $17 million for the property. Approximately $1.2 million of the sale proceeds will be kept in reserve for operating expenses. Financing includes:

- $25.3 million mortgage from MHFA
- $5.4 million rehabilitation (flexible subsidy) loan from HUD
- $5.4 million existing 221(d)3 mortgage
- $2 million energy related loan from EOCD
- $2 million BRA site loan (infrastructure improvements)
- $8.3 million from the third partner

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26 Leblanc, p.1
27 Leblanc, p. 4
Tenants and Winn will be co-general partners for 5 to 7 years. Winn will continue as the management company for the next 15 years, gradually relinquishing control to the tenant group. An important aspect of this deal which has not yet been fully resolved is the unidentified third limited partner. Winn intends to syndicate the 15 year deal using Low Income Housing Tax Credits. But O'Donnell points out that the equity interest is being marketed at a time when it is difficult to interest investors in troubled inner city projects. As a result, guarantees to the limited partners, buyout provisions and equity payment schedules continue to be negotiated.

Winn does not think that the syndication should be particularly difficult. Because Winn is committed to managing the property for the 15 years that the syndication exists, risk will be minimized. The limited partners will not be making money FROM the deal, but rather will be looking for a tax shelter. Therefore, according to Winn, the real risk to the limiteds is possible foreclosure, which would create a taxable event for the limiteds. Because he has never missed a mortgage payment on other projects, Winn argues that the limiteds should feel comfortable with the deal.

CSTO has a purchase money fund to ensure the viability of a tenant buy back of the limited partners' interests,

28 Interview: Vincent O’Donnell, Director of Development, CEDAC, July 10, 1992
29 Interview: Arthur Winn, Winn Management Company, July 13, 1992
after the tax credit benefits have been exhausted in approximately fifteen years\textsuperscript{30}. HUD's subsidy layering guidelines limit the tenant fund to 10\% of the gross syndication proceeds, roughly $830,000.\textsuperscript{31} A subsidy layering analysis must be done to insure that there is not an excess of subsidized funds in conjunction with tax credits. Because it is difficult to forecast future finance terms and expense trends, Winn ended up setting aside an additional $1.5 million from the net syndication proceeds. These additional funds will be invested so that the amount will grow over time in order to cover the anticipated $5.8 million cost of the investor buyout.

**OWNER OPTIONS**

Although the owner had three basic options available to him, the primary focus was on selling. An owner's representative states that the company did explore possible alternatives, such as holding the property as is or refinancing. But the owners, along with the other players, knew that the true motivation was to sell and get out.

It is also important to remember that the initial decision to sell preceded the regulatory environment of ELIHPA and LIHPHRA. Although the available incentives did not cause the owner to rationally select the best available

\textsuperscript{30} O'Donnell, Vincent, "Case Study: Castle Square, Boston, MA", CEDAC, July 7, 1992, p 4, Revised.

\textsuperscript{31} O'Donnell, p 5.
alternative, the restrictions probably reinforced the decision to get out. By looking at the transaction through the lens of the owner (wanting to get out) and through the lens of the buyer (the management company wanting to get in), it will be possible to see what could have been done differently to make the sale as beneficial to the owners as it was to the tenants.

**SELLER PERSPECTIVE**

The Druker Company had decided to sell Castle Square because subsidized housing was not their area of expertise and they "wanted to get out", according to a company representative.\(^{32}\) His description of the five year process: horrendous, confusing, annoying, mystifying, interminable delays. The spokesman was particularly embittered by the length of time involved to sell the project. He cited two primary reasons. The first reason was the Boston Redevelopment Authority (BRA), which did not fairly "weigh both sides". The second reason was radical tenant advocates "who would have been happy if no deal had been done - they were not serving the interests of the tenants". Endless delays and negotiations, as well as the leverage of the tenants through the BRA by with holding the necessary approvals, meant that the seller was forced to give even more concessions before it finally ended.

\(^{32}\) Interview: The Druker Company, July 7, 1992
The Druker Company views itself as a victim, having been caught in the midst of regulatory instability - ELIHPA and HUD's subsidy overlay review process which added substantially more time to the whole process. The seller's motivation was more personal than financial - get out of subsidized housing. Yet the process became very politicized. The Druker respects the tenants for looking out for their own best interest, but is angry at aggressive individuals who seemed to have antagonism as their primary agenda. In retrospect, the Druker Company believes that the seller should be allowed greater control over the process, and the process should be streamlined for speed and simplicity.

While everybody involved in the sale may share responsibility for the delays and confrontations over the past five years, it is helpful to look at what Druker might have done differently to avoid a cumbersome and time consuming process. (1) If the tenants had been more involved from the start, antagonism might have been diminished. (2) Druker could have tried to improve maintenance of the property, causing the tenants to be less adversarial, and possibly resulting in a higher sale price for the property. (3) Increased negotiating leverage might have been obtained by deciding to leave the property as it is, or refinancing, which would have greatly diminished the
influence of the tenants. These alternatives are discussed in more detail:

1. The Druker spokesman acknowledges that the seller did not initially believe there would be a problem with the tenants - there was no formal tenant organization. The seller underestimated the degree to which the original discussions would activate outside tenant advocates. The result of this oversight was an organized response to the proposed sale by the residents. According to the Druker representative, as negotiations progressed, it seemed that tenant demands escalated over time. The seller kept giving more and more concessions. When the sale finally did occur, the tenants insisted that Druker make a financial contribution to the sale, "a form of retribution for years of mismanagement," according to Vincent O'Donnell. The tenants even insisted that Ron Druker personally sign the check.

The owner's apathy toward the tenants contrasts with Winn. He told the tenants, without being patronizing, that he would maintain the affordability of the apartments, insist on making a profit and manage the building well.

2. An increase in the value of the property could have been possible with more conscientious property management. Winn has no doubt that Druker could have been an excellent property manager. However, Druker was simply not committed to subsidized housing; he was "not in the business".
Therefore, it was very easy to portray the developer of the elite Heritage on the Common as the bad guy and the villain. But Ron Druker didn't get any credit for keeping the rents low. In terms of value, the tenants at Castle Square got what they paid for: rents roughly half of what they should have been, and a property that reflected those rents. "Ron did a wonderful job of delivering a level of product comparable to the rents". The Druker spokesman also points out that if the seller were to invest time and money into improving the property, it would have meant hiring outside experts familiar with requesting additional subsidies. The owner thought that by selling the property to Winn, a recognized expert in subsidized housing, the need for outside consultants could have been avoided.

3. Druker, not wishing to deal with the tenants, and focusing strictly on getting out of subsidized housing, apparently had the impression that he had minimal control over the sale process. But if he had threatened to stop the sale and leave the project as is, the tenants may have become more anxious to get rid of him and thus would have insisted on fewer concessions in order to get the deal finished. If Druker had threatened to refinance and hire Winn as the full time management company, the tenants would not now be co-owners of the property. Instead, the seller threatened to proceed under Title VI, which being a more regulated process is hardly a threat.
Perhaps the lesson is that when an owner becomes locked into a single mind set, the inflexibility eliminates creative solutions or alternatives. The seller was so strongly motivated to get rid of the property, he actually ended up paying the price for it.

Because the history of the sale spans a time interval beginning before the first federal preservation law (ELIHPA) and continuing after the permanent law was passed, the seller's mentality might also have been influenced by an unstable regulatory environment which only encouraged the owner to want to get out when he could.

THE BUYER

The anticipated syndication of the Castle Square deal is particularly interesting because it was the prime reason for Winn's interest in acquiring the property. The buyer anticipated collecting substantial syndication fees. Management contracts were a secondary consideration. Yet because of the way the deal evolved over time and the actual amount of cash which Winn had to put into the deal, "If all goes according to plan, I will be making 65 cents an hour. It was a sickening realization. Vince O'Donnell calculated that my internal rate of return was even lower than the limiteds! Of course, that is if all goes well and I can actually pull out my syndication fee".
Winn stated that from a business perspective, he would not repeat the process of trying to purchase Castle Square: there was no economic justification. However, he stated philosophically that from a 'life experience' standpoint he would do it again. Winn has great respect for professionals at CEDAC and Legal Services who have made a life choice of social commitment; he considers them friends today. Winn also has tremendous admiration for the tenants, who rapidly became quite sophisticated. "They knew all we knew simply by asking". Winn is an experienced professional, yet here were a group of tenants, able to "use him to get everything they wanted". This included Winn's management expertise, syndication credibility, and personal financial commitment.

Winn differs from Druker largely in the way he deals with tenants. While Druker did not consult with the residents, Winn was straightforward with them from the beginning. He told them:

I want to make as much money as possible and I want to do an excellent job of managing this property. Tenants can accept and understand that. Once they understood my need for profitability, they actually became advocates for me against HUD upon discovering that my syndication fee was being reduced to 30% of what it was originally.

As a new (partial) owner of Castle Square, Winn's management technique is unlike Druker. The new part owner will make sure the project is managed well and the tenants are happy because he believes that a well managed
development is the key to a financially successful project. It is not because Winn believes that he can do a better job than Druker, rather it is because he wants to do a better job. Winn points out that Druker is very successful in developing high end residential and commercial projects. But after inheriting the troubled Castle Square property, Druker made a business decision that he would not invest the time in turning around this project; rather, he would focus on his area of expertise.

Although the new owner has learned a lot over the past five years, Winn argues he could have built four hotels in the time it took for the Castle Square transaction. In particular, Winn's confrontations with HUD made the deal "an economic absurdity". Winn feels that HUD was more concerned about his fee than any other aspect of the deal. Winn is particularly critical of subsidy layering. HUD not only questioned the adequacy of the proposed owner's contribution to match Flexible Subsidy funds, but also questioned the income and rent limits which will apply to the Section 8 Loan Management subsidies and various mortgage documentation issues.

However, it also appears that HUD was concerned with the question of whether CSTO is truly an independent partner in the project, and whether the distribution of financial benefits between CSTO, Winn and Druker justifies treating
the proposed sale as a form of tenant ownership. The tenants finally convinced HUD.

Castle Square is an example of a subsidized housing transaction that severely derailed. The motivation of the owner was probably too clear, and not readily open to revision. The tenants became sophisticated very quickly and were able to manipulate not only the seller, but to take advantage of the partial buyer as well. While these internal conflicts were going on between owner and tenants, external impacts of increased government regulation added more conflict. Rather than directing the owners motivation to sell with incentives, government restrictions added another layer of regulation (i.e. dispute over Winn's syndication fee). Druker's perception of himself as victim merely encouraged the backfiring of the process. The next two cases will show that a more methodical approach by owners to the expiring use prepayment issue can result in a less frazzled process.

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33 O'Donnell, p 3.
INTRODUCTION

After looking at the options available to them, the partners of the syndication which owns this subsidized housing project have decided to refinance. How the owners made this decision is helpful in understanding what motivates an owner to refinance instead of sell. The methodology used in arriving at the decision to "stay in" was made easier by the fact that there is substantial equity in the project beyond the HUD mortgage and secondary notes. A general partner, the Beacon Company, has dealt confidently with government agencies in the past and feels that they can continue to do so in the future.

The re-syndication of the property in the early 1980's which added another level of complexity to the refinancing process. Because all of the ownership interests agree that refinancing is the best alternative available, it was necessary for the investors, general partners and noteholders to compromise in order to make the deal work. Beacon, as general partner and property manager, found
itself acting as the middle man between tenants and the government, and between the limited partners and second note holders. The refinance Plan of Action is still in process, with information currently being disseminated to the tenants. Because Beacon has maintained a good relationship with the tenants in the past, and are not converting the units to conventional housing, they do not anticipate insurmountable opposition from residents concerned about rent increases.

BACKGROUND

These two contiguous housing projects, containing a total of 967 apartments, were constructed in 1970 - 1971 for low and moderate income households. Financed under the rental housing program authorized by Section 221 (d)(3) of the National Housing Act, the owners had the right to prepay the mortgage after 20 years (Georgetowne I on May 1, 1990 and Georgetowne II on December 10, 1991), thus ending any use and occupancy restrictions. However, during the 1980's, changes in tax laws, ownership and federal prepayment restrictions created a new, more complex set of relationships between the investors and general partners, and between the government and the limited partnership.

In 1983, acquisition of the properties occurred through the resyndication of an existing limited partnership. The new ownership vehicle, Beacon Georgetowne Limited
Partnership, was formed to "own the beneficial interests in, and to operate... Georgetowne I and II". The Beacon Company, General Partner of the original limited partnership, was also the GP of the new limited partnership. Boston Financial Group (BFG) became a Special Limited Partner, and a new group of investors became the Limited Partners. Although the new limiteds contributed a substantial amount of new investment dollars, this infusion of capital did not completely pay off the original partnership. Therefore a second mortgage was created with principal and accrued interest payable at the end of the term. The original General Partner and the original Limited Partners became independent Note Holders. These 15 year notes would be due at the end of 1998.

This tax driven deal was structured primarily to restart the property depreciation schedule, which allowed the investors to use the losses as a tax shelter to offset other income. However, changes in the tax laws in 1986 eliminated many of the tax advantages. The losses associated with the notes became less valuable due to deductibility restrictions. Tax law changes now meant that the return on the investment would have to be based on positive cash flow from the property. Although the resyndication had been created to take advantage of negative

cash flows, due to excessive leverage it was virtually impossible to generate enough income to meet the debt service. Therefore, sale of the property was one possible option. But even if the owners had wanted to sell without restrictions, it would have been virtually impossible: in 1987, ELIHPA put a temporary hold on mortgage prepayments. With the enactment of the LIHPRHA, the property owners examined the alternatives and proceeded with refinancing the project.

DEAL STRUCTURE

Based upon renegotiations with the General Partners, both the limiteds and the noteholders will share proportionately in the net proceeds available for distribution. Of the $24,000,000, a total of $18 million would be paid to the noteholders, and $6 million would be paid to the limited partners. The latter payment will deliver $60,000 per investment unit, which represents 60% of the initial capital contribution. The payment to the noteholders represents a discount from the original obligation. Noteholders will receive $0.70 on the dollar and will be paid off, according to Beacon.

Because the limiteds shared in tax advantages before and after the tax law changes, the total return for them would be different from the noteholders. The Limiteds will

Levanthal, p 4.
get back 60% of the original contribution but still remain in the deal. If the investment continued as originally structured, any remaining investment capital would be consumed by interest on the second mortgage. Therefore, it is beneficial for the limiteds to agree to the proposal.

As part of the deal being offered to the limiteds, there is a 10% "leeway deduction". This means that investor consent to the refinancing is based on achieving a minimum level of net refinancing proceeds - within 10% of the amounts projected in the memorandum. If HUD accepts without modification the appraiser's conclusions, the equity loan could be a larger amount, based primarily on prevailing mortgage rates. BFG gives an example where a rate of 9.5% would yield net proceeds of more than $30 million, of which the Limited Partners would receive 30%, or $9 million.

Because Georgetowne I and II does have significant preservation value, there is obviously an incentive for those involved to take a discounted proportion rather than ending up with nothing. The total value of the two properties is $58.8 million, with an estimated equity loan of at least $28 million which will be insured by HUD under the Section 241(f) program. After lump sum capital improvements, costs and fees, $24,000,000 will be available to distribute to the noteholders and investors.

If the primary motivation for owners investing in subsidized housing has been yield, then according to BFG,
the limiteds have done well, even with the Tax Reform Act of 1986. Every dollar invested has produced in excess of $2.38 in tax deductions. Without the proposed refinancing, the Partnership would continue to produce passive losses over the next several years, averaging $8,000 to $10,000 annually, until 1998 when the purchase money notes are due. With the proposed refinancing, an investor would be returned $60,000 from the original contribution. The total return on investment is not that different from what was projected at the time of original syndication, according to Peter Richardson at Boston Financial.

OPTIONS: Hold, Sell or Refinance

In consultation with BFG, the General Partners felt that the best alternative was to refinance under Title II which allowed the fastest processing and the least regulatory procedure. They arrived at this decision by examining and then eliminating the alternatives. Both the General Partner and Boston Financial compiled a list of the five options which they saw available to the partnership:

- Refinance under Title II (ELIHPA)
- Sell to a nonprofit under Title II
- Refinance under Title VI (LIHPRHA)
- Sell to a nonprofit under Title VI
- Do nothing and wait

Levanthal, p 10

53
Sale of the property did not seem practical: Beacon's perception was that there existed very few non-profits capable of completing a purchase of a project as large as Georgetowne. They also cited the lengthy time frame which would be involved, especially under Title VI. Meanwhile interest would continue to mount on the second notes, making a delay more expensive. Exit taxes upon sale were a further disincentive.

Waiting was also an unlikely option for reasons cited by BFG: Minimal economic growth was projected for the New England region, modest appreciation in real estate values would not create an advantage to cover accrued interest and the deal to discount the second notes was more advantageous today than it would be in the future. The risks of waiting would be greater than the rewards. The GP also noted that adverse conditions could result as the government begins feeling the costs of the Preservation Acts in the federal budget.\textsuperscript{37} BFG and the Beacon Company point out specific flaws in the strategy of doing nothing and waiting:

1. \textit{Available funding through the federal government may disappear or become even more restrictive.}

Owners are becoming increasingly conservative regarding their expectation of federal funding for subsidized housing. Beacon Company cites the federal deficit as one reason why additional funding will not be available in the foreseeable

\textsuperscript{37} Levanthal, p 6.
future. Therefore the prevailing mentality is, "Take what you can get when you can get it". Reflected in this attitude is an aversion to the uncertainty of dealing with the government. The Feds changed the rules on prepayment therefore they might change the rules again.

2. The second note holders are willing to negotiate now, but will be less likely to do so in the future.

The investment rationale of "more is better sooner" prevails. Therefore the note holders are currently willing to take less than the face value of the notes which includes not only principal repayment but also interest due. The current deal discounts the second notes to a present value based on a 6 year holding period. Waiting would result in a shorter holding period and a lesser discount to present value.

3. The limiteds have been reminded that if the balloon payment to the second note holders is not paid when due in 1998, foreclosure will mean an even bigger loss to the limiteds than in the current situation. Equally as important, the General Partner has pointed out to the noteholders that if they wait until 1998, there is no guaranty that there will be "funds available to make payments in full, or even partial payment... since the notes are non-recourse, you cannot seek payment from any other source".

Levanthal, p 6.
Both a sale and a refinance would accelerate payment on the second notes. However, the estimated preservation equity in the project meant that the Limited Partners would receive little or no return of their original investment. Therefore it would be prudent for the noteholders to take a discount and share the proceeds with the limiteds in order for them to go along with the decision. Likewise, it would be logical for the limiteds to agree to refinance now; in all likelihood it is a better deal than what the limiteds will end up with in the future.

The General Partner and Special Limited Partner advocate refinancing under Title II. A refinance under Title VI would mean a slower, more highly regulated process. The attitude of the partners is to act now; the downside risks associated with the market, i.e. minimal appreciation in real estate values, fluctuating interest rates and availability of federal financing, are far greater than any upside potential. This runs parallel to BFG's attitude toward government programs in general: take advantage of federal programs when they first become available, otherwise they become progressively less desirable.

The General Partners, Limited Partners and Noteholders all agree with this advice. The partnership is following the proposed Plan of Action, which is to refinance under Title II. At this writing, information is being disseminated to the tenants of Georgetowne Houses. Meetings
are also planned. William Stetson, Senior Vice President of Beacon Management Company, does not anticipate any strong opposition because tenant relations have been good in the past, the partnership is not changing the status of the project and is not eliminating affordable units.

Under the Plan of Action, the partnership is also seeking additional HUD subsidies in return for extending the low income use restrictions on the property. By implementing Section 8 subsidies, unit rents for very low income households will be increased to levels comparable with conventional market rents. The higher rents will generate increased revenues, which should also boost the net operating income, and in effect, the value of the property.

OWNER MOTIVATIONS

Beacon has generally not regretted becoming involved in subsidized housing. When asked if they would do it again (become involved with expiring use properties), William Stetson stated "Definitely yes". However, the only time that the company questioned its involvement was during the years that ELIHPA was in force. The prepayment process was at a standstill and Beacon had little idea of what would happen in the future. This aversion to uncertainty was combined with a sense of a loss of control. "There were a lot of odd things going on - the government was broke, no new housing was being built, and the government couldn't pay
for the existing housing". ELIHPA was the only time that Beacon was unsure if they wanted to be involved - there were too many unanswered questions about the process, and no realistic option for the company to get out.

Beacon, although uncertain of how the government would eventually deal with ELIHPA, felt that they still had a secure negotiating position. There was no new affordable housing being built, therefore the government had to be willing to work with the owners of expiring use properties to maintain the stock of affordable apartments. During the mid 1980's, because of the real estate market boom, there was a stronger incentive for owners to fight for their rights. With the enactment of permanent regulations under LIHPRHA, owners like Beacon felt that a degree of certainty had been restored.

Stetson believes that tenant advocates realized they were "losing the battle" regarding expiring use, and that the landlords would inevitably get incentives to stay in. Time was the major factor which tenants were able to institute into Title VI in an effort to intimidate owners from changing the status of the properties. Sale or refinance are now more bureaucracy intensive, but at least owners know what the process will be an element of uncertainty has been eliminated.

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Beacon viewed itself as the middle man between a variety of groups. Not only did they have to deal with Limited Partners and Noteholders on the one hand, Beacon had to deal with the federal government (HUD) and tenant groups on the other. Beacon felt a responsibility to achieve the best alternative for each of these groups. The various ownership roles of developer, property manager, etc. will be explored further.

Maintaining the project as affordable was important politically, because Beacon has such a prominent role in local development. Beacon placed a priority on an excellent reputation; therefore the company would never want to be seen as the bad guy evicting tenants in order to convert housing to market rate condominiums. Stetson pointed out that had such a situation occurred, the development of Rowes Wharf would have been a political impossibility.

It is conceivable that while it might not have been in the best interest of Beacon to convert, it might have been desirable from the Limited Partners viewpoint to proceed with a conversion. This hypothetical conflict between the GP and the LP's was never more than imaginary, because market conditions did not justify converting the units.

Conversion of Georgetowne to market rate units was not only politically incomprehensible, it was unrealistic from a practical viewpoint as well. Beacon realized during the late 1980's that if all the expiring use properties in
Massachusetts were converted to market rate, then roughly 30,000 units, primarily in the Boston area, would flood the market. The company felt that there was no way this supply could be absorbed - besides the fact that there would be 30,000 households out on the street. Therefore, even before ELIHPA, Beacon intuitively did not see any financial justification for paying to remove all the existing tenants and pay for the costs to convert Georgetowne Houses, and then have the project sit vacant.

Another aspect of this particular deal which could have affected the decision making process was debt forgiveness which had tax consequences for both the note holders and the limited partners. Because the purchase money notes would be retired at a discount, the IRS may consider this a taxable event. Discounting would require forgiveness of a portion of the principal and the accrued, but unpaid interest. Some of this purchase money debt reduction would generate passive income to the Limited Partners. Tax impacts will be different depending on whether principal or interest is forgiven. In brief, principal forgiveness favors the note holders while interest forgiveness favors the Limited Partners. The partnership resolved this issue by agreeing that any debt forgiveness would be split proportionally between principal and interest.

Although the tax law changes were not in the control of Beacon, the company nonetheless felt a fiduciary
responsibility to seek the best financial alternative for investors and noteholders. While company reputation is part of the reason, there were also the benefits to the General Partners, 41% owned by Beacon. But there is no reason why the motivations have to be mutually exclusive: the limiteds and noteholders agree with BFG and Beacon (unanimous support by the noteholders and majority support by the limited partners) about the proposed refinancing. Certainly everyone is looking out for their best interest, but if no agreement can be reached, then an unsatisfactory solution will result. Because there is significant preservation equity in Georgetowne Houses, those involved in the resyndication are willing to work together to maximize their profit.
CHAPTER FOUR
LAKEVIEW TOWERS: SALE TEAMWORK

INTRODUCTION

One of the most interesting aspects of this case study, which is a sale of a property from a private syndication to a non-profit buyer, is that the transaction has been proceeding relatively smoothly. The seller pointed out that the sale participants are a well qualified, cohesive team whose different objectives were complementary. The seller would like to maintain the management contract. The buyer needs the expertise of a large scale management firm. HUD would like to encourage sales of expiring use properties to non-profits. Sale of the property was the primary goal of all participants: the Plan of Action submitted by the seller was, in his words, "extremely pro-tenant, therefore HUD had to go along with the sale".

Because Lakeview Towers was the only subsidized property owned by the seller, they were entangled in ELIHPA and LIHPHA without even knowing it. After finding out they could not convert the property to market rate as originally planned, they began to survey the available options. The initial reaction was to refinance, as many other property owners were doing. But because the owners were willing to keep their options open, they were willing to listen when several buyers approached. The sellers discovered selling
made a lot of sense in their particular case. Everything about the process of selling meshed, and although it was time consuming, the final deal is perceived as a "win-win" situation for seller, buyer and tenants. Although the property has not yet sold, the actual sale date has been set. What made this transaction analogous to a typical market rate transaction, rather than a subsidized sale, was that there were two potential buyers (one was far superior to the other). Furthermore, the seller maintained a certain level of negotiating leverage by letting the prospective buyers know that the owners were also seriously considering refinancing.

BACKGROUND

Lakeview Towers is located across a major boulevard from Lake Michigan. The development, financed under the Section 221(d)3 program, consists of 500 housing units in two high rise towers, 7,460 square feet of commercial space and a 380 car parking garage. Section 221(d)3 encouraged the production of low and moderate income housing during the 1960's by offering low interest loans to developers. In exchange, developers agreed to certain rent, income and dividend restrictions. The loans had 40 year terms, but could be prepaid after 20 years at which time all of the use restrictions would end.\textsuperscript{40} The prepayment date for Lakeview Towers would have been January 13, 1991.
Aware of these circumstances, the Krupp Company, in 1984, purchased the property from the original developer. According to David Olney, Senior Vice President, Property Acquisitions and Sales, the motive was... "purely economic. In 1991, we planned to take advantage of the upside in the property and convert it to market rate units". The Krupp Companies are involved in property asset management, mortgage financing real estate syndications. Lakeview Towers was the company's only purchase of a federally subsidized property.

Because the acquisition of the Chicago property was relatively large, the purchase was split between two limited partnerships, Krupp 4 and Krupp 5. Both of these limited partnerships were intended to exist for 7 to 10 years and expire around the same time as the conversion date of Lakeview Towers. Each syndication was investing a total of $50 million in a portfolio of market rate properties focusing on garden and high rise apartments in Chicago, Texas and Baltimore. The geographic diversification was an attempt to minimize risk and stabilize performance. Because of changes in market conditions during the mid 1980's, the cash flow from the Chicago properties (both the subsidized

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41 Interview: David Olney, SVP, Asset Management, Krupp Company, July 13, 1992
Lakeview Towers and the market rate Park Place apartments ended up offsetting losses in Texas.

In 1990, Krupp began to scrutinize the best possible strategy to pursue regarding the syndications. At this time, the owners of Lakeview thought the property could still be converted to market rate. When ELIHPA was enacted in 1988, Krupp was not even aware of the act. Because Lakeview Towers was their only federally subsidized project, the company had not been keeping abreast of changes in prepayment restrictions. In 1990, when the owners finally did discover Title II restricted their ability to go to market rate, they enlisted the legal aid of Howard Cohen, Kathleen Flynn and Kathleen Sheehan at Mintz, Levin et al. Krupp wanted attorneys experienced with expiring use properties to tell them what their possible options were.

But first, why did Krupp decide to focus on Lakeview Towers and not some other properties in the portfolio? Generally, the company likes to hold onto properties long term. The Baltimore properties were performing well, however market conditions in the area did not warrant a sale and the lack of capital available in the financial markets meant that refinancing objectives could not be met. The Texas properties, suffering from deflated values, would have meant a significant loss if sold now.
Therefore, Krupp focused on selling or refinancing the Chicago properties, which had significant equity. Besides Lakeview Towers, they owned Park Place Towers, a 950 unit market rate high rise. Because Park Place required substantial rehabilitation, there was insufficient equity in the property. Furthermore, if there was to be a sale of any property, the company preferred to sell subsidized Lakeview Towers and keep the market rate Park Place in the portfolio. The owners concluded that Lakeview seemed to offer the only real opportunity to generate cash for the syndication.

**OWNER OPTIONS**

Initially, sale did not seem plausible to Krupp because the property could no longer be converted to market rate housing. To put it mildly, the owners were outraged, but in talking to other owners, realized that they were locked in. Therefore, the initial decision to refinance the property was made. Krupp, through contacts in the Chicago market, was aware that HUD was primarily interested in selling to non-profits, nonetheless, they believed the best alternative for the syndication was to proceed with a request to refinance.

In a memorandum to the Krupp Company, legal counsel presented five options from which the owners could choose. The following is a synopsis of the memorandum addressed to the owners: 

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A. Prepay the loan and terminate all the use restrictions.

This is no longer realistically possible because of the conditions which would have to be met. You [Krupp] would have to prove that prepayment would not materially affect:

-- the supply of decent housing for lower and very low income persons in the area.

-- the ability of lower and very low income persons to find affordable housing near employment opportunities.

-- the housing opportunities of minorities.

In addition to federal law, Illinois state law must also be considered; there are already two restrictive laws in this area. Precedent indicates that the state would also not allow removal of the (d)(3) restrictions.

B. Do nothing.

It does not appear that future opportunities will be superior to what exists now. Doing nothing provides no additional benefit to the owner.

C. Sell the development.

Federal law does not restrict you from selling to a willing buyer. The difficulty here is finding a buyer who will pay the price you want. You and a prospective buyer are unlikely to agree on an acceptable price unless incentives under Title II are part of the package. Thus participation in a plan of action is necessary. Issues regarding sale include:

42 Cohen, p 3.
-- Do you want to sell?
-- What are the needs of the fund?
-- If you sell, can you retain the management contract?
-- Tax consequences of a sale must be considered.

Assuming some taxes must be paid upon sale, you will be better off keeping the project and refinancing unless there is a way to get additional incentives if you sell. If you decide you want to sell, you will need to delve into the numbers more deeply.

Illinois law gives tenants a right of first refusal to buy the development from you ... but the law is unclear if tenants have to match the sale price. You will have to analyze the statute in more detail.

D. Refinance the development.

If the desire is to get cash from the deal as quickly as possible, then a refinance is the preferred route. HUD approval on additional debt as well as incentives which will be necessary to support that additional debt will require a plan of action.

E. Attempt to increase cash flow over time.

If the desire is to increase cash flow for future years and not pull out appreciated equity immediately, then you will not want to do an immediate refinancing. Plan of action will still be required.

At the time of this memorandum (May 1990) LIHPRHA (Title VI) had not yet been formally enacted. Therefore,
legal counsel advised the owners of possible incentives which HUD might be willing to provide under ELIHPA:

**TITLE II PROCESSING:**

Incentives which HUD will provide include:

-- 30% income cap on rent increases for current tenants
-- Limits on rent increases for new tenants
-- Low interest capital improvement loans
-- FHA mortgage insurance for equity take out loans
-- Increased access to reserve accounts
-- Increased dividend distributions
-- Other incentives (e.g. low income housing tax credits)

**OWNER MOTIVATIONS**

Based upon the information from the attorneys, Krupp decided that refinancing was the best available alternative. The owners looked at the options through various lenses: owner as taxpayer, property manager, local developer. Krupp also analyzed the strength of the prospective buyer and the perception of local and federal government.

The owners began the refinance process by obtaining an appraisal on the property. David Olney stated that refinancing under Title II was advised by Cohen because Title VI would surely be a more highly regulated process.

At about the same time, a group known as the Affordable Housing and Preservation Fund contacted Krupp about selling
the project to them. Based in Colorado, this fund eventually turned out to be a less than arms length non-profit. Apparently, their primary purpose was to generate fee income by issuing bonds. They were not concerned about sale prices (higher prices meant larger fees), nor were they concerned about managing the properties after the sale. There seemed to be a limitless upside to the deal. Krupp eventually stopped negotiating with them for at least two reasons: (1) AHPF was already having trouble with another HUD deal and (2) Tenants were likely to fight a takeover by AHPF which would mean further delays and a high risk of the sale not being consummated.

But AHPF had pointed out several things which caused Krupp to seriously start thinking about a sale instead of a refinance:
-- the syndication had accumulated substantial passive losses which could be used to offset capital gains. Because exit taxes would be minimal, the owners could realize a greater profit from sale than refinance.
-- If AHPF purchased the property, they would want Krupp to continue managing the property.
Therefore, not only would a sale mean an additional $3 to $4 million more than a refinance would generate, but the owners would also be able to keep the management contract for at least three years.
In a recent interview, Kathleen Sheehan pointed out that there were several reasons for Krupp to consider any potential buyer. First, it might be the financially better alternative and second, it was politically important. Because Krupp owns another (market rate) apartment complex in Chicago, Park Place, the owners needed to "keep a good image" with the city and HUD (which had also financed the market rate property). Even if Krupp ultimately ended up refinancing, it was important to let the government know the owners had not ignored potential buyers. Otherwise HUD, which advocated non-profit ownership, might make the refinance effort more difficult. Attorney Cohen's primary concern with a sale was the potential tax liability. But Krupp pointed out that any (or most) tax on the capital gain from a sale would be offset by accumulated passive tax losses on the property.

During the time of negotiations with AHPF, tenant advocates also approached Krupp about selling the property. Voice of the People (VOP) was a small management and housing rehabilitation group which Olney describes as "capable, knowledgeable and with surprising political pull: On an earlier project, VOP had problems with HUD, and actually were able to get U.S. Secretary Jack Kemp to personally deal with solving the problem during a visit to Chicago.

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According to Olney, VOP had numerous reasons why it wanted to become involved in Lakeview Towers:

1. Maintain the affordability of the project.
2. Tenant advocacy which encouraged resident support.
3. Within 7 to 10 years turn the project over to the tenants.
4. VOP would become a high profile player(?)
5. Income boost to VOP: 5% construction and management fee would be about $350,000.

Olney was particularly impressed by the president of VOP, whom he saw as a great team builder and mediator. Olney was never concerned about the ability of VOP to follow through with a sale, but there was always the concern about the amount of time involved in the process. The owners realized that in addition to political muscle, VOP had the tenants on their side.

Attorney Sheehan also felt confident about the capabilities of VOP. Besides talking to other Chicago based attorneys about VOP's reputation, the attorney was impressed by the high quality of consultants which VOP hired to handle the community group's side of the transaction and negotiations.

It surprised the advocacy group that they had to earn the confidence of the tenants. Perhaps VOP relationship with ONE, a militant tenant group, concerned the residents. There was concern that they would become involved in legal and political battles while the property was left
unattended. Olney points out that tenants were generally happy with the apartments, especially the good views, convenience to downtown and good security. Therefore they were distrustful of advocates disrupting their lives. But eventually the tenants were fully supportive of VOP. Krupp realized that it was illogical to continue negotiations with the other potential buyer, AHPF. The tenants and HUD would never support what looked more and more like a business fronting as a non-profit. Therefore Krupp ceased negotiations with AHPF and focused their energy on working with VOP.

VOP, as a potential buyer, clearly had negotiating leverage which appealed to Krupp. VOP welcomed a 3 year management commitment from Krupp to gain expertise. As a prospective buyer, VOP was willing to go to whatever price was necessary to purchase the property. This tenant advocate group even had bond financing available to them for the purchase. VOP had convinced the city of the excellent public relations that would come from helping to preserve affordable housing in Chicago. What better opportunity than to provide bond financing for a high profile property like Lakeview Towers? Krupp had been concerned at first that this added layer of bureaucracy would make the process even slower, but the city actually moved quickly. But as it turns out, it was HUD that slowed the process.
The proposed sale was producing an excellent team of players:
-- The prospective buyer, VOP, was experienced, well connected politically and financially, and had the support of the tenants and the city.
-- The seller, although inexperienced with subsidized properties, was willing to negotiate, and was also well connected (having done business with legal counsel on both sides of the deal). The seller also had the support of the tenants.
-- Government, especially local, strongly supported non-profit purchasers. When Krupp finally submitted a Plan of Action after signing a purchase and sale agreement, May 10, 1991, the owners believed that HUD would also support such a 'pro-tenant' plan of action.

Krupp's attorneys found this deal went comparatively smoothly. The owner's second appraisal of $22.5 million was consistent with HUD's appraisal of $21 million, the primary difference being attributed to rehabilitation costs. The buyer's request for a $7 million flexible subsidy loan was also approved. Nonetheless, the transaction is scheduled to close at the end of August, at which time Olney can breathe a sigh of relief - 15 months after the contract had been signed.

Attorney Sheehan points out that the deal was unique "because it (the deal) was very much driven by the seller,
especially David Olney. He is well organized, analytical and very committed to a quick turnover. In fact, Olney had orchestrated much of the processing by generating a weekly list of things that needed to be done. All of the participants in the transaction were sent weekly memos by David so that everyone knew exactly what had to be done next and by whom.

In choosing to sell, Krupp was able to address the motivations of the owner in the various roles of taxpayer, developer, and property manager:
1. Accrued passive tax losses would be used to offset passive gains from the sale. The limited partners would experience minimal cash impact, assuming they had not used passive losses from this project previously. Most of the proceeds will be reinvested in the syndications.
2. Cash would now be available for renovations on Park Place and to upgrade the Texas properties.
3. Krupp was promised the management contract, which will be a 70/30 split (Krupp/VOP) for the next 3 years. Tenants were concerned that Krupp would leave, but regulations would not allow the agreement to be written into the contract.

The owner also was strongly motivated to sell because of Krupp's perceptions of the two other players in the deal, government and tenants:
1. Krupp now realizes that HUD definitely leans toward non-profit ownership. This probably helped speed the
processing of the transaction. Likewise, the city supported the sale, and therefore was willing to process the bond financing quickly.

2. Tenants, acting through VOP, proved to be very capable buyers. They not only followed through on completing the transaction, but the tenants actually were able to help speed up the processing.
CHAPTER FIVE

ANALYSIS AND CONCLUSIONS

Introduction: The Multiple Roles of Owners

The primary motivation for private sector investment in affordable housing has been to make a profit. The Krupp Company readily acknowledges that the reason they became involved in Lakeview Towers was purely economic. Many of the limited partnerships that were created, like Georgetowne, invested in subsidized housing to take advantage of tax deductible losses. With the Tax Reform Act of 1986, most of these losses were no longer deductible. Federal restrictions on prepayment through ELIHPA and later, LIHPHRA, imposed further limitations on the potential to generate an acceptable (to the owners and investors) rate of return. Therefore, the opportunity to reclaim as much of their original investment as possible, either through sale or refinance, became paramount to private owners and investors in expiring use properties.

But the process by which that maximization could occur was often unclear and often shifting. If the world could be reduced to a simple model, there would be three players and three solutions. The participants would be: an owner, a
tenant and the government. The three options would be: hold the property, sell or refinance it.

OWNER TENANT

GOVERNMENT

BASIC TRIPARTITE RELATIONSHIP

TAXPAYER GENERAL PARTNER SAVVY?

OWNER

PROPERTY MANAGER

PERSONALITY TYPE

DEVELOPER

TENANTS

ADVERSARY?

SUPPORTIVE?

GOVERNMENT

UNCERTAINTY REGULATIONS

BUREAUCRATIC

EXAMPLES OF COMPLEXITIES OF OWNER DECISION MAKING
A simple, rational rule of thumb says that the owner should take the option that offers the most opportunity for profit. But such a rule fails to consider the multiplicity of issues involved in "maximum profit", i.e. the two other players (tenant & government) and their motivations. For example, the owner may be unsure of the capabilities of a non-profit buyer to be able to complete the purchase, or the owner might be concerned that there will be insufficient funding from the federal government. The rule also fails to account for a complex set of players representing owner interests. The owner is often not an individual, but rather, a general partner with limited partners who may have differing tax liability, and conflicting goals. The GP may want to refinance in order to maintain the management contract, or because they want to maintain a positive image in the local development community. For the limiteds, on the other hand, it may be more beneficial to sell. Ultimately calculating what is the best choice for the owner is a function of a set of complex, often personal and political decisions. The option which an owner ultimately chooses must then be seen as extending beyond the profit maximization decision.

There is not "the owner"; instead there is the owner as property manager, as local developer, personal decision maker, taxpayer and general partner overseeing the interests of the limited partnership. It becomes obvious that the
different roles are intertwined: the general partner is also concerned about taxes, etc. After analyzing "the owner", it is important to examine how owners perceive the tenants and the government, the two other players involved with expiring use properties. The following discussion explores the various owner roles and how they often compete. It becomes necessary to juggle different roles at the same time.

The Owner as Taxpayer

Investors became involved in limited partnerships like Georgetowne and Krupp for the tax deductions. The general partner, acting on behalf of the investors, explored the various tax implications of selling verses refinancing. Sale of the property would create a significant tax event which might possibly be minimized using passive losses.

But the tax situation was even more complex with the decision to refinance. An owner who "stays in" will receive a taxable income stream which is really comprised of two basic elements: "phantom income" and preservation yield. Phantom income is the excess of taxable income over matching cash flow (Amortization of principle now exceeds depreciation on whatever remains of the original asset base.). Preservation yield is constant; a steadily rising income stream similar to a subordinated debenture. Without a refinance, all of this is taxable. If there is a refinancing, an ever increasing amount will be principal.
Years after the closing, tax liability may exceed cash available to pay for it. Thus the phantom income problem is exacerbated by refinancing via an equity take out loan.44

A second tax consequence of refinancing is that reserve funding will probably be increased, making the phantom income situation still worse. Deposits to reserves are nondeductible; withdrawals cannot be expensed but rather must be amortized over several years. Therefore reserves are perceived as a hidden source of income and therefore taxable.

The tax situation of the owners plays a major part in the decision to refinance or sell. Beacon Company (advised by Boston Financial), as the general Partner for Georgetowne Houses, emphasized the benefits of refinancing rather than a sale to a non profit. First, investors could minimize present tax liability by refinancing, and second, lost time would be minimized (approximately 18 months to refinance verses almost 4 years to process a sale). But the equity take out loan from a refinance may not have tax deductible interest if the proceeds are not reinvested.

Krupp, initially intending to refinance, also looked closely at the tax impacts. But they discovered that the capital gain from a sale could be offset by passive losses of the partnership. Reinvestment of sale proceeds could

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also help defer capital gains taxes. Therefore, sale made financial sense.

The tax situation of individual investors has to be examined. It is very important to realize that owner motivations are strongly related to the tax implications of selling or refinancing.

The Owner and the Limited Partner

Maximizing the return on investment becomes more complicated in situations where a property, such as Georgetowne, was re-syndicated in the early 1980's. According to Peter Richardson at BFG, new limited partnerships were formed to generate a new "pot of money and restart the depreciation clock" on these subsidized housing projects. But investors in the old partnerships were not completely bought out, and became mortgagees. The high interest notes (due to interest which would be paid at the end of fifteen years) were tax deductible losses for the investors in the new partnership. With the tax law changes of 1986, the losses associated with these notes were no longer as valuable. Any sale or refinance would trigger acceleration of these notes. Furthermore, ELIHPA effectively prevented any sale from occurring until the government could figure out what to do.

This situation created the need for negotiation. Because a refinance would mean that the GP gets his return

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45 Interview: Peter Richardson, Asset Management, Boston Financial Group, July 1, 1992
on equity, and the note holders get their return, the likelihood of remaining funds for the limited partners is remote. The limiteds are unlikely to approve a sale or refinance unless they can be assured of a reasonable return of their original investment. Therefore, those properties which have enough preservation equity to justify refinancing also need to have second note holders who are willing to renegotiate: the note holders get a smaller yield and the limiteds get a corresponding yield. Beacon perceived itself as the mediator or negotiator between the limiteds and the note holders. From the viewpoint of the General Partner, half a deal is better than no deal and actually looked like a better deal than some of the alternatives when the notes came due in 1998.

It is easy to imagine situations where re-syndication has created additional conflict in the effort to sell or refinance. For example, if there is little value to a project beyond the outstanding federal loans, then the note holders might be unwilling to take a discount on the amount owed, in the hope that there will be a future value in 1998. Or the Limited Partners may be unwilling to agree to refinance because their entire investment will be wiped out after paying back outstanding federal and second mortgages.

The situation involving re-syndications is not unique. According to Robert Johnson, a financial consultant
interested in securitizing these second notes, there are
"hundreds of millions of dollars worth of these second notes
in existence. If the maturity dates are considered, the
value would be in the billions". At the current time he
believes that the notes are virtually unsalable to buyers
outside of the partnership, therefore the notes would
require a huge discount. He also notes that there is a
diversity of opinion as to what the notes are worth. It
would depend on the value of the property and the legal
quality of the paper.

According to Boston Financial, many projects in the
southeastern U.S. have values nearly equivalent to their
outstanding federal loan balances, therefore there has been
very little negotiation among the ownership interests. But
in high demand areas like Boston, there is substantial
equity to justify the refinancing effort. This is the same
scenario that existed in the late 1980's when the GAO study
was undertaken.

The Owner as Property Manager

As if the decision to sell, refinance or hold were not
complex enough, there is the question of management
contracts. Control over potentially lucrative management
contracts has been handled in different ways by different
owners. The seller of Castle Square did not want to manage
the property. Winn Management, who will be co-general

46 Interview: Robert Johnson, Securities Analyst, June 30, 1992
partner for 5 years as part of the transitional ownership, will also oversee the management for the next 15 years. Beacon Company will retain the property management contract upon refinancing Georgetowne. The Krupp Company, although selling the project to a non-profit, will keep the management contract for at least three years.

Full service real estate companies like Boston Financial Group were concerned that there might be a conflict between the best interests of the limited partners (possible sale) and the priorities of the property management division (retain the management contract). However, this has proven not to be the case. BFG is advising clients that "staying in" through refinancing under Title II is the best option for the limited partners. Fortunately for BFG, refinancing also allows Boston Financial to keep the property management contracts as well.

David Smith of Recapitalization Advisors goes on to say that the larger the portfolio of subsidized projects, the greater the likelihood of refinancing precisely in order to retain the property management fees. Since many of these subsidized properties are held in large portfolios then it follows that most of these properties will be refinanced. BFG, in their list of available options, points out that most owners are choosing to refinance under Title II. Therefore, it is likely that retaining the management
contract reinforces the decision to refinance, rather than being the pivotal issue.

The Owner as Personal Decision Maker

There is a domain of decision within which the rationale of the owner is not quantifiable.

(1) Personal circumstances have caused the owner to simply want to get out of the deal. Perhaps they are tired of dealing with the voluminous paperwork; possibly an heir has no interest in continuing ownership. This was the case with the Druker Company and Castle Square. The owners did not want to deal with the subsidized housing market and made every effort to get out.

The motivation might have to do with the perception of the neighborhood: if it is deteriorating, get out now. An undesirable location may eliminate the owner's incentive to continue dealing with the property. The opposite could also be true. If the owner believes that the location or the real estate market is improving, then the inclination might be to wait. Yet as BFG pointed out, a dramatic recovery is unlikely in the Boston area market for at least several years.

(2) Another aspect of the expiring use issue which comes into play is the mentality of owners involved in the process of selling or refinancing their properties. This is not a judgement of whether a developer is "good" or "bad" at subsidized housing. As Arthur Winn pointed out, Ron Druker
is very good at what he does, but he does not want to do subsidized housing. Therefore, Druker was locked into a mindset of getting out of the business, and he ultimately paid the price in concessions to the tenants. Winn, on the other hand, considers himself an expert in the subsidized housing field, and tried to work with the process. Ultimately, he found Castle Square to be a learning process. He was bemused, rather than embittered, by the tenants savvy.

(3) The importance of maintaining a positive image is important to an owner who is also a local developer. There may be political or public relations issues involved: particularly if the owner is planning to develop and has a prominent presence in the community, he/she will be sensitive to any attempts to change the status of the project by selling or refinancing. If the owner is trying to develop anything else in the locale, the negative publicity will not help his cause. Beacon notes that if they had tried to convert Georgetowne at the same time as they were developing Rowes Wharf on the Boston waterfront, they would never have gotten the project through the local permitting process.

After having examined the internal complexities of the owner, the focus of the collective voices of "the owner" then turns toward the other players who are the tenants and the government.
THE OWNER AND THE TENANTS

While the owner has to deal with some or all of the preceding roles which create a complex image of "owner", it is also necessary to deal with tenants, sometimes represented by advocates. Companies like Krupp and Beacon had managed the properties well during the emergence of the expiring use prepayment issue, therefore the tenants actually wanted them to continue managing. Tenant adversity seems to come more from poorly managed properties like Castle Square.

One reason an owner might be motivated to choose refinancing over a sale is the questionable strength of the non-profit buyer. Especially if Title VI requires more than a year to allow the nonprofit to secure financing, the owner wants to be sure the year is not wasted with a group that can not complete the transaction. Ironically, the community group is also unsure of their capabilities to secure financing until they are well into the process.

Beacon found it highly improbable that a community group would be able to purchase a large project like Georgetowne, therefore the choice to refinance was further emphasized. Krupp, on the other hand, increasingly became convinced of the strength of the prospective buyer, and was more strongly motivated to sell than to refinance. Judging
the capacity of the tenants as owners then becomes a critical decision for the seller.

THE OWNER AND THE GOVERNMENT

The risk of diminished funding through HUD offsets any incentive that may exist for an owner to do nothing and wait. Developers who have been involved in the roller coaster cycle of federal programs over the past twenty years all seem to have a similar attitude toward federal programs. In the words of Beacon Company's William Stetson, "You'd better take what you can get when you can get it".\(^\text{47}\) Over time the rules change or funding runs out.

Similarly, Boston Financial believes that the time to take advantage of federal programs is when they first become available. In dealing with expiring use properties, BFG has a consistent strategy of refinancing now rather than waiting to sell or refinance in the future. "Act now, otherwise the option disappears".\(^\text{48}\)

Likewise, Recapitalization Advisors believes that the federal government does not often make innovative programs available for investment, therefore when a suitable program does come along, there is a limited "window of opportunity". Investors should be ready to act before the program ends or becomes more restrictive. Perhaps this is a self

\(^{47}\) Stetson, July 6, 1992
\(^{48}\) Richardson, July 1, 1992
fulfilling prophecy: if a program is beneficial (to investors as well as the general public), then there are a large number of investors who will commit to the program. Therefore, available funding is rapidly absorbed, and the program terminates quickly. Perhaps there is also government concern that with such tremendous interest, the feds must surely be giving something away. What ever the reasons on the part of the government, the experience of companies like BFG has been to act immediately when new federal programs become available.

A frequent complaint heard by owners has been bureaucratic standstill, especially when dealing with the federal offices of HUD. There may be apprehension on the part of owners that once a Plan of Action has been submitted, it will remain in the pipeline for years. The Krupp Company wanted to first get a sense from the government "of the path of least resistance" in an effort to choose the sale or refinance option that would cause the least bureaucratic slowdowns. The interminable delays were undoubtedly a reinforcement to the frustrated seller of Castle Square that he should definitely get out of subsidized housing. The U.S. General Accounting Office also notes this deficiency in the processing of both sales and refinances: GAO recommends that the expertise and efficiency of HUD staff be improved to deal more effectively with local markets and specific property owners.
This thesis has focused on owner characteristics and perceptions in dealing with expiring use properties under the current federally regulated environment. It becomes clear that the situation is much more complex than a simple triangular relationship among the owner, the tenant and the government.

The owners are actually a complex entity wearing different hats, sometimes simultaneously: developer, property manager, general partner in a limited partnership, taxpayer. Different owner personalities approach expiring use properties with different motivations. While these dynamic worlds of property manager, general partner, etc. are sometimes conflicting, they can also be complementary. For example, a general partner that wants to refinance also benefits by keeping the management contract.

The owner of an expiring use property is trying to chose the best option (hold, sell, refinance) which reflects the various ownership roles. However, the enactment of prepayment restrictions and the various incentives designed to keep the housing affordable adds additional complexity to the sale or refinance process. The owner is now confronted with a series of choices under Title II and Title VI.
Financial advisors point to refinancing under Title II as generally the best alternative. But the advisors will also admit that each situation is unique. An owner might have a greater motivation to sell for particular reasons which are not just financial, but are likely to include other reasons such as personal, political, etc. Therefore, the nonfinancial variables which affect the ultimate decision of the owner can be more influential than anyone would like to admit.

The importance of noneconomic motivations was also cited in the GAO report. In attempting to predict prepayments of expiring use properties, the GAO noted a significant weakness in the National Low Income Housing Preservation Commission model: the model was unable to measure the effect of noneconomic variables on owners decisions to prepay. This weakness severely limited the usefulness of the estimates about prepayment. Similarly, after the enactment of LIHPRHA, the difficulty in trying to measure the non-economic variables influencing an owner's choice to hold, sell or refinance still exists. But hopefully, this thesis creates a greater awareness of the different variables.

The expiring use issue can not be reduced to: experts = success and nonexperts = disaster. Krupp, completely unfamiliar with the prepayment process, had a relatively smooth transition in their sale to Voice of
the People. It was more than luck. It was due to a methodological analysis of the options in their broadest institutional, as well as financial sense. The analysis was followed by a determination of the best available alternative and then an analysis of the best way to get there. Along the way, a better option presented itself, and the owner was ready to take advantage of it. Krupp figured out who were the players, and kept the lines of communication open. In the end, Krupp took advantage of the best option for them, which turned out to be the best option for the other players. Everyone achieved their goal. Krupp sold (as originally planned when they acquired the property in 1984), tenants bought (housing remains affordable) and the government tried to minimize costs.

Krupp actually believed that they should have gotten a slightly higher price for the property, but ended up taking less in order to keep the deal from derailing. This is not unlike a true market transaction. It also is remarkably similar to the "ideal world" between owners, tenants and the government discussed in the introduction.

If the goal of both the government and tenants is to preserve affordable housing, and private capital is needed, then it is crucial to understand the expiring use situation through the lens of the owner. Richard J. High, employed by a private builder of subsidized housing,49 states:

49 High, Richard J. "Feds Turn Toward Non-Profits", Multi Housing News, April 93
We are motivated, of course, by profit, but also by a measure of social commitment and an interest in helping to puzzle out the difficult problem of housing the poor. There are many like us.

If there is to be a successful framework for creating affordable housing programs which involve the private sector, it is necessary to first understand where we are today. This thesis has looked at the complexities of being an owner to try and understand the reasons for the choices owners make. By looking at owners actions under current legislation, lessons can be learned about what does and does not work in preserving privately owned, but publicly subsidized, affordable housing. It will then be possible to incorporate this knowledge into the next generation of affordable housing programs.
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