

Multifamily Rental Housing



Financing with Tax-Exempt Bonds

Second Edition

JUSTIN COOPER



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ORRICK

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| | | |
|------------|---|----|
| Chapter 1. | Introduction | 1 |
| Chapter 2. | Project Financing | 3 |
| | Tax-Exempt Bonds | 3 |
| | Construction Loans and Permanent Loans | 4 |
| Chapter 3. | Types of Projects and Borrowers | 5 |
| | A. <i>Types of Multifamily Projects</i> | 5 |
| | New Construction | 5 |
| | Acquisition/Rehabilitation | 5 |
| | Low-Income Rental Project | 5 |
| | Mixed-Income Project | 5 |
| | Senior/Assisted Living Project | 5 |
| | Mobile Homes | 5 |
| | B. <i>Types of Borrowers</i> | 6 |
| Chapter 4. | Types of Issuers and Transactions | 9 |
| | A. <i>Conduit Financings</i> | 10 |
| | Public Offering Structure and Documentation | 10 |
| | Ratings; Credit Enhancement | 12 |
| | Government-Sponsored Enterprises | 13 |
| | Private Placement Structure and Documentation | 14 |
| | B. <i>Pooled Financings</i> | 16 |
| | Security for the Bonds | 16 |
| | Bond Structuring Considerations | 17 |
| | Loan Rates and Terms | 18 |

| | |
|---|-----------|
| Chapter 5. Other Structuring Considerations | 19 |
| A. Sale of Bonds | 19 |
| Underwriting..... | 19 |
| Disclosure..... | 19 |
| Private Placement..... | 20 |
| B. Real Estate Security | 20 |
| C. Refinancings/Restructurings | 21 |
| | |
| Chapter 6. Federal Tax Law | 23 |
| A. Good Costs | 23 |
| B. Other Limitations on the Use of Bond Proceeds | 23 |
| Reimbursing Prior Capital Expenditures | 23 |
| Costs of Issuance | 24 |
| Interest | 25 |
| Reserves | 25 |
| C. Volume Cap. | 25 |
| D. TEFRA | 26 |
| E. Income Set-Asides and Other Restrictions | 27 |
| F. Special Rules for Acquisition/Rehabilitation Projects | 28 |
| G. 1.5% Spread Limitation | 29 |
| H. Tax Credits | 29 |
| | |
| Chapter 7. State-Specific Factors | 31 |
| | |
| Chapter 8. Choosing a Conduit Issuer | 33 |
| A. What Issuers are Eligible? | 33 |
| B. Factors to Consider in Choosing an Issuer | 34 |
| Structuring Objectives—Pooled or Conduit | 34 |
| Other Considerations Regarding Conduit Issuers..... | 34 |
| | |
| Chapter 9. Not-for-Profit Borrowers | 35 |
| Types of 501(c)(3) Borrowers..... | 35 |
| Safe Harbor for “relief of the poor and distressed”..... | 36 |
| Lessening the Burdens of Government Organizations..... | 36 |

| | |
|---|--------------------------|
| Special Rules for Acquisitions. | 36 |
| No Volume Cap. | 37 |
| State Law Differences. | 37 |
| For-Profit Managers. | 38 |
| | |
| Chapter 10. Steps to Issuing Bonds | 39 |
| Consult Bond Counsel. | 39 |
| Find a Lender (Public Sale or Private Placement). | 39 |
| Choose the Issuer. | 40 |
| Engage the Underwriter (Public Sale). | 40 |
| Financial Advisor. | 40 |
| Adopt a Reimbursement Resolution. | 41 |
| Apply for (and Receive) Volume Cap/Tax Credits. | 41 |
| Conduct TEFRA Hearing and Approval. | 41 |
| Drafts of Documents. | 41 |
| Conference Calls. | 42 |
| Issuer Approval. | 42 |
| Preliminary Official Statement. | 42 |
| Credit Approval. | 42 |
| Bond Sale. | 42 |
| Final Official Statement. | 42 |
| Closing. | 42 |
| | |
| About the Author | 45 |
| Contact Information | Inside Back Cover |

CHAPTER ONE

Introduction

Multifamily rental housing projects provide affordable housing for low- and moderate income families throughout the country; many of these projects are financed in whole or in part with tax-exempt bonds.

Governments of all levels (federal, state and local) are involved in providing housing for those who cannot otherwise afford it at market rates. In the past, subsidized housing was often built directly by the public sector. Now, governments prefer to accomplish their housing policy goals by providing tax credits and other assistance (such as eligibility to use tax-exempt bonds) to private developers of housing projects that are consistent with those goals. Developers have become sophisticated in using these government incentive programs to generate the equity and/or debt they need to finance their projects.

This pamphlet is designed to introduce or broaden the understanding of developers, state and local agencies, and others regarding the role of tax-exempt bonds in the financing of multifamily rental housing projects.

Orrick is the nation's premier tax-exempt bond counsel firm, with extensive experience in all types of housing financings, ranking number one (in terms of dollar volume of bonds issued) over the past decade. It has been bond counsel, underwriter's counsel or other counsel on more than 500 financings and refinancings of multifamily housing projects in the past decade, including some of the largest and some of the smallest multifamily housing financings ever completed.

CHAPTER TWO

Project Financing

Multifamily housing finance consists of acquiring and developing rental housing facilities, which are revenue-producing assets. Projects are generally financed on a secured, non-recourse basis, meaning that the Borrower is obligated to make payments on the debt from project revenues only (subject to certain standard carve-outs), and the lender's primary security for the financing is the asset itself.

The capital structure for a typical bond-financed project includes the following:

- Senior loan funded with tax-exempt bonds;
- One or more grants and/or subordinate loans from state or local government; and/or
- Equity from limited partners, often tax-credit investors.

Tax-Exempt Bonds

Tax-exempt bond-funded loans are a valuable part of many financing structures because (1) they offer better rates of interest than other forms of debt¹ and (2) the use of tax-exempt bonds for a project facilitates the use of Low Income Housing Tax Credits for project equity (see “Federal Tax Law—Tax Credits”).

Because interest paid on tax-exempt debt is exempt from federal (and often state) income tax, investors require less interest than they would from taxable debt to produce the same after tax return. This taxable/tax-exempt spread varies from time to time based on market factors and marginal income tax rates,

1. Other loan terms may also be favorable compared to conventional debt. For example, conventional loans for multifamily projects originated under Fannie Mae and Freddie Mac programs usually have shorter maximum terms to maturity, more restrictive amortization requirements, higher minimum debt-service coverage ratios and higher loan-to-value thresholds than are applicable to bond-funded loans.

but tax-exempt rates are usually 30% to 35% lower than rates for comparable taxable debt. Since Congress passed the Housing and Economic Recovery Act in July 2008 (the “2008 Housing Act”) and the American Recovery and Reinvestment Act in February 2009 (the “2009 Stimulus Act”), interest on some (but not all) multifamily housing bonds has become exempt from federal corporate and individual alternative minimum taxes (“AMT”), further reducing pre-tax yields on those bonds. Lower bond yields generally translate into lower financing costs for Borrowers.

Construction Loans and Permanent Loans

Financing construction of a new multifamily rental facility involves certain unique risks. Because the project has not yet been built, there are no project revenues available to pay debt service. Moreover, construction may be delayed, costs may exceed projections, and units may not be rented when and as expected. A new multifamily project is, therefore, initially financed with a construction loan, which typically bears a relatively high interest rate and includes reserves, developer guarantees, and other additional security for the lender. If and when the project is fully constructed and “stabilized” (occupied at a certain level for a certain period of time, as determined by the lender), a new “permanent” loan is made to repay the construction loan, and the additional security for the construction loan is released.

The process of replacing a construction loan with a permanent loan is called “conversion.”² In conventional mortgage financings, conversion is often accomplished just this way—a new loan is actually made, and the proceeds are used to retire the old loan. In the tax-exempt bond world, where loans are funded from proceeds of tax-exempt bonds issued by a governmental issuer, it is rare to have new bonds issued at conversion. Rather, the bonds are issued at the outset of the financing to fund a “construction-to-permanent” loan that converts from the “construction phase” to the “permanent phase” upon stabilization and satisfaction of other conditions to conversion.

2. Conversion occurs after a project has been completed and ‘stabilized,’ meaning that a certain occupancy level has been maintained for a certain period of time and is typically the point at which any sponsor guarantees or that other forms of recourse to the Borrower or its partners are released.

CHAPTER THREE

Types of Projects and Borrowers

A. Types of Multifamily Projects

Tax-exempt bonds are issued to fund loans for the acquisition, construction, rehabilitation and refinancing of a variety of multifamily housing projects.

New Construction—bond proceeds are used, together with other funds, to construct a new multifamily rental housing facility that qualifies as a “qualified residential rental project” under the Internal Revenue Code (see “Federal Tax Law”).

Acquisition/Rehabilitation—bond proceeds are used to acquire an existing facility, which may or may not already contain rental units set aside for low income families, and to make sufficient changes and improvements to it such that it constitutes a qualified residential rental project.

Low-Income Rental Project—an apartment facility may be made up entirely of rental units offered to low-income tenants, often at restricted rents.

Mixed-Income Project—certain units within an apartment facility are set aside for low income tenants, while other units are available at market rates. The whole rental facility may be bond-financed. Mixed-income projects are often favored in downtown urban areas and may be part of a larger mixed-use development.³

Senior/Assisted Living Project—some housing projects are built specifically for senior citizens; they may include on-site medical staff and facilities.

Mobile Homes—mobile home parks may be financed with tax-exempt bonds, provided certain affordability requirements are met.

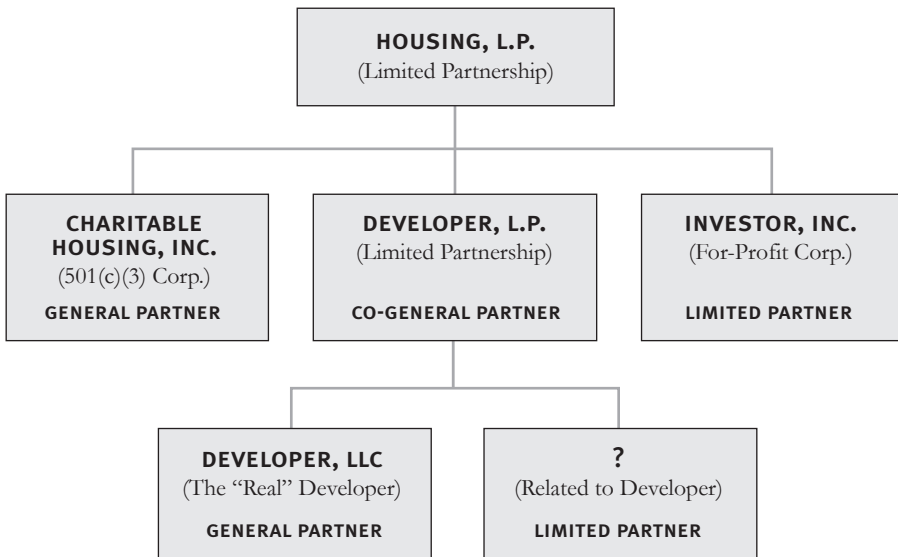
3. Typically 20% of the units are reserved for households with incomes at or below 50% of the area median—these are commonly called “80/20” projects.

B. Types of Borrowers

The term “Borrower” is used here to describe the party in a tax-exempt bond financing that receives a loan funded from bond proceeds and uses those proceeds to acquire, construct, rehabilitate or refinance a multifamily housing project. This is typically a single-purpose entity created to act as Borrower for one transaction only. Borrowers may be:

- *For-Profit Corporations*
- *Limited Partnerships*—this is **by far the most common form**, almost always a single-purpose, single-asset entity
- *501(c)(3) Corporations* (See “Not-for-Profit Borrowers”)
- *Governmental Entities*—State housing agencies, cities, counties, redevelopment agencies, local housing authorities and other public entities may act as Borrowers or as partners in a Borrower partnership.

Single-purpose limited partnerships consist of one or more General Partners and one or more Limited Partners. The chart below shows the organizational structure of a typical single-purpose Borrower limited partnership.⁴



4. The discussion in this booklet is generally limited to non-governmental Borrowers.

The General Partner is what we usually think of as the “developer,” the party responsible for acquiring, constructing, rehabilitating or refinancing the project and managing it so that it generates revenues.

General Partners may be:

- individuals;
- for-profit corporations;
- trusts;
- governmental entities or private corporations controlled by governmental entities;
- 501(c)(3) Corporations;⁵ and/or
- or almost anything else.

Limited Partners may also take a variety of legal forms. Limited Partners may join the partnership to receive tax credits (See “Federal Tax Law—Tax Credits”) or to receive a return on equity in some other way. They are typically shielded somewhat from the risk of poor project performance.

5. 501(c)(3) Corporations may serve as General Partners as true “Developers,” or they may be included as General Partners primarily for tax reasons. In some states (including California, for example) limited partnerships with not-for-profit General Partners performing significant duties are exempt from local property taxes.

CHAPTER FOUR

Types of Issuers and Transactions

There are two basic paradigms for the financing of multifamily rental housing with tax exempt bonds:

- Stand-alone or “conduit” financings.
- Issuer-as-lender or “pooled” financings.

Both paradigms require a state or local governmental entity (the “Issuer”) which, under applicable state law, has the power to issue bonds to finance multifamily housing projects and to use proceeds of those bonds to fund loans to Borrowers.

In a conduit structure, the bonds are limited obligations of the Issuer secured only by a loan, which the Issuer assigns to the bondholders or to a bond trustee to secure payment of the Bonds. The Issuer, therefore, takes no credit risk with respect to the project: if project revenues do not support repayment of the loan, the bondholders (or a third-party credit enhancer) will suffer the loss. Conduit financings are almost always done on a project-by-project basis, with a single bond issue funding a single loan for a particular project. Because the Issuer does not take credit risk or provide credit support in a conduit financing, the Borrower is effectively the obligor on the bond issue and takes the lead role, with assistance from bankers or other professionals, in structuring the bond issue.

In a pooled financing, the Issuer issues bonds secured by a pool of loans and, in many cases, by a general obligation pledge of the Issuer. The Issuer is obligated to repay the bonds even if one or more loans default, meaning that the Issuer takes credit risk with respect to each project for which it provides a loan. The Issuer is, therefore, substantively at the center of a pooled financing, acting in the roles of debtor (as obligor on the bonds) and creditor (as lender to project Borrowers who are not involved directly in the bond financing).

State and local entities frequently act as conduit issuers, while state housing finance agencies are by far the most common sponsors of pooled financing programs.

A. Conduit Financings

A conduit-bond issue and the resulting loan funding are a single, integrated transaction in which, with limited exceptions, the bonds are issued and the loan is originated at the same time. There is a direct, transparent relationship between the bond terms and the loan terms. Because the Issuer acts only as a conduit or pass-through entity, a 0.10% increase or decrease in the bond rate, for example, produces a 0.10% increase or decrease in the loan rate paid by the Borrower. The Borrower is, therefore, principally interested in driving the bond transaction to produce the lowest possible overall borrowing cost.

One of the basic choices a Borrower must make in a conduit financing is whether the Bonds should be:

- **Publicly-offered; or**
- **Privately-placed.**

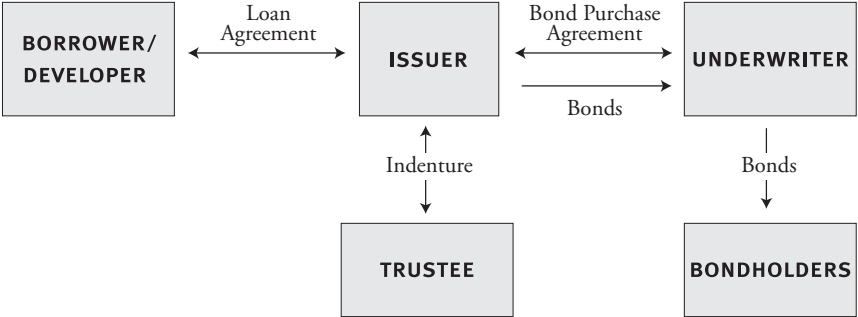
Publicly sold bonds generally offer the lowest possible interest rates, but this is not the best structure for every conduit-bond financing. Because the costs of offering bonds to the public are largely fixed, but project sizes and costs vary widely, some transactions are too small to justify the cost of a public offering. Placing bonds directly with a single investor or lender is often the most cost-effective structure for those transactions.

Public Offering Structure and Documentation. In a public offering transaction, the conduit issuer issues bonds pursuant to an indenture or trust agreement (the “Indenture”) between the Issuer and a corporate trustee (the “Trustee”) who, for the benefit of the bondholders and (to a limited extent) the Issuer, holds the funds and any other collateral pledged under the Indenture to secure payment of the Bonds and, if necessary, enforces certain rights of the bondholders and the Issuer.

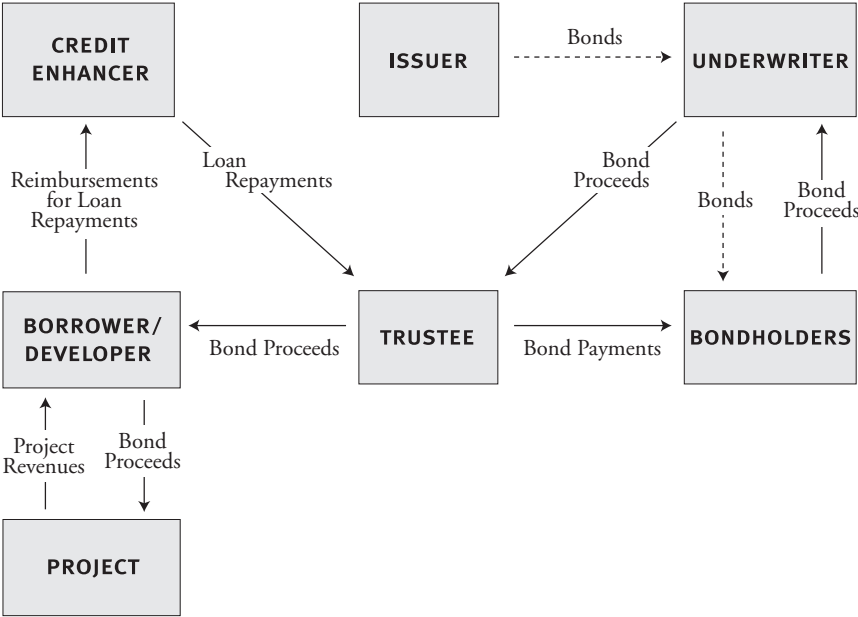
The Issuer loans the proceeds of the Bonds to the Borrower pursuant to a Loan Agreement or Financing Agreement (the “Loan Agreement”). The Issuer assigns all of its rights (except limited rights to receive fees and indemnification),

including the right to receive repayments of the loan from the Borrower, to the Trustee as security for the Bonds pursuant to the Indenture. Under the Loan Agreement, the Issuer loans the bond proceeds to pay the costs of acquiring, constructing, rehabilitating or refinancing the project as applicable. The Loan Agreement sets out the terms of repayment of and security for the loan. A deed of trust or mortgage is typically recorded as an encumbrance upon the project to further secure the loan; it is also assigned to the Trustee.

DOCUMENTS



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In addition to the Indenture and the Loan Agreement, there is almost always a Regulatory Agreement (sometimes called a Land Use Regulatory Agreement) between the Borrower, the Issuer and (sometimes) the Trustee. The Regulatory Agreement is recorded against the project and restricts the use of the project so as to ensure compliance with applicable tax laws (see “Federal Tax Law”).

Ratings; Credit Enhancement. Publicly-offered bonds are purchased by investors who, as a general rule, have no first-hand information about the project or the Borrower. These investors are interested in investing in tax-exempt securities; they do not want to take “real-estate risk.” As a result, almost all publicly-offered conduit bonds are supported by some kind of credit enhancement and, in the case of variable-rate demand bonds that may be tendered by the bondholders, liquidity support. These bonds receive long-term and, if applicable, short term credit ratings based on the ratings of the credit enhancer and liquidity support provider (which are often the same party), not the creditworthiness of the project.⁶

Credit enhancement may take any of the following forms, among others:

- Direct-pay letter of credit⁷;
- Standby letter of credit⁸;
- Bond Insurance;
- Fannie Mae/Freddie Mac credit enhancement agreement;
- FHA Insurance/GNMA mortgage-backed security; and/or
- Guaranty from third-party (sometimes related to Borrower).

6. Because multifamily housing finance is fundamentally a form of project financing, the creditworthiness of the Borrower is rarely an issue, even where there is no credit enhancement.

7. A direct-pay letter of credit allows the trustee to draw on the letter of credit to pay scheduled payments of principal and interest. The letter-of-credit provider then looks to the Borrower/Developer for reimbursement, usually on the same day on which the Trustee draws on the letter of credit. Bondholders effectively receive payment directly from the provider of the letter of credit.

8. A standby letter of credit may be drawn upon only if there is a failure by some other party to make a payment. For example, a bank with a particularly strong credit rating (such as the Federal Home Loan Bank) might issue a standby letter of credit to back up a direct-pay letter of credit issued by a bank with a lower credit rating. If the first bank fails to make a payment requested by the Trustee, the Trustee can draw on the standby letter of credit. Standby letters of credit can also be issued to support payments directly from the Borrower/Developer to the Trustee (so that if the Borrower/Developer fails to make a payment, the Trustee draws on the standby letter of credit), but this is no longer common.

Credit enhancement allows bondholders to disregard the risk that Borrower will be unable, as a result of an under-performing project or for any other reason, to make payments of principal and interest on the bonds.⁹ Purchasers of these bonds, such as money-market funds and investors in such funds, are not in a position to evaluate and absorb the credit risks inherent in individual real-estate ventures. Credit enhancers, however, are equipped to perform this kind of underwriting; they evaluate a project and, if it meets their requirements, provide insurance, a letter of credit or some other kind of guaranty for the benefit of the bondholders. The credit enhancers essentially fill the role of real estate lender, and the bondholders then look only to the creditworthiness of the credit enhancer.

Credit enhancers for conduit bonds include the following, each of which has its own requirements and procedures for loan underwriting:

- Commercial Banks;
- Fannie Mae;
- Freddie Mac;
- Federal Housing Administration (FHA).

The most common form of credit enhancement in the conduit multifamily bond market is a direct-pay letter of credit or a comparable instrument provided by Fannie Mae or Freddie Mac. In this structure, the Trustee draws on the credit facility to make all principal and interest payments on the Bonds, and the credit enhancer is reimbursed by the Borrower from project revenues or, during construction, from reserves held under the Indenture.

Government-Sponsored Enterprises. Fannie Mae and Freddie Mac, both of which are “government sponsored enterprises” (“GSEs”) that operate with some independence from the federal government, provide credit enhancement and, in many cases, liquidity support in the form of credit enhancement agreements that function like direct-pay letters of credit. The GSEs are also, at different times,

9. In most cases, the Issuer of the bonds is technically the party obligated to make debt service payments but only to the extent it receives funds from the Borrower/Developer under a loan agreement. If the Borrower/Developer defaults under the loan agreement, the Issuer has no money with which to pay bondholders and no obligation to use any of its own funds to that end.

active in other areas of the multifamily mortgage market. For example, they make and purchase conventional loans to projects; they purchase tax-exempt and taxable multifamily housing revenue bonds directly from Issuers; and they purchase Low Income Housing Tax Credits.

To understand the roles Fannie Mae and Freddie Mac play in the multifamily mortgage market, it is also important to know what they do not do. They do not originate or service their own loans (for these purposes, providing credit enhancement on bonds may be considered equivalent to making a loan), nor do they take construction risk. Rather, in a Fannie/Freddie deal, an approved lender/servicer¹⁰ does the primary underwriting for the project and services the loan when it is made (meaning that the lender/servicer is the party that demands and collects payments from the Borrower to reimburse Fannie Mae or Freddie Mac, as the case may be, for draws on its credit facility to make payments on the Bonds).

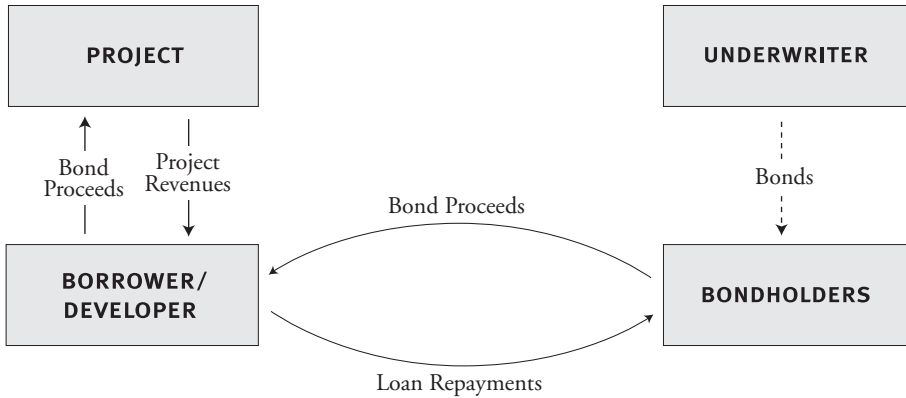
Borrowers interested in working with Fannie Mae or Freddie Mac should consult with an approved lender/servicer. Current lists of approved lender/servicers are available at

- *www.fanniemaec.com*, and
- *www.freddiemac.com*.

For new construction projects, Fannie Mae and Freddie Mac both require that a third party construction lender, which is typically a commercial bank brought into the transaction by the Borrower or by an investment banker, take the project construction risk by providing a construction letter of credit in favor of Fannie/Freddie. This construction letter of credit is only released if and when conversion occurs. If the project never meets the conditions for conversion, the bonds will likely be redeemed from a draw on the Fannie/Freddie credit facility, but Fannie Mae or Freddie Mac, as the case may be, will be made whole by drawing on the construction letter of credit, leaving the construction lender to pursue whatever remedies it may have against the project.

10. Fannie Mae calls its lender/servicers "Delegated Underwriting and Servicing (DUS) Lenders." Freddie Mac calls them "Seller/Servicers."

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Private Placement Structure and Documentation. Privately-placed conduit bonds are held by banks or other lenders that have conducted their own investigation into the creditworthiness of the project and understand that they are taking real-estate risk. In economic substance, these are two-party transactions consisting of a loan (funded by way of a governmental conduit issuer) from the bond purchaser to the Borrower (see chart, above).

A private placement is essentially a real-estate loan by the bondholder. The Borrower borrows money from a bank or other lender, just as it would if no bonds were issued, but the debt takes the form of a bond transaction in which the lender holds bonds issued by the conduit Issuer and secured by the loan made from the bond proceeds. These transactions are generally simpler and, as a result, are cheaper to execute than public offerings because there are fewer parties. For example, there may be no need for a trustee and fewer documents involved than in a public offering. Like bank loans, private-placements are often funded on a draw-down basis, meaning that bond proceeds are advanced when and as needed to pay for project costs. In certain interest rate environments, this dramatically reduces the “negative arbitrage” cost that results from fully funding a project or construction fund with bond proceeds and drawing it down over time.

There is typically no credit enhancement in a private placement, and the bonds are not rated. The same tax rules that apply to publicly-sold bonds, such

as low-income set-asides, limits on costs of issuance and so forth, apply to a private placement.

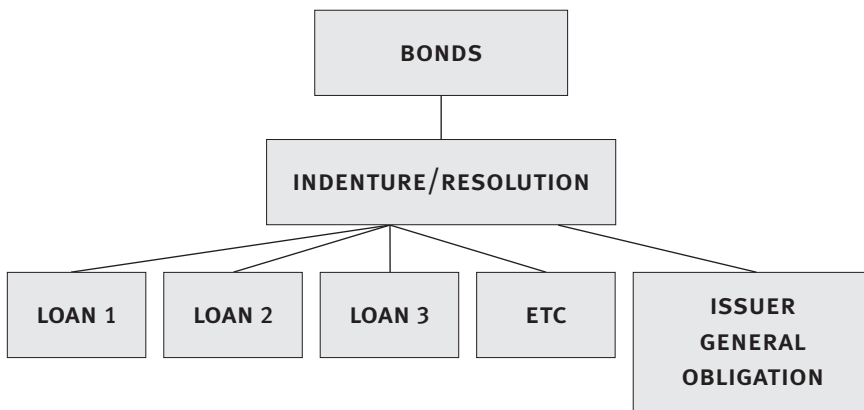
Private-placement lenders include:

- regional banks;
- national commercial/investment banks; and
- specialized non-bank financial institutions.

Different lenders and finance teams have developed different instruments to accomplish the task of documenting the issuance of the bonds and the making of a loan to the Borrower. Borrowers should consult with bond counsel about the documents to be used in a specific private placement structure.

B. Pooled Financings

Security for the Bonds. Pooled bond issues may be secured by a combination of multiple mortgage loans, mortgage-backed securities, reserves and other assets pledged by the Issuer and, in many cases, a general obligation pledge of the Issuer. Unlike in a typical stand-alone conduit bond financing, pooled bond issues fund multiple loans and are secured by multiple loans. The Issuer often has an “open”



resolution or Indenture, meaning that all the loans funded under an Indenture are pledged to secure payment of all of the bonds issued under the Indenture, including new loans funded when additional bonds are issued.

The credit rating of a pooled financing depends on the expected likelihood that revenues from the loan portfolio, together with pledged reserves and other assets, will be at all times sufficient to pay all amounts owed on the bonds. Conducting this analysis requires considerable technical expertise and effort where tens and even hundreds of loans are involved, and Issuers often engage investment bankers or financial consultants to assist them in developing “consolidated cash flow statements” that include stress tests on the loan portfolio. The nature of these stress tests may be dependent on the credit quality of the loans and any credit enhancement for the loans, such as FHA insurance or mortgage-backed securities issued by Fannie Mae or Freddie Mac. Issuers often provide additional credit support for pooled financings by making a general obligation promise of the Issuer to use all available funds to repay the bonds.

Bond Structuring Considerations. State housing finance agencies and other pooled issuers typically bring relatively large (\$50 million or more) bond issues to market. Because these issues are large and each one funds multiple loans with different rates, maturity dates and other terms, they may be highly structured to accommodate specific cash needs of the Issuer, the timing and amount of expected receipts from individual loans and many other factors to meet the Issuer’s objectives and minimize total borrowing costs, such as:

- multiple series;
- taxable and tax-exempt bonds;
- new money and refunding bonds;
- fixed rate serial bonds;
- fixed rate term bonds;
- variable rate demand bonds;
- variable rate bonds tied to an index (LIBOR or SIFMA);
- bond insurance;
- liquidity support (standby bond purchase agreements);
- letters of credit or other credit enhancement;
- interest rate swaps and caps;
- investment agreements and forward delivery agreements; and/or
- mortgage insurance, mortgage-backed securities or other loan guarantees.

Loan Rates and Terms. In a pooled financing, the terms, timing and origination of individual loans in the pool are largely removed from the process of issuing the bonds. The Issuer may fund loans before or after the bond issue occurs, and the rates on the loans may be related only generally and somewhat indirectly to the overall yield on the bond issue.

So, for example, an Issuer may commit to make 30-year permanent loans to Borrowers at a rate of 6.5% per year, expecting to be able to sell bonds at an all-in rate of 5.25% and keep a “spread” of 1.25%. If the Issuer ultimately sells bonds at an all-in rate of 5.5%, the Issuer will nonetheless have to fund loans to the Borrowers at 6.5% and absorb the resulting 0.25% loss in spread. If, on the other hand, the Issuer is able to sell bonds at an all-in rate that is lower than expected, the Issuer will enjoy the benefit of a higher spread, subject to a federal tax law limitation of 1.5% (see “Federal Tax Law”).

Because the Issuer is the Lender in a pooled loan transaction, the Issuer and the Borrower negotiate loan terms directly with each other. The Issuer typically has its own loan documents and is represented by its own lender’s counsel, which may be an in-house legal department or an outside firm.

The same tax rules that apply to conduit bonds, such as low-income set-asides, limits on costs of issuance and so forth, apply to pooled financings, and a Regulatory Agreement is typically used.

CHAPTER FIVE

Other Structuring Considerations

A. Sale of Bonds

Underwriting. Publicly-offered bonds are sold to an Underwriter pursuant to a bond purchase contract containing certain representations of the Issuer and, in the case of conduit financings, the Borrower. The Underwriter sells the bonds to its customers, the bondholders. In a fixed-rate transaction, the bond purchase contract also sets out the interest rates to be borne by the bonds and specifies any premium or discount at which the bonds are to be sold. Variable rate bonds are sold at par and bear a different interest rate from time to time according to the market.

Disclosure. The federal securities laws require that all information that an investor would reasonably find to be material in deciding whether or not to buy the bonds be disclosed to the investor in connection with the offering and sale of the bonds. The instrument for such disclosure in a public offering of municipal bonds is the Official Statement.

In the case of conduit bonds, the Official Statement describes the bonds, the indenture, the loan agreement, the regulatory agreement, the project, the Borrower, any credit enhancement or liquidity support and, in some cases, construction contracts or arrangements and operating projections. In the case of variable rate demand bonds that can be tendered (*i.e.*, sold back to the Issuer) on short notice and backed by a letter of credit, it may be enough for the Official Statement to include only minimal information about the project and the Borrower while providing more information about the bonds and the credit enhancer and/or

liquidity support provider. Although the Official Statement is the Issuer's document (which is why it is called an "Official" Statement), in a conduit transaction, the Borrower is responsible for much or most of the information in the Official Statement and may be expected to indemnify the Issuer for any suits arising out of misstatements or omissions in the Official Statement.

The Official Statement for a pooled financing also describes the terms of the bonds, the Indenture, and any credit enhancement or liquidity support. It would be unusual to see specific loan documents or regulatory agreements summarized in an Official Statement for a pooled financing. In addition, the Official Statement for a pooled transaction typically describes the Issuer and the loan portfolio in detail, including the Issuer's history, management and loan underwriting policies and procedures. The Issuer's audited financial statements are also usually included.

The Official Statement is often prepared by the underwriter and its counsel, although in some cases, bond counsel or a financial consultant may take primary responsibility for drafting the document.

Private Placement. There is often no need for an underwriter or for a disclosure document in a private placement.

B. Real Estate Security

The "Lender" in a multifamily housing revenue bond transaction is, in essence, the party that takes the real estate risk associated with the project. Depending on the structure, the Lender may be

- the credit enhancer (conduit issue);
- the private placement purchaser (conduit issue); or
- the Issuer (pooled issue).

Lenders require that their investment, whether it comes in the form of a loan or provision of credit enhancement, be secured by a deed of trust or mortgage and other security documents that encumber the project to be acquired or constructed.

Lenders engage their own counsel to protect their interests. Lender's counsel prepares a set of loan security documents, such as one or more deeds of trust or mortgages, subordination agreement(s) with respect to subordinate debt,

intercreditor agreement(s) and promissory note(s), to evidence the Borrower's obligation to repay the loan and the lender's enforcement rights and remedies, including foreclosure. Many of these documents are recorded in the county recorder's office of the county in which the project is located, along with the Regulatory Agreement.

C. Refinancings/Restructurings

Few multifamily housing revenue bond issues make it to maturity without being refunded or restructured in some way. Early on, deals are often restructured or refinanced because project performance differs from the parties' original expectations. For projects that used Low Income Housing Tax Credits, at the end of the tax credit compliance period (roughly 15 years from when the project is completed), the developer has strong incentives to sell the project to an arm's length purchaser or otherwise recapitalize it with a transaction that brings in new tax credit equity. The 2009 Stimulus Act provides that interest on bonds issued in 2009 and 2010 to refund multifamily housing bonds issued between 2004-2008 will be exempt from federal personal and corporate AMT, thereby providing further incentive for parties to pursue refunding transactions.

Borrowers may want to consult with bond counsel about the possibility of refinancing or restructuring their existing debt for a project, particularly when interest rates are low.

CHAPTER SIX

Federal Tax Law

A. Good Costs

It is a requirement for all private activity bonds, including multifamily housing bonds, that at least 95% of the tax-exempt bond proceeds, including investment earnings on unspent proceeds, be allocated to capital costs associated with the project (so-called “Good Costs”). In addition to the limitations on financing costs of issuance described below, the costs of issuing the tax-exempt bonds are not Good Costs. Similarly, as described below, certain capital costs of the project that otherwise would be Good Costs will not qualify if those costs were originally paid too long before the issuance of the bonds. There is also a separate rule that prohibits 25% or more of the tax-exempt bond proceeds from being used to finance land costs. In practice, and largely due to the use of Low Income Housing Tax Credit equity, most multifamily housing projects have development budgets well in excess of the amount of required Good Costs.

B. Other Limitations on the Use of Bond Proceeds

In addition to paying the cost of a project (whether new construction or acquisition/rehab) after issuance, tax-exempt bonds may be used to reimburse a Borrower for costs incurred before bonds are issued, as well as to finance certain costs associated with the bond issuance itself.

Reimbursing Prior Capital Expenditures. Under certain circumstances, capital expenditures that could qualify for financing with tax-exempt bonds, but which are made prior to issuance of the bonds, can be reimbursed with proceeds of the bonds when issued.

1. Certain preliminary “soft costs” such as architectural, engineering, surveying, soil testing and similar costs paid prior to commencement of acquisition, construction or rehabilitation of a project may be reimbursed up to 20% of the aggregate issue price of the bonds issued to finance the project. Land acquisition, site preparation and similar costs are not included in such “soft costs.”
2. Any other capital expenditures (including costs of issuance) paid before the bonds are issued may be reimbursed if they are paid after or not more than 60 days before the Issuer of the bonds expresses “official intent” to reimburse such expenditures by resolution, declaration or other action that meets the requirements of applicable tax regulations,¹¹ provided that the reimbursement is made no later than 18 months after the later of the date the cost is paid or the date the project is placed in service (but in no event more than 3 years after the cost is paid).

One of the first steps in any serious consideration of a tax-exempt financing for a multifamily housing project should be the adoption by the Issuer of an official intent reimbursement resolution. Properly drafted, it can be fairly general, simple and nonbinding. There is no cost or liability for not issuing the bonds or not using the proceeds for reimbursement. (See “Steps to Issuing Bonds”.)

Costs of Issuance. Costs incurred in connection with issuing the bonds, such as underwriter’s discount or fees, fees of bond counsel and other lawyers and consultants, rating agency fees, trustee’s fees and the like, may be included in the bond issue. Under federal tax law, no more than 2% of the bond issue may be used on costs of issuance (which do not include the cost of any bond insurance or credit enhancement); as a result, the Borrower or the Issuer may pay some costs of issuance from its own funds, particularly for smaller bond issues, or may finance costs of issuance with taxable bonds or other borrowings.

11. Public entities and non-profit 501(c)(3) corporations may adopt their own reimbursement resolutions, but for profit Borrowers need to have the Issuer adopt a reimbursement resolution for their projects.

Interest. Subject to the Good Costs requirement described above, interest payable on the bonds for a period not to exceed the longer of (i) three years, or (ii) the period in which the project is to be constructed plus one year, may be included in the bond issue. Generally, only interest that accrues prior to the date the project is placed in service is treated as a Good Cost. Interest included in the bond issue is generally held by the bond trustee and used to pay interest on the bonds, with the result that project revenues are not needed for bond debt service during such period.

Reserves. In some cases, a debt service reserve fund may be established and held by the bond trustee. This reserve fund may be funded with bond proceeds and generally may be equal to the lesser of 10% of the bond issue, 125% of average annual debt service on the bonds or maximum annual debt service on the bonds. The debt service reserve fund is used to pay debt service on the bonds if for any reason the Borrower fails to pay.

C. Volume Cap

The Borrowers described in this book are generally private entities, whether for-profit or not-for-profit. As a result, bonds issued on their behalf are “private activity bonds.”

In most cases, an Issuer must be specifically authorized by a state to issue private activity bonds.¹² Just as states receive an annual allocation of Low Income Housing Tax Credits, each state also receives, under Section 146 of the Internal Revenue Code, an annual allocation, called “volume cap,” to be allocated to issuers of private activity bonds. With notable exceptions (see “Not-for-Profit Borrowers”), private activity bonds may only be issued pursuant to an allocation of volume cap by the state.

States are largely free to set up their own processes for allocating volume cap. As a result, practices vary widely from state to state. In general, however, states allocate volume cap to meet their public policy objectives, so they favor

12. The amount of Section 42 tax credits and volume cap awarded to each state is based on the state's population. Every state receives a certain minimum amount, however, so the least populous states actually receive proportionally more Section 42 tax credits and volume cap per capita for allocation than do other states.

the use of private activity bonds to finance projects they feel are worthwhile. Multifamily housing enjoys a high priority or preference for volume allocation in most states. Nevertheless, Issuers and Borrowers should recognize that they may need to compete for volume cap and become familiar with the allocation processes in their states.

The 2008 Housing Act included a provision for “recycling” volume cap under certain limited circumstances. Issuers and Borrowers in states in which volume cap is scarce should consult with bond counsel regarding the possibility of recycling.

D. TEFRA

In addition to receiving an allocation of volume cap, private-activity bonds used to finance a particular project must be approved by both (i) the Issuer or the governmental entity on whose behalf the bonds are issued and (ii) an “applicable elected representative” of the jurisdiction in which the project will be located. This requirement is set forth in the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”). The governmental body or bodies giving such approval—they could be cities, counties, a state or some other entity—must publish a TEFRA notice in an appropriate journal at least 14 days before a hearing, conduct a TEFRA hearing and give TEFRA approval prior to issuance of the bonds.¹³

For multifamily rental housing projects, the governmental body may be the State, the city or the county in which the project will be built or acquired. Often, this entity is also the Issuer, in which case the TEFRA hearing and approval can be conducted by the same body when the bonds are approved (the TEFRA notice must still be published two weeks ahead of time).

13. Although the governmental body must give the public a chance to speak at the TEFRA hearing, approval is not put to a public vote and the governmental body may give approval in spite of public opposition to a project.

E. Income Set-Asides and Other Restrictions

For private activity bonds to be used to finance a “qualified residential rental project” (as defined in Section 142(d) of the Internal Revenue Code), the project must meet certain affordability requirements under that section of the Code. The Borrower may choose between the “20% at 50%” standard or the “40% at 60%” standard:¹⁴

20% at 50%. At least 20% of the residential units in the project are rented to individuals whose income is 50% or less of area median income.

40% at 60%. At least 40% of the residential units in the project are rented to individuals whose income is 60% or less of area median income.

Area median incomes are determined for each “Metropolitan Statistical Area” by the U.S. Department of Housing and Urban Development (“HUD”). Adjustments are made for household size.

Section 142(d) does not limit the rent that may be charged to tenants; it only requires that the tenants meet the applicable income requirements. In theory, a Borrower could charge market-rate rents to individuals whose incomes put them in a low-income category, but who can afford, for whatever reason, to pay market-rate rent. Many projects are nonetheless subject to rent limits because of state law limitations on issuers or state procedures regarding volume cap allocation, or because they receive Low Income Housing Tax Credits.

These income set-asides apply to the project throughout the “qualified project period,” which begins when 10% of the units have been rented and generally lasts at least 15 years.¹⁵ State or local laws or regulations may extend

14. In certain markets, consisting almost exclusively of downtown urban areas, it may be advantageous for an Issuer to make, on behalf of the Borrower, a “deep rent skewing election” under the Code, which requires additional affordability restrictions but allows the Borrower to continue to count designated low-income units as such even if tenant income rises above applicable levels. Issuers and Borrowers should consult bond counsel regarding this option.

15. Under Section 142(d), the qualified project period ends on the later of (1) the date 15 years after the first date on which 50% of the units are rented, (2) the date on which no tax-exempt private activity bonds are outstanding with respect to the project or (3) the date on which any HUD assistance under Section 8 is terminated with respect to the project.

the qualified project period considerably. Issuers ensure compliance with the affordability rules by requiring that a Regulatory Agreement be executed to encumber the project and provide remedies if the affordability requirements are not met.

Section 142(d) does not offer the Borrower any incentive to go beyond 20% at 50% or 40% at 60%. As long as the project passes one of those tests, tax-exemption is possible. Tax credits, however, are granted in proportion to the number of units set aside for tenants whose incomes are at or below 60% of the area median. As a result, projects designed to receive tax credits often have substantially more than 40% of their units set aside for these tenants; in fact, many contain no units rented at market rates. Cities and counties in which projects are located also tend to prefer projects with as many affordable units as possible, meaning that many multifamily rental housing projects financed with tax-exempt bonds end up with most or all of their residential units set aside for low-income tenants.

The 2008 Housing Act made certain technical changes to the income set-aside rules and other restrictions on qualified residential rental projects. Issuers and Borrowers should consult bond counsel regarding those changes.

F. Special Rules for Acquisition/Rehabilitation Projects

Tax-exempt bonds are often used to finance the acquisition and rehabilitation of an existing multifamily rental housing project, rather than the construction of a new project. In addition to complying with the affordability rules, the Borrower of an acquisition/rehabilitation project must also spend on rehabilitation of the project an amount equal to at least 15% of the total amount of bond proceeds used to acquire the buildings and other improvements (but not the land) that make up the project. In other words, tax-exempt bonds cannot be used merely to acquire an existing project if no improvements are made (see “Not-for-profit Borrowers” for an important exception to this rule).

G. 1.5% Spread Limitation

Issuers of tax-exempt bonds of all kinds are generally prohibited from investing bond proceeds in investments, including mortgage loans, that produce a yield over the term of the bond issue in excess of the yield on the bond issue. In the case of multifamily housing revenue bonds, the mortgage loans financed with bond proceeds are subject to a more permissive rule than the general “arbitrage” rule: the Issuer may earn a “spread” of up to 1.5% over the bond yield, meaning that yield on the loan or loans financed from a particular bond issue may not be more than 1.5% per year greater than the yield on the bond issue.

In conduit financings, the loan rate paid by the Borrower is almost always equal to the bond rate. Administrative fees charged by the Issuer, which are typically paid by the Borrower as an operating expense of the project, count against the spread limitation, but these fees very rarely approach the 1.5% threshold. As a practical matter, the 1.5% spread is only a factor in pooled financings. Issuers of pooled bonds should consult with bond counsel regarding the complex rules for calculating bond and loan yield.

H. Tax Credits

Section 42 of the Internal Revenue Code provides for credits to support housing projects containing units set aside for low-income tenants who pay restricted rents. These Low Income Housing Tax Credits offer Borrowers the opportunity to raise equity for such projects by creating a partnership in which the investors, as passive limited partners, are considered for tax purposes to own nearly all of the project and, therefore, receive the tax credits as they accrue over time (tax credits are received over a period of 10 years). In return, the limited partners make capital contributions to the partnership, either through cash up-front (or, more typically, installments during construction at conversion) in an amount related to the present value of the tax credits to be received over time.

Low Income Housing Tax Credits fall into two categories: “4% Credits” and “9% Credits.” 9% Credits are generally more valuable and more difficult to obtain than 4% Credits, but they may not be combined with tax-exempt bonds. As described below, however, 4% Credits arise only in connection with tax-exempt bond issues.

Each state receives an annual dollar amount of Low Income Housing Tax Credits to allocate to projects. The total amount of all Low Income Housing Tax Credits allocated within the state for that year may not exceed the annual allocation. An exception is made, however, by operation of the “50% Test,” paraphrased below:

50% Test: If 50% or more of the cost of the land and the building constituting a project is financed with tax-exempt bonds for which an allocation of private activity bond volume cap is received, no portion of any 4% Credits allocated to the project counts against the state’s annual allocation.

The 50% Test drives demand for tax-exempt bond financing because Borrowers only receive 4% Credits to the extent their projects satisfy the 50% Test. As a result, smaller projects for which the fixed costs of bond financing would otherwise be too high (compared to conventional debt) to justify the benefit in interest rate savings may nonetheless choose bond financing in order to obtain tax credit equity.

CHAPTER SEVEN

State-Specific Factors

Laws regarding the issuance of multifamily housing revenue bonds by state and local governments vary from state to state. As a general matter, however, any Issuer of housing revenue bonds needs to have statutory and/or constitutional authority to issue bonds and make loans to Borrowers. Typical types of Issuers include the following:

- State and local Housing Finance Agencies and Housing Authorities;
- Cities and Counties;
- Redevelopment Agencies; and
- Joint Powers Authorities.

States have typically passed laws over time granting these entities the authority to issue bonds. As a result, the state laws applying to a particular bond-financed project may depend in large part on whether the Issuer is a city, a county, a housing agency, etc.

State laws may affect almost any aspect of a transaction, including the following:

- affordability restrictions;
- rent restrictions;
- prevailing wage requirements;
- security requirements (especially regarding security interests in land);
- financial structuring;¹⁶

16. For example, some states authorizing statutes may not allow an issuer to issue variable rate debt or may not permit the issuer to enter into agreements relating to derivative financial products.

- documentation;
- taxes, including property taxes; and/or
- rating requirements.

Borrowers should expect bond counsel to be familiar with state law and should work with bond counsel to ensure compliance with applicable state laws.

CHAPTER EIGHT

Choosing a Conduit Issuer

Borrowers interested in developing affordable housing with tax-exempt bonds may choose to take out a loan from a state housing finance agency or another pooled issuer, in which case the issuer of the bonds acts in the dual roles of Issuer and Lender. For borrowers pursuing tax-exempt financing through a private Lender, however, there may be a variety of state or local governmental entities with jurisdiction over the project that are available to act as conduit Issuer for the bonds.¹⁷

A. What Issuers are Eligible?

Borrowers need to begin by finding an Issuer that can legally issue bonds to finance their project in its planned location. Cities and counties, and their issuing authorities, can typically only issue bonds for projects located within their territorial limits. State housing finance agencies, by comparison, may be able to issue bonds for projects located anywhere in the state.

In addition to legal limits, practical and political considerations may prevent certain Issuers from issuing bonds for projects in certain areas. For example, a city or county may require that it issue the bonds for a project located within its borders, even if a statewide joint powers authority or some other entity could legally issue bonds for the project. This is particularly common where the city or county itself contributes to the financing of the project, whether through grants, subordinate loans, fee waivers or otherwise.

17. In some states or jurisdictions, Borrowers have little or no choice in this matter. A state may have a statewide issuer, for example, that serves as the issuer for all housing revenue bonds issued in the state.

B. Factors to Consider in Choosing an Issuer

Structuring Objectives—Pooled or Conduit. A state housing finance agency or other pooled financing Issuer is probably best for a Borrower that wants to obtain a bond funded loan but does not want to take the lead in executing a bond financing. Choices are also limited—nearly all pooled issuers are housing finance agencies and most states have only one housing finance agency.¹⁸

By contrast, Borrowers who are comfortable structuring a bond financing, or hiring one or more professionals to assist them in this effort, may seek out a conduit issuer. State law requirements, credit considerations and policy considerations vary from Issuer to Issuer and may limit the financing structures available to a project. For example, Issuers may have minimum rating requirements or minimum bond denominations, or they may restrict ownership of bonds rated below a certain level to sophisticated investors. Some Issuers may simply prohibit financing structures that they consider too risky or experimental. Borrowers should confirm that their preferred conduit Issuer is authorized and willing to issue bonds that work with their preferred financing structure.

Other Considerations Regarding Conduit Issuers. Borrowers may want to consider a variety of factors in choosing a conduit issuer, including the following:

- scheduling flexibility and frequency of board/council meetings;
- additional affordability requirements, if any;
- other policy-driven requirements affecting the project;
- upfront and ongoing fees;
- flexibility in choosing lawyers and other professionals; and/or
- availability of grants, subordinate loans or other project assistance.

18. New York has two—the New York State Housing Finance Agency and the New York City Housing Development Corporation—which operate in New York City but are regarded as state housing finance agencies.

CHAPTER NINE

Not-for-Profit Borrowers

Tax-exempt financing is available to both for profit and not-for-profit developers of multifamily rental housing.¹⁹ Some special rules apply to nonprofits that qualify as 501(c)(3) organizations (as defined in Section 501(c)(3) of the tax code). State and tax laws applicable to not-for-profit Borrowers differ in many respects from the rules laid out in the preceding chapters. Note that simply having a 501(c)(3) organization as a general partner in a limited partnership does not qualify a project for tax-exempt financing under these special 501(c)(3) rules because the Borrower is the limited partnership, not the 501(c)(3) organization.

Types of 501(c)(3) Borrowers. The tax treatment of a not-for-profit Borrower depends in part on the charitable purpose underlying the Borrower's 501(c)(3) status. Entities obtain 501(c)(3) status by applying to the Internal Revenue Service and setting forth in detail their proposed "charitable" activities. The most common charitable purposes encountered in the multifamily rental housing area are:

- (i) providing low-income housing for "relief of the poor and distressed", and
- (ii) "lessening the burdens of government."

As a general rule, not-for-profit Borrowers do not have to comply with the income restrictions of Section 142(d) (see below for an important exception to this rule). Rather, they have to meet affordable housing requirements related to their own charitable status.

19. In the nonprofit context, the tax law draws a fine line between "housing" and "health care." Housing developers should be aware that for a project to constitute multifamily housing for tax purposes, each rental unit must have its own cooking facilities. An assisted living facility with communal cooking and dining areas, for example, would be considered a health care project, not a housing project.

Safe Harbor for “relief of the poor and distressed.” The most common charitable purpose for housing nonprofit is what the tax law refers to as *relief of the poor and distressed*. Unlike the bright-line affordability rules for tax-exempt bonds and tax credits, the affordability guidelines applied to these 501(c)(3) corporations are “safe harbors.” In other words, a not for profit borrower developer can be assured of being considered charitable within the meaning of Section 501(c)(3) so long as it complies with the applicable affordability guidelines (set forth below). Failure to comply would not, however, guarantee a loss of 501(c)(3) status, given the right specific facts and circumstances, but the Borrower would not be able to avail itself of the safe harbor.

501(c)(3) organizations whose charitable purpose is the provision of affordable housing to relieve the poor and distressed are required to set aside 75% of their units for tenants whose income does not exceed 80% of area media income. 20% or 40% of the units (which may be part of the 75%), must also be set aside for tenants with incomes at or below 50% or 60% of the area median, respectively.²⁰

Lessening the Burdens of Government Organizations. Borrowers charged with *lessening the burdens of government* are subject to income and affordability limits that are individually set depending on the specific motivations of and government involvement in the organization. Organizations in which there is minimal government involvement should expect to set aside **100%** of the units in any multifamily rental housing project for tenants whose median income does not exceed **120%** of area median income and to satisfy something like the 20% at 50% or the 40% at 60% tests.

Special Rules for Acquisitions. In addition to complying with income restrictions related to their 501(c)(3) status, not-for-profit developers may, under certain circumstances, have to meet the income requirements of Section 142(d) (20% of units set aside for tenants at or below 50% of area median income, or 40% at 60%). Specifically, where a Borrower wants to acquire an existing multifamily rental housing project, rather than construct the project from the ground up, the

20. See IRS Revenue Procedure 96-32 for more details on these safe harbors.

tax code requires either “substantial rehabilitation” or compliance with the income restrictions of Section 142(d). Unlike the 15% rehabilitation requirement for for-profit Borrowers, substantial rehabilitation in this context means that a not-for-profit must spend on rehabilitation at least an amount equal to the total amount of bond proceeds used to acquire the buildings and other improvements (but not the land) that make up the project. This is often prohibitively expensive, leading Borrowers to opt for compliance with Section 142(d) instead.

No Volume Cap. Perhaps the most significant difference between tax-exempt bonds for which the Borrower is a 501(c)(3) organization (often called “501(c)(3) bonds”) and other tax exempt multifamily rental housing bonds is that ***501(c)(3) bonds do not receive an allocation of volume cap.*** In other words, there is no limit to the principal amount of 501(c)(3) bonds that can be issued in a state in any one year. This can be an advantage in states and/or development environments in which a prospective Borrower would otherwise have to compete for scarce volume cap. On the other hand, projects financed with 501(c)(3) bonds are not eligible to receive Low Income Housing Tax Credits under Section 42 of the Code (See “Federal Tax Law”).

State Law Differences. Many states have housing revenue bond statutes that track the requirements of the tax code. For example, a typical state statute would require the issuer of multifamily housing revenue bonds to ensure compliance with the Section 142(d) income restrictions, as well as possibly adding annual rent restrictions or extending the minimum project period. Because the tax code imposes different, and often more lenient, rules on not-for-profit Borrowers than their for-profit counterparts, some states have enacted alternative housing revenue bond statutes designed specifically to enable the issuance of 501(c)(3) bonds for multifamily rental housing projects. These statutes also often impose fewer burdens and restrictions on the Borrower than standard housing revenue bond statutes. Not-for-profit Borrowers should consult with bond counsel about the state law requirements that apply to their projects.

For-Profit Managers. Private developers, operators and managers may play a role in tax exempt financings by non-profit Borrowers. For example, a non-profit

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 (hereafter, for convenience, referred to as “managers”) are set out in Revenue Procedure 97-13 and restrict the term of the management contract, the compensation of the manager and the corporate relationship between the manager and the nonprofit corporation, generally as follows:

- (1) The term of the manager’s contract (including any renewal options exercisable unilaterally by the manager) may not exceed 15 years or such shorter term as may be required on account of the type of compensation provided.
- (2) Compensation must not be based on net profits and must meet one of several tests which restrict the way the manager’s fee is determined. Depending on how the manager’s fee is determined, the maximum term of the contract may be substantially less than 15 years.

In addition to the requirements above, to prevent the manager from having a relationship with the nonprofit Borrower that could substantially limit the nonprofit’s ability to exercise its rights under the management contract, the tax law does not allow the manager to control (for example, appoint) more than 20% of the members of the board of the nonprofit, and no board member of the nonprofit corporation may be the chief executive officer of the manager or its governing board (or vice versa).

CHAPTER TEN

Steps to Issuing Bonds

The scheduling and steps to completion of a multifamily housing revenue bond transaction depend on the choice of transaction type (conduit or pooled), choice of Issuer, the policies and procedures of the Issuer, the type of project, the type of Borrower (for-profit or not for-profit), the financing structure, applicable state law and other factors. In general, however, the following is illustrative of the basic steps in a typical tax-exempt bond issue for a Borrower of a multifamily rental housing project.

Consult Bond Counsel. Bond Counsel is the law firm primarily responsible for rendering an opinion on the validity and tax exemption of the Bonds and for drafting the legal documents to be executed by the Borrower and the Issuer in connection with the bond issue (and, in some cases, for creating a not-for-profit corporation to act as Borrower and obtaining a 501(c)(3) determination). It is important to have a Bond Counsel experienced in similar multifamily housing revenue bond financings and, given the tax-driven nature of most such financings, particularly experienced in the complex tax laws that govern the tax-exemption of interest on the Bonds.

It is important in Borrower-driven (*i.e.*, conduit) and in Issuer-driven (*i.e.*, pooled) financings to involve Bond Counsel early in the financing to determine whether the project(s) proposed for bond financing are eligible for tax-exempt financing and to help design the basic legal and structural conditions for such a financing. Most bond counsel will provide preliminary advice on these matters without charge.

Find a Lender (Public Sale or Private Placement). Because multifamily housing projects are generally financed on a project-by-project basis, rather

than on the Borrower's general credit, the Borrower needs to find a party to extend credit to its project in exchange for a real estate security interest in the project. This party, the Lender, could be the Issuer (in a pooled transaction), a credit enhancer (such as a letter-of-credit bank, Fannie Mae or Freddie Mac), a federal, state or local governmental entity other than the Issuer that underwrites multifamily housing projects, or a bond purchaser in a private placement. The Lender plays a major role in structuring the financing and is a driving force in the transaction. Lender's counsel typically prepares most or all of the real estate documents evidencing the lender's security interest in the project. Consulting a lender early is crucial to determining whether a transaction is feasible, what it will look like and when it can be completed.

Choose the Issuer. If the Lender is not going to be the Issuer, determine with Bond Counsel what public entity will serve as the Issuer of the Bonds. In some states or in some situations, there may be several possible issuers with different policies, procedures, politics, governing laws and fees.

Engage the Underwriter (Public Sale). For publicly sold bonds, the Underwriter is the investment banking firm responsible for marketing the bonds, helping to structure the financing, presenting the transaction to rating agencies to obtain ratings on the bonds and/or to bond insurers or credit providers, and purchasing (*i.e.*, underwriting) the Bonds for resale to investors. The Underwriter's counsel is primarily responsible for preparing the Bond Purchase Contract and, in many transactions, the Official Statement. If a Lender has not yet been brought into the transaction (see above), consulting the Underwriter early may help determine the basic structure of the financing with Bond Counsel, what sort of lenders would be willing to extend credit to the project and what rates of interest the Borrower can expect to pay.

Consider a Financial Advisor. Because there are pros and cons to different structures and because there are many underwriters and private placement buyers from which to choose, some Issuers and Borrowers engage a financing consultant or financial advisor to explore the options and recommend the best approach

for their project. These consultants are familiar with the variety of financing structures and often can help with the tax credit side of transactions as well.

Adopt a Reimbursement Resolution. If the Borrower intends to use bond proceeds to reimburse itself for project expenditures incurred prior to the issuance of the bonds, the Borrower will want the issuer to pass a “reimbursement resolution” establishing a date after which (and up to 60 days before which) costs incurred can be reimbursed with bond proceeds. Bond Counsel can describe the specific tax rules regarding reimbursements and will normally provide this fairly simple resolution on request.

Apply for (and Receive) Volume Cap/Tax Credits. Unless the Borrower is a 501(c)(3) corporation, the project will need to receive an allocation of volume cap authority (see “Federal Tax Law”) to have tax-exempt private activity bonds issued on its behalf. The Issuer and the Borrower should become familiar with the application procedures for volume cap (and tax credits, if the project will be financed in part with tax credits) in the state(s) where project(s) will be located.

Conduct TEFRA Hearing and Approval. See “Federal Tax Law,” above. Bond counsel is normally responsible for making sure the TEFRA process is completed. From a tax law standpoint, TEFRA approval does not need to be received until just before the transaction closes, but Issuers and other entities having control over the transaction (such as the state board charged with allocating volume cap) often require TEFRA approval early on.

Drafts of Documents. Bond Counsel, Underwriter’s Counsel and Lender’s Counsel prepare and circulate to the working group drafts of the bond documents, the underwriting documents and the loan documents. These typically include some combination of an Indenture, a Loan Agreement, a Regulatory Agreement, a Bond Purchase Agreement, an Official Statement, a Letter of Credit or Credit Enhancement Agreement, a Reimbursement Agreement, a Promissory Note, a Mortgage or Deed of Trust, subordination and intercreditor agreements, and ancillary loan security documents. Alternative documentation may be used in the case of a private placement.

Conference Calls. The finance team holds conference calls to discuss the foregoing documents, followed each time by circulation of revised drafts.

Issuer Approval. After receiving substantially final drafts of any major document to which it is a party, the bond issuer adopts a bond resolution (drafted by bond counsel) authorizing the sale and issuance of the bonds, execution and delivery of the legal documents, and distribution of the Official Statement, if any.

Preliminary Official Statement. For a public sale, a preliminary Official Statement containing information about the bonds, the Issuer, the project and any credit enhancement, but excluding certain final pricing information, is mailed to potential purchasers of the Bonds. In the case of variable rate demand bonds that can be put (i.e., sold back to the Issuer) on seven days' (or other short) notice, the delivery of a Preliminary Official Statement is optional.

Credit Approval. After reviewing the bond documents and other documents, as well as projected project cash flow numbers, the Lender (which may be the Issuer, a credit enhancer or the bond purchaser) issues a commitment to extend credit to the project.

Bond Sale. For a public sale, the underwriter completes marketing of the bonds to the public and enters into the Bond Purchase Contract with the Issuer, which is usually accepted and approved by the Borrower in the case of a conduit transaction. For variable rate bonds, this step may take place the day before closing; for fixed rate bonds, the bond sale occurs a week or more before closing.

Final Official Statement. For a public sale, a final Official Statement containing the final sale information is prepared for delivery to purchasers of the Bonds at or before receipt of their purchase confirmations.

Closing. The Bonds are delivered to the Underwriter or directly to the bondholder, as the case may be, in exchange for payment of the purchase price of the Bonds simultaneously with delivery of final executed copies of the legal

documents, and various certificates, receipts and opinions. In the case of a conduit financing, the loan is typically funded concurrently, and real estate documents securing the loan of the bond proceeds to the Borrower, as well as the Regulatory Agreement, are recorded in the county recorder's office of the county in which the project is located.

About the Author

Justin Cooper is co-chair of Orrick's nationally prominent housing finance group. Mr. Cooper has an active multifamily housing revenue bond practice in California and elsewhere in the western United States, serving as bond counsel, underwriter's counsel and lender's counsel. He also serves as bond counsel and underwriter's counsel for single-family mortgage bond transactions. Mr. Cooper has represented financial institutions in connection with financings involving total return swaps, secured puts and other derivative-based financings.

