



Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Jacky Morales-Ferrand

SUBJECT: SEE BELOW

DATE: March 17, 2016

Approved

Date

3/17/16

COUNCIL DISTRICT: 5

SUBJECT: RELEASE OF THE SETTLEMENT RESERVE AND OTHER ACTIONS FOR FAIRWAYS AT SAN ANTONIO COURT APARTMENTS

RECOMMENDATION

Adopt a resolution:

1. Authorizing the Director of Housing to:
 - a. Negotiate and execute an amendment or termination for the three-party Litigation Reserve and Security Agreement (“Reserve Agreement”) between San Jose Family Housing Partners, L.P. (“Borrower”), Citicorp USA, Inc., and the City, and to any other necessary documents such that up to \$505,000 of City settlement reserve funds can be distributed with 75% of the proceeds distributed to Borrower and 25% to the City, and allowing the use of the proceeds disbursed to Borrower for certain Borrower costs including those incurred with respect to the billboard litigation, for the Fairways at San Antonio Court Apartments (“Fairways,” “Apartments” or “Development”), a restricted affordable rental development located at 305 San Antonio Court;
 - b. Negotiate and execute amendments to existing loan documents to implement the changes described in the memorandum including allowing City funds to be used for the costs of litigation incurred by the Borrower’s managing general partner, the Affirmed Housing Group (“Affirmed” or “Developer”) and changes regarding the amount and accrual of Partnership Administration Fees described below; and
 - c. Negotiate and execute amendments to existing loan documents, program agreements, and other documents as needed to implement a Transition In Place (“TIP”) program to house homeless individuals or families in nine (9) of Fairways’ apartments and any other consideration obtained by the City.

OUTCOME

Approval of the recommendation will authorize the Borrower to use City funds that have been held in reserve since 2010 for costs of litigation incurred by the Borrower's managing general partner, which is not currently allowed under the City loan documents. This approval will also allow staff to create nine Transition in Place apartments for participants in the City's General Fund homeless rental coupon program, and to make other amendments to benefit the City.

BACKGROUND

City Commitments and Billboard Litigation History

On February 13, 2007, the City Council approved a construction/permanent funding commitment of up to \$7,679,570, with \$2,120,000 in the form of a land acquisition loan, to Affirmed Housing Group (or its legal affiliate) for the development of an 86-unit restricted affordable apartment development called Fairways at San Antonio Court.

On November 20, 2007, the City Council approved an increase of \$1,150,000 to its funding commitment and authorized staff to close its acquisition loan despite pending litigation on a billboard located on a parcel contiguous to the Development's site. The lawsuit, filed in September 2007, contended that Fairways would obstruct the public's view of the billboard and would therefore diminish its value. The City loan documents initially required that \$500,000 of the increased amount was to be withheld "until such time as the City determines that all claims or actions regarding the commercial billboard on the Property have been satisfactorily resolved."

In return for the funding increase, the Developer deepened affordability of the Apartments and deferred approximately \$600,000 in developer fee, which would be taken over several years as a priority distribution from the Development's net cash flows once it was in operation. The Developer also provided the City with a completion guaranty and an indemnification of the City against any settlement costs. The Development was successfully completed in 2009. The billboard litigation was not yet resolved in March 2010 when the Development's funding converted from construction financing to its permanent financing period. At that time, the City authorized the transfer of the undisbursed \$500,000 in City funds into a combined reserve account held by the senior lender, together with \$535,403 of the Borrower's funds for a total reserve of \$1,035,403 ("Reserve"). The Reserve remains held in an account with the senior lender ("Citibank" or "Citicorp") and governed by a tri-party Litigation Reserve and Security Agreement ("Reserve Agreement") between the City, the Borrower, and Citicorp. The Agreement specified that the City's portion of the Reserve ("City Reserve") was to be used to "settle or discharge the Judgment" and was not to be used for "Borrower's legal fees and expenses."

The City Council authorization and the loan documents specified that the use of the reserve was limited to potential costs of a settlement award, and was not to reimburse attorneys' costs. In the City's Loan Agreement, the Borrower and City agreed that, to the extent that they were not

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needed for legal settlement costs, the funds in the Reserve would be disbursed 75% to the Borrower and 25% to the City.

After the billboard was determined not to be a permitted billboard, the parties to the litigation agreed not to pursue further action. Thus, while the Borrower incurred legal costs, there was no legal settlement payment required. Citibank agreed to release all but \$50,000 of the Borrower funded portion of required Reserve in 2012.

Borrower Request

When the Reserve Agreement was established, it was anticipated that the billboard litigation would be settled quickly. At the time, there were development-related expenses to which the City's portion of the Reserve funds could have been applied (e.g., deferred developer fees). Most of these costs have been paid for during the extended litigation period. At the same time, the extended litigation period resulted in higher than expected litigation costs for the Developer. To defend the lawsuit, Affirmed Housing incurred total legal costs of approximately \$281,000 on behalf of the Borrower entity, of which an Affirmed affiliate is a part owner.

Although there were no settlement costs at the conclusion of the litigation, Borrower has requested that the City Reserve nevertheless be released as a distribution per the proportions identified in the Reserve Agreement. The balance of the City Reserve, approximately \$505,000 which includes accrued interest, would be distributed as follows:

25% to the City (for fees and loan repayment)	approximately \$126,250
75% to Borrower as Project Income	<u>approximately \$378,750</u>
Total City Reserve Disbursements	approximately \$505,000

Borrower requests to use Reserve proceeds to reimburse Development-related costs, as detailed below. In addition, Developer has requested that the City synchronize its terms for payment of the Partnership Administration Fee with those of the Borrower's partnership agreement to allow annual Partnership Administration Fees to escalate over time and to accrue without interest if not paid in the current year so they can be paid in future years, consistent with the Second Amended and Restated Partnership Agreement ("Partnership Agreement").

ANALYSIS

When the City commits subsidies to affordable apartment developments, it acts as 'gap lender,' filling the gap between the funds needed to pay for all development costs and the existing available funds. If more funds are committed than are needed for actual development costs, the City lowers its loan amount, liquidates that part of that development's funding commitment, and uses the funds elsewhere.

However, rather than recapture the full amount of the \$505,000 City Reserve at this time, Housing Department staff recommends that it instead permit a release of the Reserve in order to

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pay for unreimbursed Development-related expenses, to the extent they had not already been reimbursed in full by annual distributions of Development net cash flow.

The proposed uses for the Reserve funds are as follows, as seen in the chart below: first, the remaining deferred developer fee (which should be paid off fully with this distribution); second, approximately \$281,000 in unreimbursed legal fees related to the billboard litigation incurred during the eight-year litigation period; third, escalated and accumulated partnership administration fees, which are standard in tax credit developments to reimburse yearly work overseeing audits and reports internal to the partnership that owns the Development.

<u>Unreimbursed Expenses</u>	<u>Amounts</u>
Deferred Developer Fee	\$37,013
Legal Costs from defense of billboard litigation	\$281,000
Accumulated and unpaid Partnership Administration Fee	\$74,013
Total	\$392,026

While deferred developer fees are already included in the City's Promissory Note ("Note") "permitted expenses" definition, the other items are not. In order to permit all of these expenses to be paid in a priority position to loan repayments to the City, the Note would need to be edited. Therefore, the changes to the City's documents would include:

- Clarification that the City Reserve liquidation flows through the funding "waterfall" in the Note;
- Expansion of these Development-related expenses as "permitted expenses" in the Note, therefore allowing the Borrower to be reimbursed by the City Reserve distribution; and
- Recitals explaining that the City accepted a distribution of approximately \$126,250 of City Reserve proceeds.

Because the Borrower's share of the City Reserve is approximately \$378,750, the remaining amount of these proposed Permitted Expenses (\$13,276) would be funded out of future project net cash flow in a priority ahead of the City's loan and interest payments. Any remaining distribution of annual net operating proceeds would also be applied to outstanding permitted Development-related expenses per the newly-edited Note.

The analysis of staff's rationale for allowing each expense follows below.

Eligible Uses

The Development-related expenses proposed to be reimbursed are eligible uses under the City Loan's funding source—former redevelopment 20% tax increment. Staff will review evidence of these expenditures before authorizing reimbursements to ensure they were actually incurred by the Development's partnership, and that they remain outstanding at the time of the reimbursement request. To the extent they are no longer outstanding in these precise amounts, other ongoing Development-related expenses also could be eligible for reimbursement, such as approved deposits to required project reserves.

Deferred Developer Fee

The deferred developer fee is already a permitted expense in the Note. In underwriting transactions, tax credit investors require that a deferred developer fee can be shown to be fully earned during a certain period of time. Therefore, payments to deferred developer fees typically have a priority distribution in all financing documents for Low Income Housing Tax Credit deals. Most affordable rental housing developers are able to take their developer fee within one to three years after conversion to permanent period. In the case of this Development, Affirmed will have taken six years to fully earn its developer fee.

Staff acknowledges that the deferral period has been lengthy and supports a final payout to Affirmed through this mechanism. In addition, annual repayments to the City's loan and interest as a share of annual net cash flows should increase in the future, as the deferred developer fee will have been paid in full and will no longer receive a priority distribution.

Borrower Legal Fees

The Borrower's legal expenses were specifically excluded from reimbursement out of the City Reserve funds in order to: 1) Insulate the City from unknown legal costs in the early stages of litigation, both as gap lender and as potential party to the litigation; and 2) Discourage risk-seeking behavior at the City's cost by Affirmed or by other developers;

The goals of the original limitation on use of these funds have been met in the following ways: 1) The City was not exposed to unknown financial risks, and the \$281,000 cost is not exorbitant, especially given the length of time that litigation took; 2) Risk-seeking behavior by developers has been already discouraged by the City's strict requirements—especially given the protracted period for which the Developer has been out-of-pocket to reimburse legal expenses and has been unable to collect its full deferred developer fee; 3) The site was developed promptly and the apartments have been occupied for over six years, meeting urgent affordable housing needs of its residents.

As the City's objectives have already been met, staff recommends allowing \$281,000 in legal expenses to be reimbursed by funds in the City Reserve.

Partnership Administration Fees' Escalation and Accrual

Partnership Administration Fees up to a certain amount are a Permitted Expense in the Note. This fee is typically included in all affordable housing projects with Low Income Housing Tax Credits. It is intended to reimburse the general partner (and project sponsor) for the costs of oversight, management, and reporting to a development's investors and lenders during the term of the partnership. However, the Note does not specify that these fees can escalate. Furthermore, to the extent that they are not payable out of current property net cash flow, they cannot accrue for the purpose of payment in a future year.

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The Development's cash flow projection that staff approved at original underwriting did incorporate incremental annual escalations to the Partnership Administration Fee amount. Escalations were consistent with the City's underwriting policies at that time. Therefore, staff believes that escalation language was unintentionally omitted from the Note. The proposed escalation factor is one already used in the Borrower's Second Amended and Restated Partnership Agreement ("Partnership Agreement") based on the annual percentage increase in the national Consumer Price Index ("CPI"). Staff is able to administer this index, as it is one that certain other deals have also used. As it is a national average, it is also likely more predictable and moderate than a local CPI index could be. The current year-over-year increase is approximately 1.4%. For these reasons, staff recommends edits to the Note to include an escalation at CPI consistent with the Partnership Agreement.

Accrual of the Partnership Administration Fee is permitted under the Borrower's partnership agreement. The Partnership Administration Fee reimburses costs for work that must be performed and reimburses costs that must be incurred regardless of whether the property has sufficient cash flow to cover the costs. The City's underwriting policies do not address accrual of these permitted fees. Practices vary among transactions in the City's loan portfolio. However, the Fee is particularly important to those properties with relatively thin revenues compared to expenses, such as Fairways is experiencing. Therefore, staff agrees that it is acceptable to allow a priority payment for these accumulated Partnership Administration Fees for Fairways, and recommends that edits be made to the City's Promissory Note to clarify the Partnership Administration Fee's permitted accrual.

Consideration

As consideration for making the recommended changes, Borrower has agreed to give the City the following:

1. An extension of the Apartments' term of affordability from 55 to 60 years.
2. A right to refer tenants to nine apartments designated for the City's Transition in Place ("TIP") homeless housing program. This will allow the City or its designee to refer non-chronic homeless households possessing a rental subsidy to nine of the Development's apartments as they become vacant. This referral right is ongoing. The TIP coupons financed from the City's General Fund will help an individual renter for two years. After this time, it is expected that the individual will be employed and able to afford a normal rent for households at or below 30% of area median income without a rental subsidy. If and when the former coupon-holder vacates that apartment, Affirmed will make the apartment, or a comparable apartment, available ongoing to future referred rent subsidy-holders so as to maintain a total of nine TIP units at any given time, subject to availability.
3. Edits to the City's documents to reflect the Housing Department's current practices. These include requiring enhanced operating covenants of the Borrower and payment of annual monitoring fees to help recoup City staff costs.

Finally, this action delegates to the Director of Housing the authority to negotiate and execute all documents necessary to effectuate the disbursement of the City Reserve for the specified uses, to

make clarifications on Partnership Administration Fees, and to incorporate the above consideration to the City. This package of changes is to the City's benefit and is sufficient for the specified actions.

EVALUATION AND FOLLOW-UP

The recommended actions will effectively close out the arrangements put in place to manage the Development's billboard litigation risks. No evaluation or follow-up is therefore anticipated in this regard. The Housing Department will include the nine TIP units in its periodic reporting to the Council on progress in housing the homeless.

POLICY ALTERNATIVES

In developing the recommendations set forth in this memorandum, the following alternative was considered:

Alternative #1: *Deny the Borrower's request to disburse City Reserve funds, and recapture the funds in their entirety.*

Pros: The City would receive up to \$505,000 that it could use in another project to help the City meet its priorities.

Cons: Affirmed Housing took considerable risk, incurred direct costs, and deferred a significant amount of fee income for several years as a result of lengthy litigation in order to create Fairways Apartments, an attractive asset that provides much-needed affordable housing for the community. Affirmed kept its obligations, and the proposed costs to be reimbursed are allowable and reasonable. Further, the City's objectives for limiting the use of the City Reserve funds have been met. It is also in the City's interest to ensure that Affirmed has adequate liquidity to continue in its role as a valued property owner and development partner for San José.

Reason for not recommending: It is warranted to disburse these funds for development-related costs as they are permitted by the funding source, they are reasonable in nature and size, and they help to offset the unintended consequences of lengthy litigation in which the Developer prevailed. For these reasons, staff asks for approval of the recommendations herein.

PUBLIC OUTREACH

This memorandum will be posted on the City Council Agenda website for the March 15, 2016 meeting.

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COORDINATION

Preparation of this report was coordinated with the City Attorney's Office.

FISCAL/POLICY ALIGNMENT

These actions are consistent with the City's *Envision 2040 General Plan*, *The 2014-23 Adopted Housing Element* and with the City's *2015-20 HUD Consolidated Plan* in that they will help to preserve existing affordable housing opportunities for very low- and extremely low-income households through lengthened and strengthened affordability restrictions; and, with the *Community Plan to End Homelessness*, approved by the City Council in February 2015, in that it is providing nine apartments for non-chronic homeless residents.

COST SUMMARY/IMPLICATIONS

Approval of the recommended actions would allow the City to receive a 25% distribution of the litigation reserve proceeds totaling approximately \$126,250. The anticipated revenue will be deposited in the Low and Moderate Income Housing Asset Fund (Fund 346) and will be used for future affordable housing opportunities.

As the funds in the City Reserve were already appropriated and disbursed to an account held at Citicorp, no budgetary actions are needed.

CEQA

Section 15061 (b) (3) Review for Exemption for Release of the Settlement Reserve & Other Actions for Fairways at San Antonio Court Apartment.

Fairways at San Antonio Court was approved as Mitigated Negative Declaration, File No. PDC05-104.

/s/

JACKY MORALES-FERRAND
Director, Housing Department

For questions, please contact Jacky Morales-Ferrand, Director of Housing, at (408) 535-3855.

Attachment

ATTACHMENT

Site Map Fairways at San Antonio Court Apartments District 5

