Tax-Exempt Bond Financing for Middle-Income Housing

Justin Cooper

orrick

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CHAPTER 1

Introduction

As housing costs have risen in the first part of the 21st century, American households have struggled to compete for high-quality housing near areas of employment in major cities, suburbs, exurbs and rural areas (especially resort towns). Many individuals and families in these areas do not earn enough to afford market-rate housing but earn too much to qualify for traditional "low-income housing" support, such as the federal housing choice voucher program (Section 8) and Low-Income Housing Tax Credit program. Housing advocates, developers, policymakers and others have responded by looking for new ways to support the housing needs of this "missing middle" population.

This booklet introduces the ways tax-exempt bonds and other governmental financing can help produce rent- and income-restricted middle-income or "workforce" housing.

Orrick is the nation's premier public finance firm, consistently ranked number one (in terms of dollar volume of bonds issued) over the past two decades, with extensive experience in all types of multifamily housing financings. Orrick has served as bond counsel, underwriter's counsel or other counsel on thousands of financings and refinancings of multifamily housing projects since the late 1990s, including, beginning in 2020, pioneering workforce housing transactions in multiple states.

CHAPTER 2

Beyond LIHTC: Tax-Exempt Bonds for Middle-Income Housing

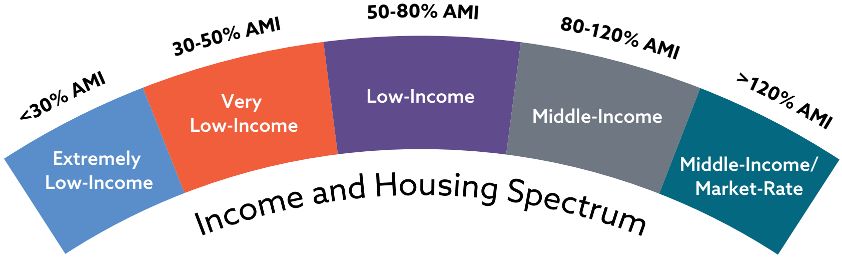
The federal Low-Income Housing Tax Credit (LIHTC) program, provided for in Section 42 of the Internal Revenue Code, is arguably the most successful affordable housing program in the United States. Since the program's inception in 1987, LIHTC tax equity — on its own or with federally tax-exempt bonds called "exempt facility bonds"[1] — has generated more than three million units of housing set aside for households earning 60% or less of area median income (AMI). *For more information on financing low-income housing with exempt facility bonds, see Orrick's "Multifamily Rental Housing: Financing with Tax-Exempt Bonds."*

While the LIHTC program has been extraordinarily successful, it has limits. LIHTC financing offers little for the missing middle who earn too much to qualify for subsidized low-income housing but cannot afford market rents or homeownership. Traditional mortgage underwriting standards embedded in the LIHTC market also limit flexibility in financial structuring. From the developer perspective, the market is mature, crowded and increasingly competitive as states exhaust allocations for tax credits and exempt facility bonds.[2]

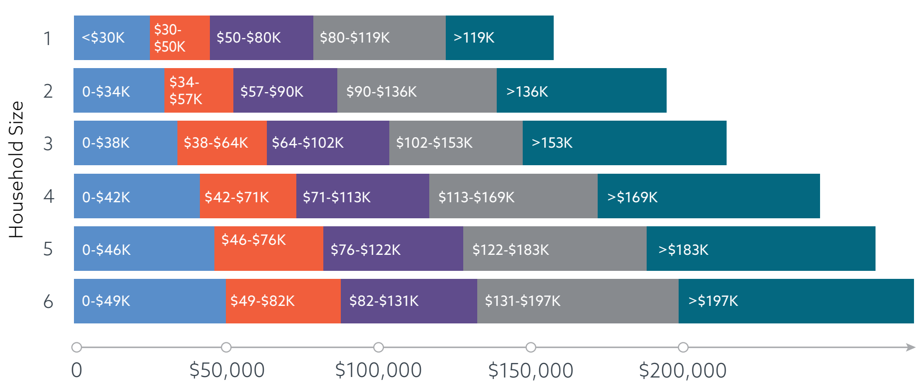
1 These are often referred to in the multifamily affordable housing context as "private activity bonds" although that term encompasses other types of bonds in addition to exempt facility bonds (e.g., single-family mortgage revenue bonds and 501(c)(3) bonds).

2 Sections 42 and 146 of the Internal Revenue Code provide annual limits on the amount of tax credit equity and private activity bond "volume cap," respectively, awarded to each state based on the state's population.

INCOME BANDS FOR LOW-INCOME AND MIDDLE-INCOME CLASSIFICATIONS



ELIGIBLE INCOME LEVELS BY HOUSEHOLD SIZE



Source: nyc.gov/housingconnect; 2023 AMI levels (rounded)

Where LIHTC financing may fall short, other forms of municipal bond financing can support middle-income rental housing, combining the benefits of:

- Tax-exempt interest rates,
- Favorable underwriting terms, and
- Property tax abatement or exemption.

Tax-Exempt Rates. A major benefit of tax-exempt bond financing is that tax-exempt interest rates are typically lower than conventional borrowing rates. Because investors do not have to pay federal or state income tax on interest income, they require less interest to generate the same after-tax return, which lowers overall interest cost to the issuer/borrower.

VALUE OF TAX EXEMPTION

Ratings	30-Year Tax-Exempt Muni Bonds	30-Year Taxable Muni Bonds
AAA	3.7%	5.4%
AA	4.1%	5.4%
A	4.5%	5.5%
BBB	5.5%	6.5%
Unrated	6.5%	7.75%

Source: Bloomberg; December 2023

The interest tax-exemption benefit is particularly valuable in middle-income housing financings, as compared to low-income transactions, because deal sizes are relatively large and the amount of long-term tax-exempt debt is high as a percentage of total project funding. Middle-income housing transactions are also typically executed as public bond offerings and not in the form of private placements or bank loans. Retail and institutional bond investors derive more value from tax-free interest than commercial banks that typically buy bonds in private placements, further reducing borrowing costs.[3]

[3] Since the Great Recession, most bonds for low-income housing have been placed directly with commercial banks and other mortgage lenders (e.g., Freddie Mac). Private placements have remained popular with low-income housing borrowers in spite of tax inefficiency because loan sizes are small, costs of issuance are relatively low, execution is easy and predictable, drawdown funding is available, and absolute interest rates were historically low throughout the 2010 decade.

Favorable Underwriting. Most bonds issued for middle-income housing are unrated and are sold and traded in the high-yield municipal bond market. This market functions largely independently of the mortgage lending market, which typically imposes strict underwriting standards, including a maximum loan-to-value (LTV) ratio (often 80–90%), a minimum debt service coverage ratio (often 1.15-to-1 or 1.20-to-1), required, scheduled amortization, limited or no "balloon payments" or refinancing risk, completion and repayment guaranties from the developer/sponsor and loan-to-cost limits for construction debt.[4]

By contrast, in "risk on" environments, when bond investors are seeking yield and willing to take risk, it is not uncommon to see non-recourse project financings in the high-yield bond market featuring:

- 100% debt financing,
- Lower projected debt service coverage (as low as 1.10-to-1),
- Long-term (30+ years) fixed rate, callable debt,
- Sequential pay or "turbo" amortization as opposed to fixed/scheduled principal payments,
- "Balloon" payments or planned refinancings, to the extent permitted by tax law
- Relatively light guaranties, and
- Acceptance of construction risk as part of long-term debt financing (i.e., no separate construction loan).

Public and private sector actors have executed middle-income housing transactions in the high-yield bond market with terms that could not be achieved in the conventional multifamily mortgage or LIHTC markets.

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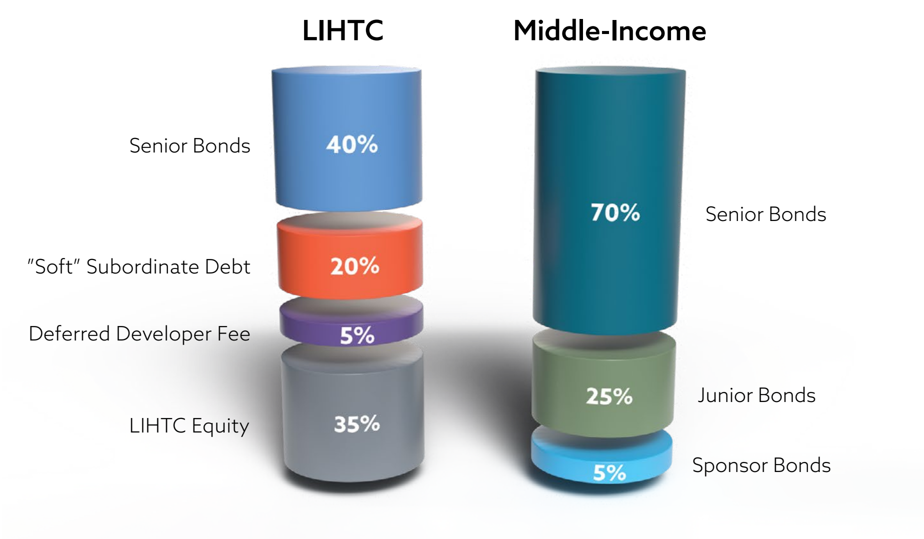
4 Similar requirements apply to financings with investment-grade rated municipal bonds unless investors are provided with recourse to a highly rated guarantor or obligor (e.g., a pooled financing undertaken by a state housing finance agency with an investment-grade issuer credit rating or indenture rating).

SAMPLE CAPITAL STACK



Nothing is free, however, and this flexibility comes at a cost. In a public bond offering, issuers/borrowers take pricing risk — interest rates and risk tolerances can move dramatically in a short time based on outside factors — and investors who provide favorable terms and aggressive underwriting take increased default risk.

Property Tax Exemption. Property tax is a major expense for most multifamily rental housing facilities. Because taxes are paid ahead of debt service, every dollar of property tax owed represents a dollar reduction of net operating income (NOI) available to pay debt service. Likewise, any reduction or elimination of the obligation to pay property tax increases NOI and project feasibility. Many jurisdictions provide property tax exemptions and abatements that can help finance middle-income housing. While tax-exempt bonds do not convey a real property tax exemption, the forms of ownership required for tax-exempt financing of middle-income housing (ownership of all bond-financed facilities by a 501(c)(3) organization or a governmental unit) frequently result in exemption of a bond-financed project from real property taxation. The substantive and procedural requirements for obtaining a property tax abatement or exemption vary, but common elements include:

- Income set asides (sometimes up to 80% AMI or higher),
- Maximum annual rents,

- Governmental or nonprofit ownership,
- Some component of governmental funding (bonds, loans, grants), and
- Favorable purchase rights granted to nonprofits or other entities with affordable housing missions.

Governmental ownership typically results in a clearer and more complete exemption from property tax than statutory abatement programs based on nonprofit ownership. This can be important in choosing between governmental bonds and 501(c)(3) bonds. *See "Bond Types" chart on page 9 to structure middle-income financing.*

In addition, obtaining a property tax abatement or exemption is often a matter of both law and administrative practice, with some experience and effort required in local government relations, especially for facilities already on the tax roll.

CHAPTER 3

Types of Tax-Exempt Bonds

Three kinds of tax-exempt bonds may finance middle-income housing:

- 501(c)(3) bonds,
- Governmental bonds (sometimes called "essential function" bonds), and
- Exempt-facility bonds issued under IRC Section 142(d).

Each type of bond is defined by who owns the bond-financed facilities. 501(c)(3) bonds require a 501(c)(3) nonprofit owner, and governmental bonds require a governmental owner. Only exempt-facility bonds may be used if a for-profit private entity has an ownership interest in the bond-financed facilities.

Side-by-Side Comparison. The chart on the next page compares 501(c)(3) bonds, governmental bonds and exempt-facility bonds, along with brief explanations of key terms and concepts.

501(c)(3) Bonds. In a 501(c)(3) bond transaction, a state or local governmental entity issues bonds and loans the proceeds to a nonprofit corporation that acquires or constructs facilities it will ultimately own.

To be eligible to borrow using tax-exempt bonds:

- A nonprofit corporation must have received a determination letter from the Internal Revenue Service qualifying it as an organization of the type described in Section 501(c)(3) of the Internal Revenue Code, and
- *The financing must further the 501(c)(3) borrower's charitable purpose.* Section 501(c)(3) generally contemplates nonprofit corporations organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, educational or other purposes.

501(c)(3) borrowers with different charitable purposes may be eligible to finance middle-income housing facilities. The charitable purpose most commonly seen in middle-income housing financings is "relief of the poor and distressed," which carries safe harbor requirements, provided in Revenue Procedure 96-32, that apply during a 501(c)(3) bond financing:

BOND TYPES

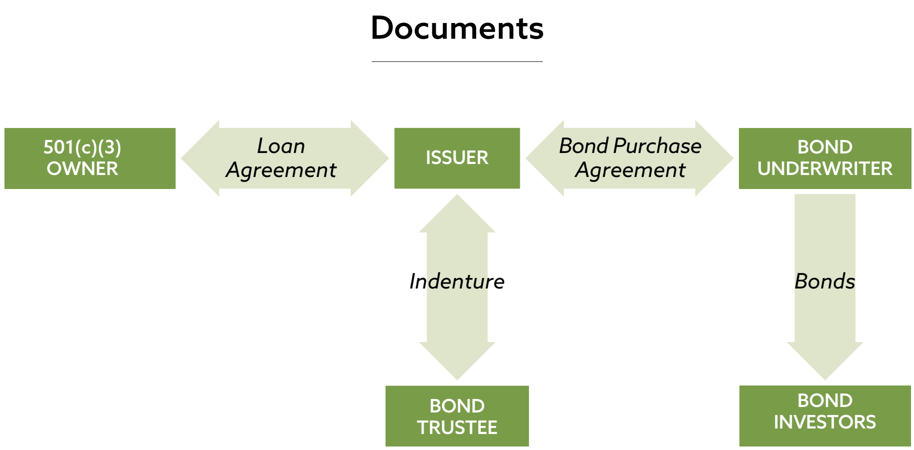
	501(c)(3)	Governmental	Exempt-Facility*	Taxable
Volume Cap Required	No	No	Yes	No
LIHTC Eligible	No	No	New Volume Cap: Yes Recycled Volume Cap**: No	No
For-Profit Ownership	No	No	Yes	Yes
Qualified Management Contracts Required	Yes	Yes	No	No
TEFRA Required	Yes	No	Yes	No
95% Good Costs	Yes***	No	Yes	No
2% Costs of Issuance Limit	Yes	No	Yes	No
"Private Use" Limitation	5%	10%	None	No
Income Set-Asides (Federal)	Acquisition: 20%@50% AMI or 40%@60% AMI New Construction: Depends on Charitable Purpose****	None/ Contractual	20%@50%AMI or 40%@60%AMI	No
Rent Restrictions (Federal)	Depends on Charitable Purpose	None/ Contractual	None (except LIHTC)	No
Issuer Jurisdiction Requirement	No	Yes	No	No
State and Local Requirements	Varied	Varied	Varied	Varied

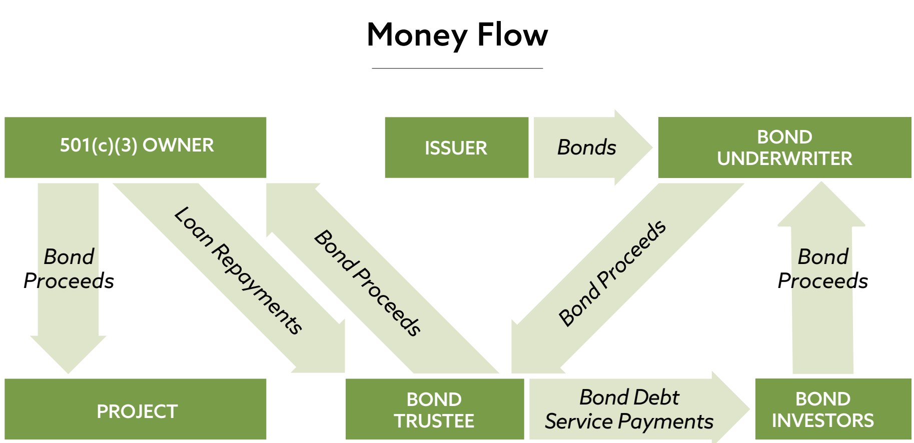
*These are often referred to (imprecisely) as "private activity bonds" or "PABs"
**Exempt facility bonds issued with recycled volume cap do not count toward the "50% Test" contained in IRC Section 42(h)
***The "95/5 Test" is applied somewhat differently for 501(c)(3) bonds than for exempt-facility bonds
****For example, a 75%@80% AMI requirement may need to be added

- At least 75% of units in the project must be occupied by households with incomes at or below 80% of AMI, and
- At least 20% of units must be occupied by households with incomes at or below 50% of AMI **or** 40% of units must be occupied by households with incomes at or below 60% of AMI.

These requirements are cumulative, meaning 25% of units may be rented without restriction.

CONDUIT FINANCING





Another charitable purpose that may be used for middle-income housing is "lessening the burdens of government." There are no tax rules requiring specific income set asides or rent limits associated with lessening the burdens of government. However, the 501(c)(3) borrower must establish a nexus with a state or local government in a way that meets the requirements for 501(c)(3) bond financing, and the state or local government may require such set asides. Owners and sponsors should consult bond and 501(c)(3) counsel before embarking on a 501(c)(3) bond financing for the purpose of lessening the burdens of government.

Bonds issued for nonprofit corporations with other charitable purposes, such as providing higher education or healthcare services, also may finance middle-income housing in some circumstances.

Additional tax requirements apply to 501(c)(3) bonds, primarily relating to (a) private business use limitations, described below, and (b) limitations on uses of proceeds similar to those found in low-income/LIHTC financings. *See "Bond Types" chart on page 9.*

Special Rule for Acquisition Financings. Regardless of the 501(c)(3) borrower's charitable purpose, for any 501(c)(3) financing to acquire multifamily rental housing facilities (as opposed to financing new construction), the "Donnelly Amendments" in Section 145(d) of the Internal Revenue Code require compliance with one of the following income set asides:[5]

- 20% at 50% of AMI, or
- 40% at 60% of AMI.

In either case, the applicable set asides must be maintained for as long as the tax-exempt bonds are outstanding or for a period of at least 15 years, whichever is longer.[6]

Governmental Bonds. State and local governmental entities can (and frequently do) use tax-exempt bonds to finance their acquisition or development of capital assets in furtherance of a governmental purpose. Common examples include a city hall, fire station or wastewater-treatment plant. Units of government can also finance multifamily rental housing with tax-exempt bonds on the same legal basis.

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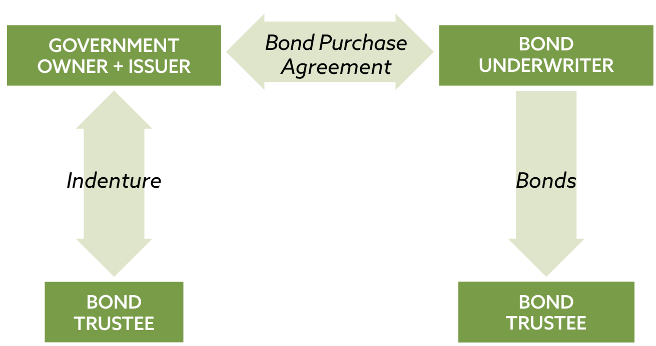
[5] Depending on the charitable purpose of the 501(c)(3) borrower, additional income set-asides may apply.

[6] There is an exception for "property that will be substantially rehabilitated within a two-year period beginning one year after the date of acquisition of such property." However, because "substantially rehabilitated" generally means incurring rehabilitation expenditures <u>at least equal to the adjusted basis of the building</u>, this exception is rarely if ever used.

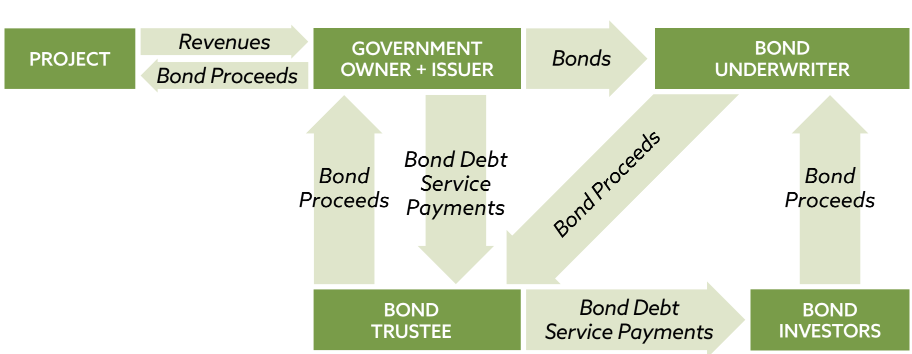
As with 501(c)(3) bonds, strict limits govern the roles for-profit entities can play in an issue of governmental tax-exempt bonds. For-profit entities may provide a variety of services and derive compensation by a variety of means, but they cannot have ownership or leasehold interest in tax-exempt bond-financed facilities. *See Chapter 4 "Qualified Management Contracts" and "Private Business Use."* An additional requirement of governmental bonds issued to finance multifamily rental housing is that the project must be in the bond issuer's "jurisdiction" — a technical term encompassing a number of legal authorities.

GOVERNMENTAL OWNERSHIP

Documents



Money Flow



Exempt-Facility Bonds. Exempt-facility bonds rarely finance middle-income housing. They are instead used either for 100% low-income projects (in combination with LIHTC) or, in limited cases, for "80/20" projects in which 20% of units are restricted for households earning 50% of AMI or less, and the remaining units are rented at market rates without income restrictions.

Exempt-facility bonds require an allocation of private activity bond volume cap as provided in Section 146 of the Internal Revenue Code. These are the bonds used in connection with the LIHTC program.[7] *For more information, see Orrick's "Multifamily Rental Housing: Financing with Tax-Exempt Bonds*."

They are also the only category of tax-exempt bonds that can be used where a private party has ownership interest in the bond-financed facilities. Middle-income housing transactions can be executed using exempt-facility bonds with 20% of units restricted at 50% AMI or less or 40% of units restricted at 60% of AMI, and some or all remaining units restricted at higher income levels, often with corresponding rent limitations.

In 2008, Congress added provisions for "recycling" private activity bond volume cap for multifamily housing. Exempt-facility bonds issued using recycled volume cap, often called "recycled bonds," can be a valuable tool in certain middle-income housing financings, particularly in states where private activity bond volume cap is scarce. Issuers and other parties should consult bond counsel regarding recycled bonds.

. . .

Governmental bonds are in many ways the most flexible tool available for tax-exempt financing of middle-income housing. 501(c)(3) bonds remain popular, however, in part because they are a common and well-understood way to finance multifamily rental housing on a non-recourse basis. Most if not all states have at least one program for "conduit" (i.e., no recourse to the bond issuer) 501(c)(3) financings for a variety of purposes, including, but not limited to, housing. Comparatively few governmental entities have shown interest in taking ownership of multifamily rental housing projects.

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[7] Although so-called "4% Tax Credits" require the use of exempt-facility bonds, exempt-facility bonds do not require use of low-income housing tax credits.

CHAPTER 4

Additional Tax Rules

TEFRA. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) requires that all private-activity bonds (a category that includes both exempt-facility bonds and 501(c)(3) bonds) be approved by an "applicable elected representative" of:

- The issuer or governmental entity on whose behalf the bonds are issued **and**
- The jurisdiction in which the bond-financed project will be located.

A governmental body giving approval must publish a TEFRA notice in a newspaper or post to its primary public website at least seven days before a hearing. It also must conduct a TEFRA hearing and give TEFRA approval before the bonds are issued.

There is no TEFRA requirement for governmental bonds.

Qualified Management Contracts. A governmental or 501(c)(3) borrower may choose not to operate all or part of a project and instead contract with a private operator or manager to do so. The tax rules governing private operators or managers are set out in Revenue Procedure 2017-13. They restrict terms of the management contract, including its length, compensation of the manager, corporate relationship between the manager and the nonprofit corporation. They also specify which entity bears the risk of loss of the project and the manager's ability to take certain positions with respect to the project on its tax returns.

Qualified management contracts are not an issue for exempt-facility bonds.

Good Costs. "Good" costs vary according to the type of bonds issued. For governmental bonds, good costs generally include capital costs that further a governmental purpose; the issuing governmental unit generally determines the governmental purpose. For qualified 501(c)(3) bonds, "good" costs generally include capital costs that further the charitable purpose of the 501(c)(3) borrower and finance property not used for activities that constitute an unrelated trade or business activity.[8] In this context, whether a cost is a good cost is determined by the IRS definition of a charitable purpose, the 501(c)(3) application of the charitable entity and, in some cases, an organization's annual Form 990 tax return.

In addition to capital costs, both governmental purpose and qualified 501(c)(3) bonds offer limited opportunities to finance working capital.

Private Business Use. Federal tax law governing tax-exempt governmental purpose and qualified 501(c)(3) debt includes a concern with private businesses being the beneficiaries of such tax-exempt financing (a.k.a. "private business use"). As a result, tax-exempt governmental bonds may not be issued if:

- 10% or more of the proceeds is used directly or indirectly in the trade or business of persons other than state or local governmental units or members of the general public on an equal basis.
- 10% or more of the debt service on the bonds is secured by funds from private users (e.g., a mortgage or rental payments for the use of bond-financed facilities). The limitation on private business use is reduced to 5% for facilities financed with proceeds of qualified 501(c)(3) bonds. Any use that constitutes unrelated trade or business use for the 501(c)(3) borrower — or for any other 501(c)(3) using the property — also is considered private business use.

"Use" includes leases of bond-financed facilities or the operation of bond-financed facilities under management or service contracts. Likewise, ownership of bond financed property can constitute private business use subject to the 10% limitations described above for facilities financed with the proceeds of governmental bonds. Qualified 501(c)(3) bonds, however, do not permit ownership of property financed with the proceeds of any entity that is not a governmental unit or a 501(c)(3).

Private business use is not an issue for exempt-facility bonds.

Costs of Issuance. For qualified 501(c)(3) bonds and exempt-facility bonds, total costs of issuance (which may include a portion of the developer fee) paid from bond proceeds may not exceed 2% of the principal amount of the bond issue. No such limitation applies to governmental bonds.

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[8] In addition, in some circumstances, a 501(c)(3) organization cannot benefit from more than $150 million of outstanding "qualified 501(c)(3) bonds" that are not "qualified hospital bonds" (95% or more of the net proceeds used for a hospital).

CHAPTER 5

The Owner Role

Governmental and 501(c)(3) bonds both require that no for-profit entity have an ownership or possessory interest in any portion of the tax-exempt bond-financed facilities or an interest that is too similar to an ownership interest. This is determined on a substantive basis — it is not merely a matter of who shows up on title as the record owner — and many types of contractual and financial arrangements can create an ownership interest or an interest that is too similar to an ownership interest. For example, any of the following arrangements or agreements between a government or 501(c)(3) on the one hand, and a for-profit private entity on the other, could be treated for tax purposes as constituting an ownership interest (or something too similar to it) by the for-profit entity:

- Leases
- Purchase options at a price less than fair market value
- Management contracts with compensation based, even in part, on net profits
- Subordinate debt that
  - is repayable only on sale **or**
  - has an uncapped "upside" return **or**
  - is highly speculative or unlikely to be repaid within a reasonable period of time
- Full payment guaranties

In other words, for governmental and 501(c)(3) bonds, the owner really has to be the owner. As a result, the owner cannot raise funds by way of equity investments or a joint venture (except with another government or 501(c)(3)). The government or 501(c)(3) may, however, put its own equity into projects in the form of a cash contribution or by contribution of surplus land or other items or incentives of value.

CHAPTER 6

The Sponsor Role

Governmental and 501(c)(3) owners of middle-income housing facilities may perform property-related functions themselves, such as acquiring, building, developing or operating the project. Alternatively, the owner may hire a developer/operator or "sponsor" to perform some or all of these roles. This sort of arrangement is particularly common in governmental ownership transactions. Engaging a sponsor can benefit both the owner, who is relieved of responsibilities and liabilities they may not be equipped to take on, and the sponsor, who receives compensation for its services.

Tax-exempt financing limits the compensation that can be paid to sponsors, particularly if they are for-profit entities. For-profit entities may provide a variety of services and derive compensation in a number of ways in a 501(c)(3) or governmental bond financing, but they cannot hold an ownership interest in any bond-financed facilities at any time. ***This is a substantive requirement that cannot be overcome by way of structuring*** (in other words, calling something a "lease" or a "note" does not prevent it from being characterized as an equity interest).

The primary allowable means of compensating a for-profit sponsor are:

- Operator/manager fees
- Cash developer fees
- "Sponsor bonds"

Fees for Operation and Management. A sponsor may be paid a commercially reasonable fee to act as an operator or manager of a middle-income housing facility. Services can include property management as well as maintaining books and records, interacting with investors, making discretionary decisions regarding repairs and improvements and other responsibilities of a higher-level "asset manager" or operator. Fees for these services are typically paid on a periodic basis in return for services rendered. Any such arrangement for compensation must meet the requirements for a Qualified Management Contract. *See Chapter 4.* The same rules apply to governmental bonds and qualified 501(c)(3) bonds.

Cash Developer Fee. A sponsor may also receive a commercially reasonable fee for development services, such as identifying a site or facility for development or purchase, obtaining development rights, arranging for financing, overseeing construction and/or rehabilitation work and taking financial risks prior to project acquisition/bond closing. Such fees are typically paid in cash at the time of the bond closing, subject to applicable limits on uses of proceeds. *See "Costs of Issuance" on page 14.*

Sponsor Bonds. Instead of receiving a cash developer fee at closing, the sponsor may be compensated partially or entirely in tax-exempt debt, typically payable on a deeply subordinated basis (after expenses, senior debt service, reserves, etc.) *See Chapter 7 "Cash Flow Waterfall."*

For example, if a sponsor performs services such as acquiring or taking control of a development site, arranging financing, performing construction, etc., and the value of those services is $5 million, the sponsor could be paid $1 million in cash at closing and receive $4 million in sponsor bonds.

A number of reasons could prompt parties to include sponsor bonds in a middle-income housing transaction:

- Unlike a cash developer fee, sponsor bonds do not require a funding source at closing.
- Interest income on sponsor bonds is tax-exempt, which makes them valuable to the sponsor.
- If the sponsor is involved in project operations, sponsor bonds provide an incentive to run the project effectively because sponsor bond debt service is paid from excess cash flow.[9]

Sponsor bonds raise two principal legal concerns:

- Total compensation to the sponsor, consisting of cash and/or sponsor bonds, cannot exceed the value of services rendered.
- Sponsor bonds must be respected as "true debt" (i.e., not subject to re-characterization as an equity interest) for tax purposes.

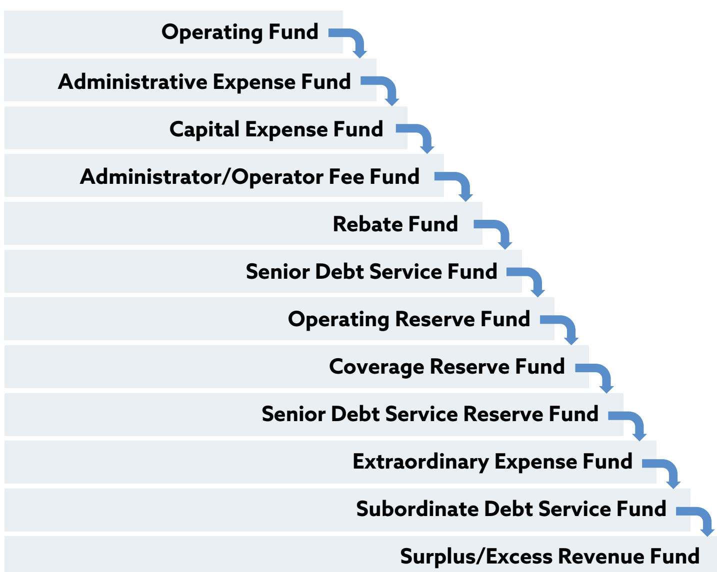
Transaction parties should consult bond counsel early in the transaction regarding the possibility of using sponsor bonds.

[9] Any tax-exempt sponsor bonds must be solely in consideration of services delivered in connection with project acquisition; they cannot be issued as a prepayment for managerial services.

CHAPTER 7

Cash Flow Waterfall

Middle-income housing financings are usually structured so gross project revenues are collected periodically — weekly collection is common — and delivered to the bond trustee. The trustee distributes them by way of a "cash flow waterfall" — so named because each fund or account (or "bucket") must be filled completely before any funds can flow into the next bucket. Below is a typical cash flow waterfall:



Operating Fund. For payment of project operating expenses such as taxes, insurance, utilities, property management and routine repairs and maintenance.

Administrative Expense Fund. For payment of bond-related expenses such as the trustee's fee and any fees of the bond issuer.

Capital Expense Fund. Equivalent to a "replacement reserve," with funds used to make capital improvements and significant repairs/replacements (e.g., a new roof or HVAC replacement).

Administrator/Operator Fee Fund. To compensate the sponsor as project operator and asset manager.

Rebate Fund. For arbitrage rebate payments to the Internal Revenue Service.

Senior Debt Service Fund. For paying interest and principal due on senior bonds.

Operating Reserve Fund. A reserve fund for operating expenses, with withdrawals made only if amounts on deposit in the Operating Fund are insufficient.

Coverage Reserve Fund. A temporary reserve fund for payment of (senior) bond debt service, with withdrawals made only if amounts on deposit in the Revenue Fund are insufficient; may be closed and funds released upon satisfaction of a certain debt service coverage threshold.

Senior Debt Service Reserve Fund. A reserve fund for payment of (senior) bond debt service; withdrawals are made only if amounts on deposit in the Revenue Fund are insufficient.

Extraordinary Expense Fund. A reserve fund for payment of extraordinary expenses (e.g., litigation), typically not pledged to secure the bonds.

Subordinate Debt Service Fund. For payment of interest and principal due on subordinate bonds purchased for cash.[10]

Surplus/Excess Revenue Fund. For payment of interest and principal on sponsor bonds and, thereafter, distribution to the owner.

Establishing the right cash flow waterfall, including adequately sized reserves, is one of the most crucial structuring elements in any middle-income housing financing. Owners and sponsors should consult with their investment banking team and counsel to put together a term sheet that sets out the waterfall and the priority of payment among different classes of bonds before commencing the time-consuming and expensive process of drafting bond documents.

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[10] Subordinate bonds may be sold to investors motivated purely by financial returns, or they may be placed with investors who have a non-monetary interest in the project's success. For example, area employers may purchase subordinate bonds at below-market yields in exchange for a preferential right to rent for employees, subject to compliance with fair housing and other applicable laws.

CHAPTER 8

Financing Documents and Third-Party Reports

There are a number of ways to structure and document a tax-exempt financing for middle-income housing. However, the following is representative of the key documents and due diligence items:

Trust Indenture. The trust indenture sets out terms of the bonds and creates a pledge of the trust estate, which typically consists of the project and all its revenues, together with certain reserves and other funds and accounts.

Loan Agreement. In a 501(c)(3) or exempt-facility bond financing, there is usually a loan agreement between the bond issuer and the borrower/owner. The issuer's loan to the borrower is pledged to the bond trustee (making it part of the trust estate) to secure repayment.

Project Administration Agreement. This is an agreement between the project owner, who may be a governmental entity or a 501(c)(3) organization, and a professional operator who will manage and oversee project operations, including making decisions on major repairs and maintaining books and records. *See Chapter 5 "The Sponsor Role."*

Property Management Agreement. The owner or operator — or both — may enter into an agreement with a professional manager who undertakes property management responsibilities such as collecting rents from tenants and overseeing routine maintenance and repairs.

Purchase and Sale Agreement. In an acquisition financing, the sponsor typically enters into a purchase and sale agreement with the seller weeks or months in advance of closing of the bond financing.

Assignment of Purchase and Sale Agreement. If the bond transaction succeeds, the sponsor assigns the purchase and sale agreement to the owner, who uses proceeds to acquire the project from the seller — the sponsor does not appear in the chain of title.

(Land Use) Regulatory Agreement and/or Declaration of Restrictive Covenants. The issuer typically executes and records a LURA or other document restricting occupancy of available units to middle-income households and limiting the rent that may be charged.

Tax Certificate and Agreement. Bond counsel relies on the Tax Certificate, together with its own due diligence, to support its opinion that interest on the bonds is exempt from gross income for federal income tax purposes.

Bond Purchase Agreement. The bond underwriter agrees to purchase bonds from the issuer. The agreement also identifies key documents required at closing.

Offering Memorandum. Considerable time and effort is required to craft a complete disclosure document that provides all information investors would want, including summaries or complete copies of third-party reports such as appraisals, and describing risk factors potential investors should consider.

Investor Letters. Middle-income projects are typically financed with unrated (i.e., below investment grade) bonds. As a result, the issuer and bond underwriter may require investors to sign a letter confirming they have sufficient sophistication and resources to evaluate the investment opportunity and provide certain releases or limitations of liability.

Continuing Disclosure Agreement. The issuer/owner agrees to disclose material events, such as unscheduled draws on reserves, after issuance of the bonds. This responsibility may be delegated to the sponsor or another party.

Appraisal. A third-party appraisal will typically be required as a matter of due diligence and for disclosure.

Property Condition Report. For acquisition financings, a property condition report provides information on required repairs and other physical needs.

Market Study. The market study describes expected demand for the rental units, including expected occupancy levels and rental rates.

Environmental Reports. One or more reports may be required to describe environmental hazards or risks that require remediation.

Construction Contract. For new construction, or projects involving substantial rehabilitation, a guaranteed maximum price contract will establish the cost of capital improvements.

CHAPTER 9

Steps to Closing

A lot of things need to happen for a middle-income housing financing to reach a successful closing. Fortunately, experienced professionals in a number of jurisdictions have created something of a playbook, including a number of common steps and elements:

Identifying the Owner

- If governmental ownership is the goal, it will generally be advisable to create a separate legal entity, such as a joint powers agency, to serve as title owner. This insulates the underlying governmental entity from potential credit issues with the project and vice versa.
- Similarly, if 501(c)(3) ownership is intended, a separate LLC or other single-asset, special purpose entity owned and controlled by the 501(c)(3) should be created.

Identifying the Issuer

In a governmental financing, it may be possible for the owner to issue the bonds itself. On the other hand, for practical reasons, it may make sense to have a separate financing authority act as issuer and loan the proceeds to the governmental owner. For 501(c)(3) financings, a governmental conduit issuer is required.

Selecting the Project(s)

- The owner, whether governmental or 501(c)(3), may source and develop projects itself. Alternatively, the owner may issue an RFQ/RFI to let the developer community know what types of projects the owner is interested in owning, with guidance as to expected levels of income and rent restriction. Developers then bring potential projects to the owner to evaluate, approve and finance.
- If the owner approves moving forward, the developer bids on behalf of the owner to acquire and/or develop the project using tax-exempt bond financing. The combination of tax-exempt bond rates, favorable

terms in the municipal bond market and exemption from *ad valorem* property tax typically makes it possible for a bidder to offer a higher price than conventional bidders while still leaving room to charge below-market rents.

Executing the Financing and Real Estate Transactions

- The bond financing team puts together a bond offering, including documents to be approved and executed by the owner/issuer as well as an offering document for potential investors.
- The developer enters into a guaranteed maximum price construction contract for development work (ground up or rehabilitation).
- The developer arranges for third-party reports such as an appraisal, physical needs assessment and environmental report.
- The bond underwriter offers the bonds for sale at roughly the same time the developer is required to make an earnest money deposit under the purchase and sale agreement for the real estate. Ideally, the developer does not have to put money down until after a successful bond sale.
- Simultaneously with closing of the bonds, the developer assigns the purchase and sale agreement and other material contracts to the owner. On the closing date, the owner uses proceeds of the bonds to acquire the real property (land or land and improvements) from the seller. The developer is not in the chain of title.
- The developer's earnest money deposit is released, and the developer typically receives a cash developer fee from bond proceeds.
- The owner engages the developer or another operator on a fee-for-service basis to run the project.

ORRICK CONTACTS

For further information about any of the topics discussed in this book, please contact the author or one of the Orrick lawyers listed below.

AUSTIN

Julia Houston
+1 512 582 6952
juliahouston@orrick.com

Jerry V. Kyle, Jr.
+1 512 582 6951
jkyle@orrick.com

HOUSTON

Marcus Deitz
+1 713 658 6420
mdeitz@orrick.com

Barbara Jane League
+1 713 658 6786
bleague@orrick.com

Amanda Stephens
+1 713 658 6412
astephens@orrick.com

LOS ANGELES/ ORANGE COUNTY

Marc Bauer
+1 213 612 2325
mbauer@orrick.com

Don Field
+1 949 852 7727
dfield@orrick.com

Greg Harrington
+1 213 612 2280
gharrington@orrick.com

Larry Sobel
+1 213 612 2421
lsobel@orrick.com

NEW YORK

Richard Chirls
+1 212 506 5250
rchirls@orrick.com

Douglas Goodfriend
+1 212 506 5211
dgoodfriend@orrick.com

Eileen Heitzler
+1 212 506 5235
eheitzler@orrick.com

Thomas Myers
+1 212 506 5212
tmyers@orrick.com

Helen Pennock
+1 212 506 5321
hpennock@orrick.com

Jeff Philp
+1 212 506 5056
jphilp@orrick.com

Kevin Roche
+1 212 506 5238
kroche@orrick.com

Neil Wolk
+1 212 506 5185
nwolk@orrick.com

PORTLAND

Greg Blonde
+1 503 943 4823
gblonde@orrick.com

Doug Goe
+1 503 943 4810
dgoe@orrick.com

Townsend Hyatt
+1 503 943 4820
thyatt@orrick.com

Christine Reynolds
+1 503 943 4821
cereynolds@orrick.com

Michael Schrader
+1 503 943 4840
mschrader@orrick.com

SACRAMENTO

Brandon Dias
+1 916 329 4904
bdias@orrick.com

Patricia Eichar
+1 916 329 7917
peichar@orrick.com

Jenna Magan
+1 916 329 7980
vcmagan@orrick.com

Bryan Victor
+1 916 329 7979
bvictor@orrick.com

SAN FRANCISCO

Devin Brennan
+1 415 773 4261
dbrennan@orrick.com

Chas Cardall
+1 415 773 5449
ccardall@orrick.com

Eugene Clark-Herrera
+1 415 773 5911
ech@orrick.com

Justin Cooper
+1 415 773 5908
jcooper@orrick.com

Roger Davis
+1 415 773 5758
rogerdavis@orrick.com

Robyn Helmlinger
+1 415 773 5925
rhelmlinger@orrick.com

Rich Moore
+1 415 773 5938
rmoore@orrick.com

John Palmer
+1 415 773 4246
jpalmer@orrick.com

Steve Spitz
+1 415 773 5721
sspitz@orrick.com

John Stanley
+1 415 773 5713
jstanley@orrick.com

John Wang
+1 415 773 5993
jwang@orrick.com

WASHINGTON, D.C.

Darrin Glymph
+1 202 339 8401
dglymph@orrick.com

Edwin G. Oswald
+1 202 339 8438
eoswald@orrick.com