

Navigating the Challenges of Troubled Loans

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In the wake of recent financial and economic upheavals, commercial loan defaults have escalated significantly, and it seems likely they will continue to do so. Loans made under the new markets tax credit (NMTC) program are not immune from this trend. Community development entities (CDEs) and their investors now are having to navigate a challenging array of issues that the NMTC program rules pose with respect to troubled loans.

This article will focus primarily on issues of a practical or structural nature. A companion article, to follow in an upcoming issue, will discuss particular tax issues that must also be addressed. The following discussions assume a situation in which a CDE has received funding through a leveraged investment structure and made a loan or loans secured primarily by a mortgage on the real estate and related assets of the qualified business (though they generally have broader application).

Restructuring vs. Foreclosure

When faced with a troubled loan, a CDE decides whether to attempt to restructure the loan or to foreclose, and in the case of foreclosure, whether to take back and hold the property or to liquidate the collateral and re-invest the proceeds. The factors that drive these decisions will generally be much the same as for any commercial loan. However, the challenges involved in taking back property and re-investing proceeds (as discussed in more detail in the copy that follows) may make restructuring a more favorable alternative than it would be outside an NMTC structure.

Yet, NMTC rules impose constraints on how a restructuring might be done. For example, a common approach is to reduce interest rates and instead apply avail-

able funds to the reduction of principal. In the case of an NMTC loan, though, principal pay-downs are limited by the "substantially all" requirement. Moreover, because of the "redemption" restrictions, paying down principal will leave money trapped at the CDE, earning little or no return for the leverage lender.

It is also common to require additional collateral in the form of cash or other liquid assets, to assure that funds are available for the borrower's future needs. But in the NMTC context, the non-qualified financial property restrictions limit how much of this kind of property the borrower can hold. Thus, while restructurings may be preferable, constraints such as these can make them more difficult to accomplish.

Taking Title to Collateral

Where the decision is made to foreclose, the foreclosure process itself should be much the same as for any commercial loan (though the procedures for making decisions within the CDE can make the process cumbersome). The more significant challenges arise from what happens after the foreclosure.

In most foreclosure situations, the lender ends up taking title to the collateral. As a practical matter, foreclosure sales rarely produce buyers who are willing to make cash bids that would be attractive to the lender. Furthermore, lenders often prefer to take back the property and spend time and money repositioning it for an orderly sale, to increase their recoveries.

However, CDEs are required to keep substantially all of their qualified equity investments (QEIs) invested in qualified low-income community investments (QLICIs),

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i.e., loans to or equity investments in qualified active low-income community businesses (QALICBs). Direct ownership of property by a CDE is not a QLICI. Thus, if a CDE itself takes title to the property, it would no longer have its QEIs invested in QLICIs, and consequently the 12-month re-investment period would begin running immediately, even though the CDE doesn't yet have cash to re-invest.

If the CDE instead sets up a separate entity that holds title to the property, and provided that entity meets the requirements for being a QALICB, the CDE would simply have an equity QLICI instead of a loan QLICI, and the 12-month re-investment period would not begin running until the property is actually liquidated and the CDE has the cash to re-invest. Because the CDE can generally control the timing of the disposition and can seek out re-investments at the same time that it seeks to dispose of the property, this minimizes the re-investment risk.

The ownership entity should be formed as a separate entity for tax purposes. This would usually be a partnership (or LLC) in which the CDE holds 99 percent

or more of the equity (with at least one other partner or member holding the remainder), although using a corporate entity could be more beneficial in some cases. If a third party (such as a servicing agent) holds title as agent for the CDE, the agent's ownership may be disregarded for tax purposes, so that the CDE itself would be treated as owning the property. If the ownership entity is a single-member LLC, it would also be disregarded for tax purposes (with the same result). While it is tempting to try to use the "portion of the business" rules to enable a CDE to hold title directly or in a single-member LLC, this seems to stretch those rules beyond their intended purpose.

Of course, the CDE's equity interest in the title-holding entity will mean that the CDE will be "related to" the entity for purposes of the CDE's allocation agreement and will "control" that entity for purposes of the NMTC regulations. However, in each case there is an allowance for the CDE to become related to or to "control" the QALICB "due to financial difficulties of the business that were unforeseen at the time the allocatee made a QLICI in the

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business.” [Allocation Agreement, Section 3.2(d); Treas. Reg. §1.45D-1(d)(6)(ii)(C).] This seems directed precisely at the situation described above.

Under the regulations, this exception applies only for a period of 12 months. Still, the consequence of holding the property beyond 12 months is that the CDE needs to ensure that the QALICB it controls meets the qualification requirements throughout the period when it has control – something that should not be difficult under the circumstances.

Having acquired the property, the CDE as a property owner must make decisions that are quite different than those involved in administering a loan. These can include matters such as investing additional capital, engaging management and leasing agents, negotiating and approving leases, and implementing the process for disposing of the property.

Typically, the leverage lender, the tax credit equity investor and the allocatee will all have some stake and some input in these decisions. However, rarely do the documents governing the transaction address these sorts of issues in any detail, requiring the parties to work out such matters as they go along. When faced with the prospect of holding a property for any significant length of time, the parties would be well advised to develop ground rules for administration and decision-making early in the process.

Re-investment of QLICI Proceeds

Once the CDE receives cash proceeds from its original loans, the CDE must re-invest those proceeds within 12 months. The first question is, how much does the CDE actually need to re-invest? This is not as simple as it may seem.

A loan that goes into default will likely have a substantial amount of unpaid interest. The CDE may also have expended significant amounts on legal fees and other enforcement costs, generally out of additional funds provided by investor advances to the CDE. Furthermore, during any period in which the CDE holds the property prior to sale, it may have received additional investor advances for the property.

When the CDE finally does receive cash, how does one determine how much of that cash is attributable to repaying advances, covering expenses and paying accrued interest, as opposed to return of principal? The regulatory language on re-investments is anything but clear (and a thorough analysis of the issues involved is beyond the scope of this article).

But there can be a lot at stake in this determination. Clearly, the CDE must meet the 85 percent substantially all threshold to avoid recapture. Beyond that, under CDFI Fund guidance, once a CDE has received repayments that cause it to fall below the substantially all threshold, it must again meet the higher investment threshold required under its allocation agreement – typically not less than 95 percent and sometimes as high as 100 percent.

At the same time, however, the leverage lender may want to recover as much cash as it can as soon as it can, particularly if it has had to advance additional funds, and for reasons discussed in the following copy, it may feel that the less money that has to be re-invested, the better. Thus, calculating the amount that can be paid out by the CDE and how much be re-invested is both an important and potentially contentious matter.

Once the parties have made this determination, there are at least two serious constraints on the ability to actually find and make qualifying re-investments. Generally, CDE’s are required under their allocation agreements to make QLICIs on “flexible, non-conventional, or non-conforming terms” that must meet one or more specific criteria, and to make most or all of their investments in areas of special distress.

In most cases in which a QLICI loan has been foreclosed, all or nearly all of the NMTC equity will have been lost, as probably will a significant part of the leverage loan capital. Thus, if the CDE does comply with these requirements on a re-investment, this can subject the leverage lender to further loss exposure by forcing it to take on the lower returns and higher risks that were originally covered by the tax credit equity.

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We believe the CDFI Fund needs to afford CDEs some relief from such requirements on re-investments. Where a CDE has lost all or most of the value of the tax credits on its initial QLICs, it is simply not realistic to expect CDEs to make loans or investments on terms that were committed to on the basis of the tax credit subsidy, when that subsidy no longer exists.

The other practical problem with re-investments is that because they are still subject to NMTC program requirements, the CDE must impose on the new borrower all of the same compliance representations and covenants, reporting requirements, recapture indemnity obligations and (usually) restrictions on prepayments that will have been imposed for the initial investment. But with little or no tax credit subsidy available, what incentive is there for a borrower to accept such burdens? It will be no easy task to

“sell” a financing product that presents all these complexities with little or no corresponding benefit.

The above discussion illustrates that at each stage of the process of dealing with troubled loans, NMTC program requirements present unique and sometimes subtle issues that can make what is already a difficult situation even more challenging. It is therefore important for the parties involved to recognize and anticipate the impacts of these issues as they decide on their strategies and objectives throughout the enforcement process. ❖

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