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Memorandum

TO: Solutions Group Members

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SUBJECT: Rural Joint Ownership Entity - Structure and Operations

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Rural Joint Ownership Entity

Structure and Operations

I. Concept and Guiding Principles

This paper imagines the optimum structure for a Rural Joint Ownership Entity ("***R-JOE***") that seeks to balance the imperative for economies of scale in the development, financing, operation and preservation of small rural affordable housing projects and the desire for maximum control by the local non-profit organizations (each, an "***NPO***") that traditionally have sponsored rural housing projects.

Typically, rural housing projects are relatively small (20-40 units) and dispersed. Their residents frequently come from the surrounding community and are closely integrated into them. Traditionally, rural housing projects have been owned by NPOs (including community development corporations, land trusts and other structures) operating on a local or regional basis. These organizations derive much of their strength from the immediate connections between the people involved in the organization (members, board members, and contributors); local governmental entities; related networks of service providers; and the housing projects they sponsor.

Those very strengths, however, bring limitations. Small community-based NPOs may have a shallower pool of involved supporters and be more vulnerable to ebbs and flows in enthusiasm, energy, talent and monetary support. Rural projects, by virtue of their small size if nothing else, may suffer from relatively high per-unit operating costs and be vulnerable to occupancy fluctuations. Projects located in economically challenged rural areas may have inadequate income to meet maintenance and operation needs. And stressed projects lead to stressed owners, which may adversely impact the ability to retain dedicated and talented staff and directors, in a worsening feedback loop.

Preservation and redevelopment situations, in particular, illustrate the disadvantages faced by rural housing organizations. Tax-exempt bond financing that is necessary in order to access 4% Low-Income Housing Tax Credits ("***LIHTC***"s)[1] has high fixed-costs that can be prohibitive when not spread across a large unit count. Likewise, even where a small project can qualify for LIHTC on paper, it is likely to be unattractive to many investors who likewise have threshold costs regardless of project size, on top of reservations they may have based on lack of CRA credit and doubts about rural projects generally (whether based on unfamiliarity or actual characteristics).

This paper, then, sets outs a structure in which local NPOs may combine and jointly access capital for rural housing preservation, while preserving as much as possible of the independence and local control that gives them strength and vitality. Broadly speaking, this model proposes the formation of a single entity that can own multiple small projects, finance them under a common plan, and perhaps provide financial and staff resources for operations and asset management, but that looks to local NPOs to support and operate each property and have primary ownership of its success or failure.

While anyone who considers the issues posed and choices made in this paper will readily see an overall tension between "efficiency" considerations and "local control" considerations, we caution against too hastily assuming these are always tradeoffs; we are optimistic that thoughtful balancing between the two poles will contribute strength to each. Ideally, retaining a strong degree of local involvement in, and control over, each project will result not only in personal and community commitment, creativity, enthusiasm and other "soft" virtues, but efficiencies in project operation, prompt attention to problems, and other virtues that have real effects on a project's bottom line and on the pooled projects' attractiveness to capital providers.

II. Organizational Structure

A "***Rural Joint Ownership Entity***", or "***R-JOE***" as we have unimaginatively named it, is an entity formed by multiple local NPOs to acquire and own affordable housing projects that are currently owned by each of those local NPOs individually. As discussed in more detail below, an R-JOE would presumably be organized to acquire projects that require recapitalization, at a time when they are ripe for recapitalization. Thus, the model assumes that each NPO member would contribute (in a colloquial, not a legal, sense) one or more affordable housing projects (each, hereafter, a "***Project***") that may be exiting or have exited an initial tax credit compliance period and require recapitalization for the purpose of effecting repairs and improvements.

[1] Under the tax reform bill passed the House of Representatives, private activity bonds would lose their tax exemption and the 4% LIHTC would be eliminated. The Senate bill retains tax exemption for private activity bonds. The disparity is to be resolved in conference.

As shown on the accompanying organization chart, it is proposed that the member NPOs or their respective affiliates (each, hereafter, a "***Member***") acquire membership interests in a limited liability company referred to on the chart as the "***JOE GP, LLC***", which entity in turn would serve as general partner of a limited partnership[2] whose other partner would be an investor limited partner (hereafter the "***Investor***"); the limited partnership would be the R-JOE. As in all such owner entities for LIHTC properties, the GP would own an approximate .01% interest, and the Investor would own an approximate 99.9% interest for which it would make a substantial equity contribution.

Within the R-JOE, the GP serves as a vehicle both to (i) represent the common and collective interests of the NPO Members and (ii) meet common and collective obligations to the Investor.

In a conventional syndicated housing ownership entity, a general partner would be required to:

- Contract for development services to accomplish the design, construction financing and execution of necessary repairs and improvements;
- Structure and obtain permanent financing;
- Engage and oversee a property manager;
- Oversee and ensure Project stabilization and continued operation in accordance with all legal and third-party requirements, including LIHTC requirements; and
- Perform or oversee necessary partnership management functions, including accounting, legal compliance, and tax and other reporting.

The structure proposed here contemplates that JOE GP would indeed perform all these functions, but with respect to each Project owned by the R-JOE would delegate them to the individual Member that has a prior relationship with that Project (the "***Project Member***"). Particulars of that delegation are discussed in the following section. If a Member were to prove unable to meet its obligations satisfactorily, however, the JOE GP would retain the authority, and would need to maintain the ability in fact, to perform those obligations.

Very clearly, the interplay of these rights and obligations is a sensitive matter requiring careful consideration and the thoughtful allocation of incentives and consequences. The same model that gives maximum incentives and authority to the Project Members with respect to their local

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[2] The choices of a limited liability company for the GP entity and a limited partnership for the ownership entity are to some extent random, and illustrate that any prescription of organizational forms is necessarily generic. The actual choice of entities in a particular state would be made by local counsel based on state and federal law as well as prevalent practice with which investors are most familiar. (For instance, HUD requires the use of limited partnerships and not limited liability companies in the syndication of a Section 202 elderly project.) Additionally, there might be situations where it was optimal for the NPOs to form a corporation that was the sole member of the GP. One such situation might be if it was desirable for the GP itself to gain recognition under Section 501(c)(3).

Project, will give the least incentive for Members collectively to assist each other proactively. By contrast, a model that places greater emphasis on collective responsibility for each Project, and collective share of any benefits that flow from it, may be seen to encourage interference and diffuse responsibility. We have tried to go beyond the simple appeal of phrases like "local control" and "collective strength" to think through what allocation of powers, responsibilities, and economic consequences is likely, ordinarily, to result in the best operation of each Project, while providing assurance to lenders and investors that someone will step in to fix problems before they have to.

We should emphasize that this last point – providing assurance to lenders and investors – need not go unquestioned as a necessary feature of the model, or at least should be seen, like other features, as one of degree. It could reasonably be argued that each Member has enough to do managing its own Project(s), and if some other Member's Project encounters problems, the Investor should be the one to intervene. This proposal, however, starts from the perspective that potential investors will far more readily be attracted to rural housing projects if given some assurance that local NPOs will collectively form a first line of defense against problems, and serve as the strength multiplier that bundling proverbially brings to individual sticks.

The model described here resolves these entirely legitimate different perspectives with a bias toward local control, with a concomitant local focus to risks and rewards, as the base line for Project operations, and accordingly for the allocation of responsibilities within the R-JOE and JOE GP. However, it provides Members with the authority to assist when requested and to step in when necessary, and ultimately exposes them to financial consequences should they fail to do so.

III. Project Member Responsibilities and Rights

A. Responsibilities: It is intended that each Project Member have direct responsibility for the Project(s) it brings to the R-JOE, more-or-less similarly to if it was the general partner in a partnership that owned them. Elements of this responsibility would include, directly or through affiliated entities:

1. Provide development services to plan and accomplish necessary renovation and improvements;

2. Prepare financing applications particular to that Project, if any, and pursue the same;

3. Provide property management services or oversight and asset management;

4. Provide all Project-level guarantees to lenders and Investor (completion, timing adjusters, tax credit compliance, operating deficits);

5. Replenish Project reserves to the extent required. (See reserve discussion below).

B. Rights/Benefits: It is intended that each Project Member receive all or a substantial part of the benefits generated by the Project(s) it brings to the R-JOE, more-or-less similarly to if it was the general partner in a partnership that owned them. Elements of these benefits would include, directly or through affiliated entities:

1. Receive some or all of the attributable developer fee (with any balance going to JOE GP to fund operations or backstop reserves);

2. Receive property management fee;

3. Receive portion of Project cash flow (as payment from R-JOE on seller note, and/or as special allocation within JOE GP operating agreement);

4. Hold first priority Right of First Refusal and Purchase Option.

C. The foregoing rights and obligations could be documented in various ways, and further thought is warranted in addition to specific state law analysis. At present we suggest:

1. JOE GP, as general partner of R-JOE, would have full and usual responsibility to the Investor for the redevelopment and operation of all Projects owned by R-JOE, and would be entitled to the shares of income, gain etc. specified in the R-JOE partnership agreement;

2. Each Member, as an aspect of their membership in JOE GP, would be responsible under the JOE GP operating agreement for the redevelopment and operation of the Member's Project(s). Thus, although it would be expected that the JOE GP operating agreement would provide for the limited liability company to be managed by a Manager and would detail "Major Actions" for which Member consensus was required, the Project Member would be revocably delegated the Manager's authority for matters only affecting that Member's Project(s), and would not need the consent of other Members to take action pursuant to the delegation.

3. Each Project Member while exercising the foregoing authority would be personally responsible for JOE GP's obligations with respect to the Project, such as payment of development deficits and operating deficits, payment of timing adjusters, replenishment of reserves, and payment of tax credit compliance guarantees.

4. JOE GP by decision of the other Members could revoke this delegation of authority and take over the Project development and/or operation under specified circumstances, which might include some or all of:

a) Any failure of the Project Member to meet material obligations of JOE GP under the R-JOE partnership agreement or any loan or regulatory documents affecting the Project;

b) Any failure of the Project Member to accomplish a cure of a default noticed by a Project lender, Investor or governmental regulator within the cure period;

c) Any development period delay or cost overrun beyond some threshold; any persistent operating deficit; repeated inspection failures;

d) Material adverse change in the financial or staff capacity of the Project Member that reasonably puts in question its ability to meet its obligations with respect to the Project.

5. Where it is usual and customary to document such relationships through a separate service and fee agreement, as with development services agreements and property management agreements, R-JOE would enter into such agreements with the Project Members.

6. Under the JOE GP operating agreement the Project Member could receive a special allocation of a portion of whatever income, gain, etc. was realized by JOE GP with respect to that Project.

IV. <u>Backstop Authority and Rights of JOE GP and Members Collectively</u>

A. An aspect of making this package attractive to an Investor is for the Members collectively to joint and severally guaranty the performance by each Project Member of its obligations. While the Project Member would have first and primary exposure under its guarantees with respect to its Project, if the Project Member did not or could not perform its obligations and/or honor its guaranties, then JOE GP and its other Members would be required to backstop those guaranties. Presumably, potential guarantee exposure would compel JOE GP and all its Members to step in and try to remedy the situation before their backstop guaranty was called.

B. Ideally, all collective responsibility of the Members would be concentrated in JOE GP, which would maintain sufficient assets (funded by developer fees, Member contributions, or other sources) to satisfy the Investor. These assets could be retained in an operating reserve or a replacement reserve, or as general equity available to support all guarantees

C. To the extent that the assets of JOE GP were insufficient to backstop the Project Members' individual and Project-specific guarantees in a manner acceptable to an Investor, the Members could jointly and severally provide guarantees backed by their own individual assets. Various devices could be used to limit the exposure of an individual Member to the failure of another Member, with the caveat that some of those devices would be unappealing to an Investor:

1. Each Member's backstop guaranty could be limited to some finite number or a percentage of the Member's net worth;

2. Each Member's backstop guaranty could be sized, relative to other Members' guarantees, based on that Member's number of units in the R-JOE relative to others.

3. Each Member's backstop guaranty for a particular claim could be limited to a percentage of that claim, thereby forcing the Investor to collect a portion of the guarantee from each Member.

Regardless of the guarantee provided to the Investor, the Members would all be party to a Risk-Sharing and Contribution Agreement requiring each to bear their share of any common guarantee exposure, so that if the Investor collected the entire guarantee from one Member, the others would be required to reimburse that Member for their share of the liability.

D. Specific Rights/Benefits of JOE GP

1. Earn that part of developer fee and cash flow that is not payable to Project Member; use to pay common costs and fund upper level reserves;

2. Hold Second Priority Right of First Refusal and Purchase Option.

V. Meeting the Backstop Obligations and Asset Management Needs of R-JOE

A. If JOE GP and its Members collectively are to have financial exposure to setbacks suffered by any particular Project that are not successfully dealt with by the Project Member, and/or are expected to step in to address problems before they become crises, then serious thought needs to be given to the staffing and capacity of JOE GP. It is not enough to say that Project performance reports should be sent to JOE GP; someone with appropriate training and ability needs to review them, spot issues, seek answers, and provide assistance as appropriate. Each of these functions could be performed by dedicated JOE GP staff or by the staff of a particular Member engaged by JOE GP for that purpose. In either event, third-party asset manager could be engaged to assist. However, there should realistic assessment of the ability of individuals with primary responsibility for their own organizations and projects, to effectively monitor the projects or organizations of others, much less to step in if something were going wrong with an "orphan Project".

B. Accordingly, R-JOEs should be cautious about admitting Members or accepting Projects which are challenged at the outset. We are not saying this should not be done; the very purpose of the R-JOE is to address the difficult circmstances and uneven capacity of small rural sponsors. However, to the extent that an R-JOE knows it there is a distinct risk of Member failure or Project failure, it needs to pay more attention to its own ability to step in effectively.

C. Likewise, the model permits the Members to approve acquiring a Project from an NPO that from the outset does not wish to continue in operation, or at least to be a Member. There is no reason in theory that another Member could not serve as the Project Member for this orphan project, but the practicalities should be examined thoughtfully.

VI. Mechanics of Project Acquisition and Financing

A. Presuming that the point of this exercise is to recapitalize the Projects using a single issuance of tax-exempt bonds and resulting 4% LIHTC , the R-JOE would need to acquire the Projects by purchase from an unrelated seller in accordance with Code Section 42 (d)(2). Compliance with this provision has various technical requirements that must be observed, but that should not create major obstacles, including:

1. No Member may have more than a 50% interest in the R-JOE, and thus no Member may receive more than 50% of all items of income, gain, etc.

2. The Investor also may not have had more than a 50% interest in any Project seller. Observing this rule may require investigation into previous upper-tier investors, and sometimes requires inquiring into whether a previous investor has been absorbed by merger into the current Investor.

3. The Project must have been last placed in service more than 10 years ago, unless an exception applies. One exception we presume will frequently apply is if the NPO has acquired the Project, or 100% of ownership interests, by exercise of its Right of First Refusal; provided, that the ten-year rule was met at the time of that acquisition. Another possibly relevant exception would be the exception for projects that are substantially assisted by certain federal or state housing programs.

B. The R-JOE could acquire the Projects at or prior to the bond issuance and syndication, but any earlier acquisition (presumably with seller take-back financing) would need to be observant of applicable rules, including:

1. Acquisition should not precede by more than 60 days the adoption of a bond inducement resolution.

2. If 9% credits are used (which we recognize is not the expectation), acquisition cannot be earlier than the year of the carryover allocation.

C. While acquisition of the Member’s partnership interests in the old owner entity would presumably be possible, it would not create basis qualifying for 4% credits. For the R-JOE to have acquisition basis qualifying for tax credits, a fee (or capital leasehold) transfer is required. Accordingly, transfer taxes and recording costs due under state law would need to be budgeted.

D. If a Project is owned by a partnership in which an investor is still present who has a material claim on disposition proceeds, it may be advantageous to have the Member exercise its right of first refusal to take out the investor at the lowest possible cost, and then transfer the Project to the R-JOE for the highest price justifiable by appraisal.

E. This model assumes that all Projects are located in the same state, so that a single entity – presumably the housing finance agency – could issue bonds and award credits. No HFA would have jurisdiction to do so in another state. While in theory one owner could own projects in two states, separately financed, that would not seem to offer cost savings relative to two state-specific owners. In either case there would be separate costs of bond issuance, and while one syndication rather than two might appear economical, we believe that (a) any savings would be modest, since the syndication structure could be identical but for underwriting and document provisions relating to the separate financings, and (b) an investor would not unreasonably have concerns about the implications of one HFA taking actions with respect to half the portfolio, putting the other half at risk.

F. This model also assumes that each Project is 100% LIHTC; mixed-income buildings may be treated as a single tax credit project only if they are contiguous properties. (Non-contiguous properties that are 100% LIHTC cannot be treated as a single project for bond purposes, but can still achieve substantial economies if they are treated as separate bond projects financed with a single bond issuance.)

G. It is presumed that some Projects will be transferred to R-JOE subject to debt (likely soft governmental debt) or use restrictions. We see no apparent problems arising from this, other than the need to obtain consent to transfer from the lienholder or regulator.

H. Consideration should be given to reserve structure. The concept of having individual Members manage individual Projects, and stand behind their financial stability at least up to some point, would be consistent with having Project-level reserves over which the Project Member had control (and not other Members, but still subject to requisite third-party consents), perhaps backstopped by a general reserve subject to collective Member control (again, subject to requisite consents).

I. Corollary consideration should be given to the treatment of reserves held by the previous owner prior to Project acquisition by the R-JOE. Perhaps the Project Member could have a general duty to inject funding into its Project, whether by transferring the old reserves, contributing part of its developer fee, or otherwise.

VII. Valuation of Projects; Membership Interests

A. Presumably R-JOE would want to acquire Projects for the highest amount supported by an appraisal, in order to maximize LIHTC basis. Presumably as well, for each Project, the R-JOE would pay the same percentages of the price in cash and assumption of debt (if any) and through a seller note, in order to treat each Member equitably. As suggested above, seller notes could be structured as a vehicle for the Project Manager to capture some percentage of the cash flow that the R-JOE would otherwise realize from the applicable Project.

B. Because each Member of JOE GP is selling, not contributing, its Project(s) to the R-JOE, the Member's capital account in JOE GP would have no necessary relation to the size or value of the Member's Project(s). Moreover, if the Member retains substantial authority over the Project, it will receive a property management fee and perhaps a special allocation of cash flow. Accordingly, there is no evident reason why a Member's voting rights or economic interest within the JOE GP should be based on the size or other characteristics of the Member's Project(s). (This is in contrast to JOE NYC, where members are awarded economic interests based on the characteristics of the projects they contribute.)

C. If a Member's interest in JOE GP need not be related to the size or value of the Project it brings in, or the number of Projects, other determinants of economic interests and voting rights suggest themselves, including:

1. Members could have equal interests (one Member, one vote); or

2. Members could have interests based on their guarantee exposure as a percentage of all exposure.

VIII. New Project Development

A. The model described in this paper is for the purpose of consolidating ownership of small existing Projects for recapitalization purposes. There is, however, no a priori reason that the R-JOE could not act as sponsor of a new development Project on behalf of a Member. While presumably the new Project would need separate financing even if developed contemporaneously with the perseveration effort, and would thus be subject to the diseconomies of small scale that burden any rural housing Project, the reputation and back-up strength of the R-JOE might work to reduce financing costs.