An Unconstitutional Attempt to Address Affordable Housing

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Other Views:

• Homeowner's Rehab, Inc. v. Related Corporate V SLP, 99 N.E. 3d 744 (Mass. 2018), *available at* https://law.justia.com/cases/massachusetts/supreme-court/2018/sjc-12441.html.

• Press Release, *Cantwell, DelBene, Bipartisan Colleagues Introduce New Legislation to Combat Affordable Housing Crisis*, Maria Cantwell, United States Senator for Washington (June 4, 2019), https://bit.ly/31HVzPz.

Abstract:

This paper analyzes recent legislative proposals that are purportedly designed to strengthen and improve the federal affordable housing program. The author argues that these proposals would violate multiple provisions of the U.S. Constitution and would upend bedrock principles of tax law.

Members of Congress recently introduced the Affordable Housing Credit Improvement Act of 2019 (S.1703) to "expand and strengthen the Affordable Housing Tax Credit (also known as the Low-Income Housing Tax Credit) to produce more units of affordable housing and better serve a number of at-risk and underserved communities."[1] Although these are important goals, the Act seeks to pursue them in a manner that disrupts decades of settled expectations, retroactively changes the terms of already-executed affordable housing partnerships, strips investors of valuable property and contract rights, and disregards foundational principles of tax law. The relevant provisions of the Act (in particular, Sections 303(b)(3) and (c)(2)) are incompatible with the Due Process and Takings Clauses of the U.S. Constitution, as well as the longstanding "economic substance" doctrine of tax law. Those provisions would likely be found unconstitutional if enacted.

I. Background

A. Overview of the LIHTC Program

In the United States, there is a significant shortage of affordable housing available to extremely low-income ("ELI") households, whose income is at or below 30% of the median income for the area. According to some estimates, there is a shortage of 7.4 million affordable rental homes for this population, which means there are only 35 units available for every 100 ELI households.[2] Moreover, an estimated 12 million households are forced to pay over 50% of their annual income for housing.[3] Housing instability has been shown to adversely affect employment and academic achievement, as well as physical and mental health outcomes.[4]

The federal government has adopted multiple programs to address these important issues. Chief among them is the Low-Income Housing Tax Credit ("LIHTC"), codified in Section 42 of the 1986 Tax Reform Act.[5] The LIHTC provides tax credits to incentivize private acquisition, development, and rehabilitation of affordable rental housing for low-income households. This program costs the federal government approximately $9 billion per year in foregone tax revenue, which makes it by far the largest federal program to address affordable housing. The LIHTC has helped to create or maintain over 2.4 million homes in

1 Press Release, *Cantwell, DelBene, Bipartisan Colleagues Introduce New Legislation to Combat Affordable Housing Crisis*, Maria Cantwell, United States Senator for Washington (June 4, 2019), https://bit.ly/31HVzPz.

2 *See* National Low Income Housing Coalition, *The Gap: A Shortage of Affordable Homes* at 2 (Mar. 2017), *available at* https://bit.ly/2JzNi87.

3 *See* HUD, *Affordable Housing FAQs*, *available at* https://bit.ly/2BToZ3y.

4 *See Who's hit hardest by the affordable housing shortage?*, Greater Greater Washington (Jan 10, 2019) (collecting sources), https://bit.ly/2XYL6jz.

5 26 U.S.C. § 42.

35,000 separate properties since its enactment in 1986, and it is responsible for over 90% of the total production of affordable housing currently being built.[6] Without the LIHTC, many affordable housing projects would not be economically feasible.

To implement the LIHTC program, Congress allocates the available tax credits to the states based on their population, and the states then award the credits to various projects through a competitive process that is overseen by each state's housing finance agency.[7] The specific amount of the credit varies depending on whether the project is financed through tax-free bonds; projects that use tax-free bonds may receive a credit of 4% of the project's qualified basis (i.e., cost of construction), and those that do not use tax-free bonds may receive a 9% credit.

To qualify for a credit, a project sponsor must agree to set aside at least 40% of the units for renters earning no more than 60% of the area's median income or 20% of the units for renters earning 50% or less of the area's median income.[8] These units are also subject to rent restrictions under which the maximum permissible gross rent, including an allowance for utilities, must be less than 30% of the renter's imputed income based on the area's median income.[9] The affordability restrictions must remain in place for a minimum of 15 years.

LIHTC-financed projects are typically structured as limited partnerships between the sponsor/developer of the project—which is often a nonprofit organization that focuses on low-income housing—and an investor or group of investors.[10] The developer serves as the general partner and exercises management authority over the project, but typically retains only a nominal equity stake (1% or less). The investors, by contrast, are limited partners who make a direct capital investment in the project in exchange for 99% or more of the project's equity.[11] This structure allows the investors to claim the vast majority of the LIHTC tax credits, since they have provided nearly all of the equity; the tax credits are also useless to a nonprofit entity that pays no federal income tax. Although the investors typically have limited authority over the management or operation of the project, most partnership agreements require the consent of the investors before any capital event such as a sale or refinancing.

The LIHTC tax credits may be claimed over a 10-year period, beginning when the project is placed into service.[12] But the affordability limitations and rent caps must remain in place for 15 years. After that 15-year compliance period has ended, the IRS will no longer attempt to recapture the tax credits for non-compliance.

Although the LIHTC tax credits are the primary reason why investors participate in affordable housing projects, they are by no means the only reason. In addition to the tax credits, a limited partner investor may also receive tax losses from depreciation deductions as well as residual value upon sale if the project appreciates. Indeed, it is critical for the limited partner investor to have *upside potential* in any appreciation as well as *downside risk* if the project fails; if the investor does not have upside potential and downside risk, it may be treated as a mere lender rather than an owner of the project and would thus be ineligible to claim any tax credits.[13]

A sale or change in the ownership structure of a LIHTC project can happen at any time, but it is most likely to happen after year 15.[14] All of the tax credits have been claimed by year 10, and those credits cannot be recaptured by the IRS after year 15. The limited partner investors may be able to obtain additional benefits from ongoing ownership after year 15 (such as depreciation deductions and other tax losses), but many seek to exit the project at that time. In many—but by no means all—projects, a limited partner investor exits the partnership by conveying its ownership interests to the general partner nonprofit. A 2012 survey of syndicators and investors found that between 60% and 85% of properties are ultimately transferred to the nonprofit.[15]

B. Options and Rights of First Refusal in LIHTC Partnerships

The partnership agreements between general partners and limited partners typically include multiple avenues through which ownership of a project can be conveyed from the limited partners to the general partner after year 15. One common term is a *purchase option*. An option "gives the optionee the right to purchase the property at his election within an agreed period at a named price."[16] The purchase option in a LIHTC agreement will typically allow the nonprofit general partner to unilaterally purchase the property at market price within a set period of time after the end of the 15-year compliance period.

In addition to a purchase option, many LIHTC partnerships also grant the nonprofit general partner a separate *right of first refusal* (ROFR). Section 42(i)(7)(A) provides that:

> No Federal income tax benefit shall fail to be allowable to the taxpayer with respect to any qualified low-income building merely by reason of a right of 1st refusal held by . . . a qualified nonprofit organization . . . to purchase the property after the close of the compliance period for a

6 *See* HUD, *What Happens to Low-Income Housing Tax Credit Properties at Year 15 and Beyond?* at 1-2 (Aug. 2012) ("*What Happens at Year 15*"), *available at* https://bit.ly/2XnPhG6.

7 *Id.*

8 *Id.*; *see also* 26 U.S.C. § 42(g).

9 *See* Office of the Comptroller of the Currency, *Low-Income Housing Tax Credits: Affordable Housing Investment Opportunities for Banks* at 2 (Mar. 2014) ("*OCC Report*"), *available at* https://bit.ly/2JePlza.

10 *Id.* at 3-4.

11 *Id.*

12 *See* 26 U.S.C. § 42(f).

13 *See*, *e.g.*, Historic Boardwalk Hall, LLC v. C.I.R., 694 F.3d 425, 454-55 (3d Cir. 2012).

14 *See*, *e.g.*, *What Happens at Year 15* at 29; *OCC Report* at 14.

15 *See What Happens at Year 15* at 25-30.

16 Advanced Recycling Sys. v. Southeast Properties, Ltd., 787 N.W. 2d 778, 783 (S.D. 2010); *see also* Tachdjian v. Phillips, 568 S.E. 2d 64, 66 (Ga. Ct. App. 2002) (option defined as "a contract by which the owner of property agrees with another that the latter shall have the right to buy the owner's property at a fixed price, within a certain time, and on agreed terms and conditions").

price which is not less than the minimum purchase price determined under subparagraph (B).[17]

The "minimum purchase price," in turn, is defined as the sum of "the principal amount of outstanding indebtedness secured by the building" plus "all Federal, State, and local taxes attributable to such sale."[18] In short, Section 42 allows a LIHTC project to maintain its eligibility for tax credits notwithstanding the inclusion of a ROFR for the nonprofit at a price equal to the value of outstanding debt on the property plus exit taxes. The debt-plus-taxes price under Section 42(i)(7) is typically far below the market value of the property.

Congress did not define the term "right of 1st refusal" in Section 42(i)(7). But, as the Supreme Court has repeatedly held, "[i]t is a settled principle of interpretation that, absent other indication, 'Congress intends to incorporate the well-settled meaning of the common-law terms it uses.'"[19] That is:

> where Congress borrows terms of art in which are accumulated the legal tradition and meaning of centuries of practice, it presumably knows and adopts the cluster of ideas that were attached to each borrowed word in the body of learning from which it was taken and the meaning its use will convey to the judicial mind unless otherwise instructed.[20]

In such cases, the "absence of contrary direction" from Congress "may be taken as satisfaction with widely accepted definitions, not as a departure from them."[21]

"Right of first refusal" is a legal term of art that has a well-established meaning at common law.[22] Section 42(i)(7) must accordingly be interpreted in light of this settled understanding about the meaning of a ROFR.

A ROFR is fundamentally a *defensive* or *preemptive* mechanism that "limits the right of the owner to dispose freely of its property by compelling the owner to offer it first to the party who has the first right to buy."[23] That is, "a 'right of first refusal' means '[the] [r]ight to meet terms of [a] proposed contract before it is executed; e.g. right to have [the] first opportunity to purchase real estate when such becomes available, or [the] right to meet any other offer.'"[24] There are several integral components of a ROFR.

1. Bona Fide Third-Party Offer

A ROFR is triggered only by a bona fide offer to purchase the property that is made by a third party. An "offer" means a proposal that "results in a binding contract upon acceptance by the other party acceding to its terms."[25] An "indefinite" proposal or mere "invitation to enter into negotiations" is insufficient.[26]

Moreover, an offer must be *bona fide* and "made in good faith."[27] The purpose of this requirement is to provide "protection . . . against a sham offer, made not in good faith, precipitating exercise of the preemptive right."[28] Absent the requirement of a bona fide offer, a party could seek to self-trigger its ROFR by soliciting a sham offer from a friend who had no intention of actually buying the property. In determining whether an offer is bona fide, courts consider factors such as the relationship of the parties, whether the offer approximates fair market value, and whether there is any fraud or misrepresentation.[29]

2. Acceptance

It is equally well established that the property must actually be for sale and that the owner must indicate a willingness to *accept* the third-party offer in order to trigger preemptive rights under a ROFR. That is, "the holder of a right of first refusal holds only a general contract right to acquire a later interest in real estate *should the property owner decide to sell*."[30] In sum, if the property owner "only received an offer on its property and did not display any desire or willingness to sell," then "as a matter of law, the right of first refusal is not operative."[31]

3. No Power to Compel a Sale

Relatedly, courts have made clear that a ROFR can never be invoked to force an unwilling property owner to sell. Instead, a ROFR is a purely *defensive* mechanism that is triggered only

17 26 U.S.C. § 42(i)(7)(A).

18 *Id.* § 42(i)(7)(B).

19 Sekhar v. United States, 570 U.S. 729, 732 (2013) (citing Neder v. United States, 527 U.S. 1, 23 (1999)).

20 Morissette v. United States, 342 U.S. 246, 263 (1952).

21 *Id.*; *see also* Astoria Federal Savings & Loan Ass'n v. Solimino, 501 U.S. 104, 108 (1991) ("[W]here a common-law principle is well established, . . . the courts may take it as a given that Congress has legislated with an expectation that the principle will apply except 'when a statutory purpose to the contrary is evident.'").

22 *See*, *e.g.*, Keeper's, Inc. v. ATGCKG Realestate, LLC, 80 A.3d 88, 91-92 (Conn. App. Ct. 2013) ("[W]hat constitutes a 'right of first refusal' has been well-defined," and this term "has been defined and distinguished in many treatises and reported decisions.").

23 25 R. Lord, Williston on Contracts (4th ed. 2002), §67:85, p. 502.

24 *Tachdjian*, 568 S.E.2d at 66 (quoting Black's Law Dictionary (6th ed. 1990)).

25 Baldwin v. New, 736 S.W.2d 148, 152 (Tex. App. 1987).

26 *Id.*

27 *Id.*; *see also* Jones v. Riley, 471 S.W.2d 650, 659 (Tex. App. Ct. 1971) ("[A] 'bona fide offer' . . . had to not only be made in good faith, but it had to also be of such a nature and in such form that it could be, by an acceptance thereof by the offeree, caused to ripen into a valid and binding contract that could be enforced by any party to it.").

28 Steuart v. McChesney, 444 A.2d 659, 663 (Pa. 1982).

29 *See* DCM Inv. Corp. v. Pinecrest Inv. Co., 34 P.3d 785, 789 (Utah 2001).

30 Jones v. Stahr, 746 N.W.2d 394, 399 (Neb. Ct. App. 2008) (emphasis added); *see also* Riley v. Campeau Homes, Inc., 808 S.W.2d 184, 188 (Tex. App. 1991) ("A right of first refusal ripens into an option when the owner elects to sell."); *Advanced Recycling*, 787 N.W.2d at 783 ("[A] right of first refusal ripens into an option contract when the owner receives the third-party offer and manifests an intention to sell on those terms."); Mandell v. Mandell, 214 S.W.3d 682, 688 (Tex. App. 2007) ("A preferential right of purchase is a right granted to a party giving him or her the first opportunity to purchase property if the owner decides to sell it.").

31 *Keeper's, Inc.*, 80 A.3d at 92.

when a property owner decides to sell and receives a bona fide third-party offer.[32] As a Texas appellate court explained, "[u]nlike an option contract, a right of first refusal does not give the [holder] the power to compel an unwilling owner to sell."[33] Furthermore:

> An owner does not have to sell and, until the owner decides to sell, there is nothing to exercise, ... However, once an owner decides to sell, there is an obligation to offer the holder of the right of first refusal the opportunity to buy the burdened property on the terms offered by a bona fide purchaser.[34]

4. Option v. ROFR

The core attributes of a ROFR discussed above make clear that a ROFR is fundamentally different from an option.[35] An option "gives the optionee the right to purchase the property *at his election* within an agreed period at a named price."[36] A ROFR, by contrast, is a "conditional" right that "ripens into an option contract when the owner receives the third-party offer and manifests an intention to sell on those terms."[37] The "purpose of a [ROFR] is not to allow the holder to compel the property owner to sell the property at a designated price, as may be the case with the existence of an option," but is instead merely "the right to buy before or ahead of others . . . *only if the seller decides to sell*."[38] Because a ROFR "does not give the preemptioner the power to compel an unwilling owner to sell," it is therefore "distinguishable from an ordinary option."[39]

5. Sale Price

There is only one way in which Congress indicated an intent to depart from the longstanding common-law concept of a ROFR. At common law, the ROFR price would be equal to the price at which the third party offered to buy the property.[40] Section 42(i)(7), however, authorizes a ROFR at a below-market price consisting of the value of outstanding debt plus exit taxes. Thus, in this single aspect of the ROFR, Congress has expressed its intent to modify the common-law definition. In all other aspects, however, Congress has left unchanged "the well-settled meaning of the common-law" term "right of first refusal."[41]

If ownership is not transferred to a nonprofit through exercise of a purchase option or ROFR (or some other agreement between the investors and the nonprofit), the property can then be sold pursuant to Section 42(h)(6). That provision requires the limited partner to give the state tax credit agency one year to find a qualified buyer to purchase the property at the price of debt plus taxes. If no buyer is found, the project can then be sold freely at market price. A project may also change hands through foreclosure, abandonment, or charitable contributions, but these are much less common exit strategies.

C. The Legislative History of Section 42(i)(7)

Section 42(i)(7) was added to the LIHTC program through the Low-Income Housing Tax Credit Act of 1989 ("1989 Act"). The legislative history of that provision eliminates any doubt that Congress expected the "right of 1st refusal" held by a nonprofit general partner to be an *actual* right of first refusal as that term is understood at common law, not just an option. Indeed, Congress made clear that a ROFR, rather than an option, was needed to avoid disrupting longstanding principles of tax law.

In May 1988, Senators George Mitchell and John Danforth convened a task force to review the operations of the LIHTC program and propose improvements. Their report, issued in January 1989, expressed concerns that affordable housing projects would be sold to for-profit entities after the expiration of the compliance period and would no longer be available for low-income tenants.[42] The report thus urged Congress to explore new ways to ensure the ownership and management of affordable housing projects by nonprofit groups, including by granting nonprofits an option to purchase the properties at a below-market price after the end of the 15-year compliance period.[43]

Consistent with the recommendations of the Mitchell Report, an early version of the 1989 Act proposed the use of

32 *See* 25 Williston on Contracts § 67:85, p. 503-04 ("The 'right of first refusal' or 'preemption' is conditioned upon the willingness of the owner to sell.").

33 *Riley*, 808 S.W.2d at 187.

34 *Id.*; *see also* Peter–Michael, Inc. v. Sea Shell Associates*,* 709 A.2d 558, 561 n.5 (Conn. 1998) ("A right of [preemption] is a right to buy before or ahead of others . . . but . . . only if the seller decides to sell."); CBS, Inc. v. Capital Cities Communications, Inc., 448 A.2d 48, 56 (Pa. Super. Ct. 1982) ("A right of first refusal does not require the promisor to offer the [property] at all."); Mercer v. Lemmens, 230 Cal. App. 2d 167, 170 (Cal. Dist. Ct. App. 1964) ("A preemptive right does not give the preemptioner the power to compel an unwilling owner to sell."); Ollie v. Rainbolt, 669 P.2d 275, 279 (Okla. 1983) ("The right of preemption does not give to its holder the power to compel an unwilling owner to sell.").

35 *See Advanced Recycling*, 787 N.W.2d at 783 ("It is essential to the resolution of this case to appreciate the difference between options and rights of first refusal.").

36 *Id.* (emphasis added).

37 *Id.*; *see also* Four Howards, Ltd. v J & F Wenz Rd. Invest., L.L.C., 902 N.E.2d 63, 71 (Ohio Ct. App. 2008) ("A purchase option is 'a unilateral contract, binding one side without binding the other.' . . . In contrast, a right of first refusal is a preemptive right that gives its holder the first opportunity to purchase property if, indeed, it is ever sold.").

38 Tadros v. Middlebury Medical Center, Inc., 820 A.2d 230, 240 (Conn. 2003).

39 *Id.*; *see also Tachdjian*, 568 S.E.2d at 66 (discussing differences between options and ROFRs); 25 Williston on Contracts § 67:85, p. 502 ("[A]n option must be accepted and then performed within the time limit specified, or if none is mentioned, then within a reasonable time, whereas a right of first refusal has no binding effect unless the offeror decides to sell.").

40 *See CBS,* 448 A.2d at 56 (ROFR allowed holder to purchase the property "for the consideration [the promisor] is willing to accept from the third party").

41 *Sekhar*, 570 U.S. at 732.

42 *See* Report of the Mitchell-Danforth Task Force on the Low-Income Housing Tax Credit (1989) ("Mitchell Report").

43 *Id.* at 19.

below-market purchase options.[44] But Congress expressly rejected that proposal "because of the tax policy concern that use of such options removed any reasonable expectation that investors would derive a profit independent of tax benefits."[45] Congress was concerned that the "grant of a below-market option . . . was a substantial enough relinquishment of one of the benefits of ownership" that it would be questionable whether the investors retained a sufficient ownership interest to be eligible to receive the tax credits.[46] This concern arose because of the "economic substance" doctrine of tax law, under which every business transaction must have a "substantial purpose (apart from Federal income tax effects)," and entering into the transaction must "change[] in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position)."[47]

Instead of allowing a below-market purchase option, Congress enacted a "compromise" proposal: "a special rule that permits owners to receive the credit and other tax benefits even though the tenants hold a *right of first refusal* for the purchase of their units (at the end of the fifteen-year compliance period) for a specified minimum purchase price."[48] Congress determined that the use of a ROFR—which, as explained above, confers far more limited rights than an option—would still leave the limited partner investors with a sufficient economic interest to satisfy the economic substance rule.

The legislative history further shows that Congress expected the Section 42(i)(7) "right of 1st refusal" to include the standard common-law accoutrements of a ROFR. As Tracy Kane, the tax consultant to the ranking senator on the Finance Committee, explained:

> The formula [for the] right of first refusal is a rather unusual legislative creation. Normally a right of first refusal is "a right to buy before or ahead of another; thus . . . the contract gives to the prospective purchaser the right to buy upon specified terms, but, and this is the important point, *only if the seller decides to sell.*" Therefore, unlike an option, the *right of first refusal does not give the holder the power to compel an unwilling owner to sell.* The compromise was most likely structured in this manner because the right of first refusal leaves more power in the hands of the owner whereas a purchase option would have given more discretion to the prospective buyer.[49]

These sources make clear that the ROFR contemplated by Section 42(i)(7) would not confer on the nonprofit a unilateral right to compel a sale, but would instead be triggered only after the owners had "decided to sell" and had received a bona fide third-party offer.

D. Recent Litigation and Legislative Proposals Regarding the Right of First Refusal

In the early 2000s, the first wave of affordable housing projects to be financed through the LIHTC program began reaching year 15. When a project was in a distressed area or was worth the amount of existing debt or less, the limited partner investors would generally be willing to exit the project and sell to the developer at the Section 42(i)(7) price: outstanding debt plus exit taxes.

But many projects in desirable or high-cost areas had appreciated in value and were worth considerably more than outstanding debt plus taxes. As noted, the limited partner investors were entitled to their share of such appreciation; if they had not been able to obtain this "upside potential," then it would have been questionable as to whether they were actually owners of the property for tax purposes under the economic substance doctrine.[50]

For projects that had appreciated in value, some limited partners insisted on adherence to contractual terms about whether and under what conditions a nonprofit was entitled to exercise a ROFR and buy the property at the Section 42(i)(7) price. For example, the investors may have refused to allow a nonprofit to invoke its rights under a ROFR absent a bona fide, third-party purchase offer that was deemed acceptable to the partnership. These disputes have led to both litigation and proposed legislation.

1. The Memorial Drive Litigation

The Memorial Drive case involved a LIHTC partnership for a large affordable housing project in Cambridge, Massachusetts.[51] As in many other agreements, the general partner possessed both an option and a ROFR. The option allowed the general partner to purchase the development at market price at any time after the 15-year compliance period had run.[52] The ROFR, by contrast, would be triggered only if the general partner produced an "offer to Purchase the property" from a third party, along with the price being offered and "all other terms of the proposed disposition."[53] Once the ROFR was triggered, the nonprofit would have the right to purchase the property at the lesser of the Section 42(i)(7) price, the market price, or the amount of the third-party offer.[54]

After the 15-year period had run, the general partner in the Memorial Drive project sought to buy out the limited partners' interests at the Section 42(i)(7) price. But the limited partners refused that deal, arguing that the general partner could not exercise its right under the ROFR to buy at that price unless a

44 *See* S.B. 980, 101st Cong. (1st Sess. 1989) (providing that determination of ownership for tax purposes of a LIHTC project "shall be made without regard to any option by a qualified nonprofit organization . . . to acquire such building at less than fair market value after the close of the compliance period").

45 Tracy A. Kaye, *Sheltering Social Policy in the Tax Code: The Low-Income Housing Credit*, 38 Vill. L. Rev. 871, 895-96 (1993).

46 *Id.* at 893.

47 26 U.S.C. § 7701(o)(1).

48 Kaye, *supra* note 45, at 896 (emphasis added).

49 *Id.* at 896-97 (emphasis added); *see also* 136 Senate Congressional Record for Oct. 18, 1990 at S30528 (noting that ROFR rights and below-market price are available only "should the owner decide to sell"); H.R. Rep. No. 101-247 at 2665 (1989) (same).

50 *See, e.g.*, *Historic Boardwalk Hall*, 694 F.3d at 454-55.

51 *See* Homeowner's Rehab, Inc. v. Related Corporate V SLP, L.P., Civ. No. 14-3807, 2016 WL 7077901 (Sup. Ct. Sept. 13, 2016).

52 *Id.* at *4-5.

53 *Id.* at *2-4.

54 *Id.*

third-party offer had been made that was acceptable to the entire partnership. The general partner then reached out to another nonprofit and asked it to make an offer as a "favor" solely to trigger the ROFR.[55] The investors argued that this sham offer could not trigger the ROFR because it was not a bona fide offer and the partnership had not consented to a sale.

The Massachusetts courts ruled in favor of the general partner. The Superior Court conceded that the investors' position "has some superficial appeal" based on the language of the contract.[56] But the court ultimately ruled in favor of the general partner based largely on what it deemed the "purpose" of Section 42. For example, the court noted that if a nonprofit needed to pay more than the Section 42(i)(7) price, this would "limit the cash flow that is available for operating the property and meeting its capital needs."[57] A transfer at the Section 42 price thus "contributes to the overall goal of promoting the continuing availability of affordable housing."[58]

The court further concluded that allowing the general partner to solicit a sham offer to trigger the ROFR would not "deprive the defendants of the benefit of their bargain" since they would still have been able to claim the available tax credits.[59] The court asserted that "maximizing tax benefits for the Limited Partners was a key component of the arrangement," and that there was "no language to support the claim that the Limited Partners expected to receive the residual value of the property on a sale."[60] In other words, the investors had made enough money through the tax credits, so the court would not enforce the clear contractual provisions regarding the conditions for triggering the ROFR.

The Superior Court issued its decision in September 2016, and the Massachusetts Supreme Judicial Court later affirmed based on the so-called "purposes" and "key policy goals" of the LIHTC program.[61]

2. The 2017 Cantwell-Hatch Bill

In March 2017, while the Memorial Drive litigation was still pending, a bipartisan group of legislators (led by Senators Maria Cantwell and Orrin Hatch), introduced the Affordable Housing Improvement Act of 2017 (S.548). As relevant here, Section 303 of the bill proposed a "modification of rights related to building purchase" by a nonprofit. Section 303 would have expressly converted the right of first refusal authorized by Section 42(i)(7) into an option.[62] The legislation expressly recognized that this proposal was a "modification of rights" that would change existing law.

Critically, however, this significant change to the nature of the ROFR would apply only prospectively to new projects. Section 303(c) provided that "[t]he amendments made by this section shall apply to agreements entered into or amended after the date of enactment of this Act." The 2017 Cantwell-Hatch bill thus recognized that it would severely disrupt reliance interests and investment-backed expectations if the new modifications applied retroactively to existing projects that had already been negotiated and financed in reliance on the current state of the law. The Cantwell-Hatch bill was introduced in March 2017, but no further action was taken on it during the 115th Congress.

3. The *SHAG* Litigation

Meanwhile, another case about the scope of investors' ROFR rights was progressing through the federal district court in Washington State. In *Senior Housing Assistance Group v. AMTAX Holdings 260, LLC*,[63] a nonprofit developer (SHAG) sought to self-trigger its right of first refusal just days before it expired by soliciting a so-called offer from a friend who had no intention of actually buying the property.

The court squarely rejected that maneuver. Because the term "right of 1st refusal" in Section 42(i)(7) was undefined, the court looked to long-established common-law principles interpreting that concept. As the court explained, a right of first refusal is a legal term of art, and is triggered only if the owner receives a "bona fide offer from a third party, acceptable to the property owner."[64] To be "bona fide," the offer must be "made in good faith; without fraud or deceit," and must be sincere or genuine.[65] The offer must also be *enforceable*, and not merely "an expression of interest or invitation to negotiate."[66]

Applying those longstanding principles, the court held that the offers at issue were insufficient to trigger SHAG's ROFR. The offers in question were "not made in good faith and [] not sincere or genuine," but were instead "sham offer[s]" made by a friend of SHAG's owner "solely as a business favor that could pay dividends in future business dealings."[67] Moreover, even if the offers had been bona fide, they could not trigger the ROFR because the property owner "never formed or expressed a willingness to accept" them.[68] Finally, the court also concluded that SHAG was not entitled to equitable relief (such as an order of specific performance on the contract terms) because it acted with unclean hands. As the court explained, SHAG "engaged in inequitable, bad faith, and unjust conduct when it secretly colluded with [a friend] to procure sham offers from straw buyers" for the projects in question.[69] The court

55 *Id.* at *5.

56 *Id.* at *6.

57 *Id.* at *7.

58 *Id.*

59 *Id.* at *9.

60 *Id.*

61 *See* Homeowner's Rehab, Inc. v. Related Corporate V SLP, 99 N.E. 3d 744, 754, 758 (Mass. 2018).

62 *See* S.548, § 303(a) (amending Section 42(i)(7) by "striking 'a right of 1st refusal' and inserting 'an option'").

63 No. C17-1115-RSM, 2019 WL 1417299 (W.D. Wash. Mar. 29, 2019), *appeals dismissed* Nos. 19-35354, 19-35377 (9th Cir. Sep. 13, 2019).

64 *Id.* at *9 (quoting Matson v. Emory, 676 P.2d 1029 (Wa. 1984)).

65 *Id.* at *10.

66 *Id.*

67 *Id.*

68 *Id.*

69 *Id.* at *12.

thus entered judgment for the limited partners, holding that SHAG's ROFRs "were neither triggered nor validly exercised."[70]

4. The 2019 Cantwell Bill

The *SHAG* court issued its decision on March 29, 2019. Two months later, on June 4, 2019, Senator Cantwell introduced a revised version of the Affordable Housing Improvement Act (S.1703). Like the 2017 version of the bill, S.1703 would convert the "right of 1st refusal" safe harbor in Section 42(i)(7) into an option, and it would apply this "modification" prospectively to new projects only.

But the 2019 bill also includes several provisions not present in the bipartisan 2017 bill that appear designed to override the holding of the *SHAG* court. In a section labeled "clarification with respect to right of first refusal and purchase options," the 2019 bill would add language to Section 42(i)(7) stating:

> For purposes of determining whether an option, including a right of first refusal, to purchase property is described in the preceding sentence—
>
> (i) such option or right of first refusal may be exercised with or without the approval of the taxpayer, and
>
> (ii) a right of first refusal may be exercised in response to any offer to purchase the property, including an offer by a related party.[71]

These provisions of S.1703 would effectively gut the key requirements of a right of first refusal by stripping any consent rights for limited partners and by allowing the ROFR to be triggered by a sham offer from a person who has no bona fide intent to purchase the property. The legislation would abrogate the holding of the *SHAG* court, which refused to allow a general partner to self-trigger its ROFR by soliciting a sham offer from a friendly party.

Furthermore, Section 303(c)(2) provides that, "[t]he amendments made by subsection (b) shall apply to agreements among the owners of the projects . . . entered into before, on, or after the date of enactment of this Act." These so-called clarifications would thus apply retroactively to projects that were already negotiated, executed, and financed in reliance on the existing state of the law regarding rights of first refusal.

II. Analysis

A. The Act's Retroactive Application to Already-Executed Partnership Agreements Violates the Due Process Clause

1. The Due Process Clause Limits Congress' Ability to Pass Retroactive Laws

Our Constitution strongly disfavors retroactive lawmaking.[72] The principle that laws should not apply retroactively "has long been a solid foundation of American law" and "has timeless and universal human appeal."[73] Indeed, "our law has harbored a singular distrust of retroactive statutes" for "centuries."[74] As Justice Joseph Story recognized more than 150 years ago, "retrospective laws . . . are generally unjust; and, as has been forcibly said, neither accord with sound legislation nor with the fundamental principles of the social compact."[75] In a "free, dynamic society, creativity in both commercial and artistic endeavors is fostered by a rule of law that gives people confidence about the legal consequences of their actions."[76]

Retroactive legislation "presents problems of unfairness that are more serious than those posed by prospective legislation, because it can deprive citizens of legitimate expectations and upset settled transactions."[77] For example, "if retroactive laws change the legal consequences of transactions long closed, the change can destroy the reasonable certainty and security which are the very objects of property ownership."[78] Thus, "whereas prospective economic legislation carries with it the presumption of constitutionality, 'it does not follow . . . that what Congress can legislate prospectively it can legislate retrospectively.'"[79]

Although retroactive legislation implicates a number of constitutional provisions—including the Takings Clause, Ex Post Facto Clause, Bill of Attainder Clause, and others—the primary protection against "retroactive laws of great severity"[80] lies in the Due Process Clause. The Due Process Clause gives effect to the law's general distrust of retroactive laws by "protect[ing] the interests in fair notice and repose that may be compromised by retroactive legislation."[81] "The retrospective aspects of [economic] legislation, as well as the prospective aspects, must meet the test of due process, and the justifications for the latter may not suffice for the former."[82] The Supreme Court has accordingly "treat[ed] due process challenges based on the retroactive character" of legislation "as serious and meritorious, thus confirming the vitality of our legal tradition's disfavor of retroactive economic legislation."[83] "Both stability of investment and confidence in the constitutional system . . . are secured by due process restrictions against severe retroactive legislation."[84]

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70 *Id.* at *13.

71 S.1703, § 303(b)(3).

72 *See* Eastern Enterprises v. Apfel, 524 U.S. 498, 532 (1998) (plurality op.); Bowen v. Georgetown Univ. Hosp., 488 U.S. 204, 208 (1988).

73 Kaiser Aluminum & Chem. Corp. v. Bonjorno, 494 U.S 827, 855 (1990) (Scalia, J., concurring).

74 *Eastern Enterprises.*, 524 U.S. at 547 (Kennedy, J., concurring in the judgment and dissenting in part).

75 *Id.* (quoting 2 Joseph Story, Commentaries on the Constitution § 1398 (2d ed. 1851)).

76 Landgraf v. USI Film Prods., 511 U.S. 244, 266 (1994).

77 Gen. Motors Corp. v. Romein, 503 U.S. 181, 191 (1992).

78 *Eastern Enterprises*, 524 U.S. at 548 (Kennedy, J.).

79 *Id.* at 547-48 (quoting Usery v. Turner Elkhorn Mining Co., 428 U.S. 1, 15 (1976)).

80 *Id.*

81 *Landgraf*, 511 U.S. at 266.

82 *Eastern Enterprises*, 524 U.S. at 548 (Kennedy, J.).

83 *Id.*

84 *Id.* at 549.

In determining whether legislation operates retroactively, the Supreme Court has drawn on an "influential definition" offered by Justice Story in 1814.[85] Under that definition, a statute is retroactive if it "takes away or impairs vested rights acquired under existing laws, or creates a new obligation, imposes a new duty, or attaches a new disability, *in respect to transactions or considerations already past.*"[86] In short, "the court must ask whether the new provision attaches new legal consequences to events completed before its enactment."[87] That inquiry considers "the nature and extent of the change in the law and the degree of connection between the operation of the new rule and a relevant past event," and "familiar considerations of fair notice, reasonable reliance, and settled expectations offer sound guidance."[88] Courts are also more likely to find impermissible retroactivity when a statute affects "substantive rights, liabilities, or duties," as opposed to a procedural or jurisdictional rule.[89]

2. S.1703 Would Have Significant Retroactive Effects That Violate Due Process

Although S.1703 labels the changes in Section 303(b) as mere "clarifications," they unquestionably affect "*substantive* rights, liabilities, or duties."[90] "Right of first refusal" is a term of art with a well-established meaning at common law. A party's purchase rights are triggered only by a bona fide third-party offer, and only when the owner has decided to sell the property and has indicated a willingness to accept the offer.[91] Yet Section 303(b)(3) would eliminate these aspects of the ROFR. Section 303(b)(3) provides that a ROFR may be exercised *with or without* the approval of the investor and may be exercised in response to *any* offer to purchase, even from a related party. Thus, whereas the common law has long refused to allow a ROFR to be triggered by a "sham offer, made not in good faith,"[92] Section 303(b)(3) would permit exactly that by allowing a ROFR holder to self-trigger its purchase rights by soliciting a sham offer from a related party.

Moreover, most limited partner investors entered into LIHTC partnerships only because they were able to retain blocking rights or consent rights for capital events (e.g., a sale or refinancing). Those critical contractual rights ensure that the limited partners are able to protect their investments by exercising some degree of control over any disposition of the property. Indeed, blocking or consent rights are especially important in the context of an agreement that also includes a ROFR at a below-market price. Most investors would not have accepted a below-market ROFR at all absent the protection provided by contractual consent rights. Yet Section 303(b)(3)'s purported clarifications would eviscerate investors' blocking or consent rights by allowing a nonprofit to unilaterally exercise its ROFR "with or without the approval of the [investor]."

Section 303(b)(3)'s significant retroactive changes to thousands of existing LIHTC partnership agreements fail every guidepost the courts have established to evaluate whether legislation violates the Due Process Clause. Most importantly, this legislation would directly affect "contractual or property rights, matters in which predictability and stability are of prime importance."[93] In particular, it would "take[] away or impair[] vested rights acquired under existing laws . . . *in respect to transactions or considerations already past.*"[94]

Affordable housing projects financed through the LIHTC program typically have a two-decade time horizon and involve the investment of millions of dollars of capital. Most investors would not have made the massive capital contributions needed to fund those projects unless they could depend on adherence to the contractual terms negotiated by the parties—especially the terms that require investor consent before any sale or disposition of the property. Moreover, the retroactive effect of S.1703 would stretch far back into the past. The projects that are currently reaching year 15 entered into service in 2004, which means that they were likely negotiated and developed in the late 1990s or early 2000s. Section 303(b)(3)'s significant change to the nature of the ROFR would thus reach far back into the past to upset contractual agreements that were signed more than 20 years ago.[95]

Section 303(b)(3) would also have a "severe" impact on the "stability of investment,"[96] because the ROFR that this legislation seeks to modify is an integral component of LIHTC partnership agreements. When a ROFR is triggered, it allows a nonprofit to buy out its limited partner investors at a price far below the fair market value of the building, thereby allowing the nonprofit to effectively capture all of a project's appreciation in value. The precise scope of a ROFR, and the conditions under which it can be triggered, are thus of central importance to a LIHTC partnership agreement and have powerful and far-reaching implications for both the investors and the nonprofits. Congress recognized as much when it enacted Section 42(i)(7) in 1989. As explained above, the legislative history of this provision shows that Congress was well aware when it enacted Section 42(i)(7) that "the right of first refusal does not give the holder the power to compel an unwilling owner to sell," and that the enacted version "leaves more power in the hands of the owner" than a purchase option would.[97] Yet S.1703 now seeks to retroactively undo this careful legislative compromise. This attempt to readjust core provisions

85 *Landgraf*, 511 U.S. at 268.

86 *Id.* at 269 (emphasis added).

87 *Id.* at 269-70.

88 *Id.*; *see also id.* at 280 (asking whether legislation "would impair rights a party possessed when he acted, increase a party's liability for past conduct, or impose new duties with respect to transactions already completed").

89 *Id.* at 274-78.

90 *Id.* at 278 (emphasis added).

91 *See SHAG*, 2019 WL 1417299 at *9-10.

92 *Steuart*, 444 A.2d at 663.

93 *Landgraf*, 511 U.S. at 271.

94 *Id.* at 269 (emphasis added).

95 *See*, *e.g.*, *Eastern Enterprises*, 524 U.S. at 549 (Kennedy, J.) (legislation that "creat[ed] liability for events which occurred 35 years ago . . . has a retroactive effect of unprecedented scope").

96 *Id.*

97 *See* Kaye, *supra* note 45, at 895-96.

of transactions negotiated decades ago is "far outside the bounds of retroactivity permissible under our law."[98]

Section 303(b)(3) also appears designed to abrogate the holding of the *SHAG* case—decided just a few months before S.1703 was introduced—which properly enforced the conditions of a ROFR and held that a nonprofit could not self-trigger its ROFR by soliciting a sham offer as a favor from a friend. Section 303(b)(3) would gut the holding of *SHAG* by eliminating any need for the limited partner to accept an offer, and by allowing *any* offer (even a sham offer solicited by the nonprofit) to trigger the ROFR. The fact that Section 303(b)(3) appears designed to override the holding of a decision by a federal district court is a powerful indication that the legislation is not merely clarifying the law but is instead attempting to retroactively adjust substantive rights.

Proponents of Section 303(b)(3) may argue that this legislation is not retroactive because it merely affects the *tax treatment* of ROFRs rather than directly abrogating contract or property rights. They will likely argue that Section 42(i)(7) does not create ROFRs or require ROFRs but instead merely creates a safe harbor under which the use of a ROFR as specified in that section will not jeopardize a project's eligibility for LIHTC credits. But that argument ignores how LIHTC projects work in practice. Section 42 is referenced in many LIHTC partnership agreements, so courts will often look to Section 42 in interpreting the scope of ROFR rights under a partnership agreement. For example, the limited partnership agreements at issue in the *SHAG* case repeatedly referenced Section 42(i)(7). The partnership agreement at issue in Memorial Drive similarly contained a clause stating that the parties "wish to enter into a right of first refusal agreement with respect to the Property "in accordance with Section 42(i)(7) of the Internal Revenue Code." Thus, any modification of the meaning of "right of 1st refusal" under Section 42(i)(7) will likely have an equivalent impact on the courts' interpretation of ROFR rights under LIHTC partnership agreements. And the impact of such a holding will be to severely disrupt existing property and contract rights arising out of transactions that were negotiated decades ago.

Proponents of Section 303(b)(3) may also argue that this legislation is a proper "clarification" of the law because it ensures that ROFR rights have some value to the nonprofits. According to this line of reasoning, which the Massachusetts state courts endorsed in the Memorial Drive litigation, a proper application of the common-law requirements of bona fide offer and acceptance would mean that the nonprofits' ROFRs were "almost never triggered" because third parties would be unlikely to seek to purchase a property on which another party held a below-market ROFR.[99] But, to the contrary, the ROFR remains highly valuable to a nonprofit even if it is enforced consistent with its common-law meaning. Most importantly, the ROFR ensures that the nonprofit will be able to *remain in the partnership* by limiting investors' ability to convey the property to an outside party. That is, regardless of how often ROFR rights are actually triggered, they remain highly valuable to the nonprofit as a defensive or preemptive mechanism to ensure that the nonprofit remains involved in the operation and management of the project, and that the nonprofit cannot be cut out of the project without first being given a chance to buy the property at a favorable price. There is accordingly nothing anomalous about insisting that a ROFR in a LIHTC partnership agreement be interpreted consistent with all applicable common-law requirements.

3. At a Minimum, S.1703 Does Not Speak with Sufficient Clarity to Have Retroactive Effect

For all the reasons discussed above, Section 303(b)(3) is no mere clarification of the law but instead a *substantive* modification of existing contract and property rights that would violate the Due Process Clause's prohibition on legislation with severe retroactive effects. At a minimum, however, this legislation is insufficiently clear about its intent to apply retroactively.

The Supreme Court has long recognized a "presumption against retroactive legislation" that stems from "[e]lementary considerations of fairness."[100] This presumption "is deeply rooted in our jurisprudence, and embodies a legal doctrine centuries older than our Republic."[101] Where the presumption applies, "congressional enactments" are not "construed to have retroactive effect unless their language *requires* this result."[102] This is the case "[e]ven where some substantial justification for retroactive rulemaking is presented."[103]

Here, far from speaking clearly about the intent and effect of Section 303(b)(3), the Act describes the change it seeks to make as a mere "clarification" of the law rather than what it actually is: a major change to the contractual rights of thousands of investors in affordable housing projects. This legislation would not only destroy valuable contract and property rights but also abrogate the holding of a major decision from a federal court. If the statute is to be interpreted to effectuate these major retroactive changes to the law, *Landgraf* makes clear that Congress must speak with greater clarity than it has done in S.1703.

B. The Act Would Strip Limited Partner Investors of Valuable Property and Contract Rights Without a Public Purpose or Just Compensation, in Violation of the Takings Clause

Even if Section 303(b)(3) could satisfy the Due Process Clause, and even if the legislation were clear and candid about its intent to make substantive changes in the law retroactively, it would separately violate the Takings Clause, which provides that "private property [shall not] be taken for public use, without just compensation."[104]

1. The Supreme Court's Takings Jurisprudence

The Supreme Court has "been unable to develop any 'set formula' for determining when 'justice and fairness' require that

98 *Eastern Enterprises*, 524 U.S. at 550.

99 *See Homeowner's Rehab*, 99 N.E. 3d at 758.

100 *Landgraf*, 511 U.S. at 265.

101 *Id.*

102 *Bowen*, 488 U.S. at 208 (emphasis added).

103 *Id.*

104 U.S. Const., amdt. V.

economic injuries caused by public action be compensated by the government."[105] Instead, the Court "has examined the 'taking' question by engaging in essentially ad hoc, factual inquiries that have identified several factors . . . that have particular significance."[106] "The general rule at least is that while property may be regulated to a certain extent, if regulation goes *too far* it will be recognized as a taking."[107]

It is well established that investors' contractual rights are private property protected by the Takings Clause.[108] The three primary factors courts consider in determining whether a taking has occurred are: (1) "the economic impact of the regulation on the claimant"; (2) "the extent to which the regulation has interfered with distinct investment-backed expectations"; and (3) "the character of the governmental action."[109] In applying this test, the Supreme Court has been guided by the principle that the Takings Clause "was designed to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole."[110]

2. S.1703 Would Effect Takings of the Property of Limited Partner Investors in the LIHTC Program

All three "primary factors" in the takings analysis support the conclusion that Section 303(b)(3) of S.1703 goes "too far" and effects an unconstitutional taking.[111] First, the "economic impact" of the Act on limited partner investors would be severe. The Act would strip investors of a highly valuable contractual right that forms an essential part of the complex contracts between limited partners and general partners in LIHTC developments. By modifying critical aspects of the ROFR to allow a nonprofit to self-trigger its purchase right by soliciting a sham offer from a related party, Section 303(b)(3) would effectively ensure that limited partner investors are never able to share in the upside potential of their projects.

This legislation would also nullify the blocking or consent rights that many investors demanded as a precondition to putting millions of dollars of equity into a project. Indeed, most investors never would have accepted a below-market ROFR at all but for the protection provided by their blocking or consent rights for any capital events. Under the modified version of the ROFR contemplated by Section 303(b)(3), however, a nonprofit would be able to unilaterally force a transfer to itself at a below-market price notwithstanding clear language in the partnership agreement requiring the investors' consent before any capital event such as a sale or refinancing.

Simply put, the statute would "force[] a considerable financial burden" upon the investors.[112] That economic burden, moreover, is wholly divorced from any "responsibilities that [the investors] accepted."[113] The limited partners in LIHTC projects—like any equity investors—had every reason to believe based on the economic substance doctrine that they were entering into transactions in which they would receive, not just tax benefits, but meaningful upside potential if the projects were successful. And they had every reason to believe that their consent rights for capital events such as a sale of the property would be enforced as written.

Second, the Act would significantly interfere with distinct, investment-backed expectations. Whether a statute impermissibly interferes with distinct investment-backed expectations is "an objective test," because "to support a claim for a regulatory taking, an investment-backed expectation must be 'reasonable.'"[114] "A reasonable investment-backed expectation must be more than a unilateral expectation or an abstract need."[115] The Takings Clause "protects private expectations to ensure private investment," and "reasonable, investment-backed expectations" are to be "understood in light of the whole of our legal tradition."[116] The expectations inquiry—like the due process inquiry—is animated by concerns about fair notice and reliance; its purpose is to provide compensation to "property owners who . . . bought their property in reliance on a state of affairs that did not include the challenged regulatory regime."[117]

Section 303(b)(3) of S.1703 is a paradigmatic example of a statute that would effect a taking by destroying the affected parties' reasonable and distinct investment-backed expectations. The limited partner investors' contractual rights are unquestionably "property" for purposes of the Takings Clause.[118] And their "expectations"—that they will continue to possess their

105 Penn Cent. Transp. Co. v. City of N.Y., 438 U.S. 104, 124 (1978).

106 Kaiser Aetna v. United States, 444 U.S. 164, 175 (1979).

107 Pennsylvania Coal Co. v. Mahon, 260 U.S. 393, 415 (1922). (emphasis added); *see also* Lucas v. S.C. Coastal Council, 505 U.S. 1003, 1015 (1992).

108 *See, e.g.*, U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 19 n.16 (1977) ("[C]ontract rights are a form of property" for purposes of the Takings Clause.); Lynch v. United States, 292 U.S. 572, 579 (1934) ("The Fifth Amendment commands that property be not taken without making just compensation. Valid contracts are property[.]"); Connolly v. Pension Benefit Guaranty Corp., 475 U.S. 211, 224 (1986) ("The fact that legislation disregards or destroys existing contractual rights" may "transform the regulation into an illegal taking."); City of El Paso v. Simmons, 379 U.S. 497, 533-34 (1965) (Black, J., dissenting) ("Contractual rights, this Court has held, are property, and the Fifth Amendment requires that property shall not be taken for public use without just compensation.").

109 *Connolly*, 475 U.S. at 225 (citing *Penn Central*, 438 U.S. at 124).

110 Armstrong v. United States, 364 U.S. 40, 49 (1960); *see also* Palazzolo v. Rhode Island, 533 U.S. 606, 617-18 (2001); Lingle v. Chevron U.S.A., Inc., 544 U.S. 528, 537 (2005); Ark. Game & Fish Comm'n v. United States, 568 U.S. 23, 31 (2012).

111 *Pennsylvania Coal*, 260 U.S. at 415.

112 *Eastern Enterprises*, 524 U.S. at 529-30.

113 *Id.* at 531.

114 Cienega Gardens v. United States, 331 F.3d 1319, 1346 (Fed. Cir. 2003) (citing Ruckelshaus v. Monsanto Co., 467 U.S. 986, 1005 (1984)); *see also* Colony Cove Properties, LLC v. City of Carson, 888 F.3d 445, 452 (9th Cir. 2018) ("To form the basis for a taking claim, a purported distinct investment-backed expectation must be objectively reasonable.").

115 *Ruckelshaus*, 467 U.S. at 1005.

116 *Lucas*, 505 U.S. at 1034-35 (Kennedy, J., concurring).

117 *Cienega Gardens*, 331 F.3d at 1345-46.

118 *See, e.g.*, *U.S. Trust Co. of N.Y.*, 431 U.S. at 19 n.16.

contractual rights unless and until they decide to sell or relinquish them—are clearly "investment-backed," in that they grow out of sizeable investments made in affordable housing projects. The Act would burden those "distinct investment-backed expectations" by stripping LIHTC contracts of any meaningful constraints on the exercise of ROFR rights, notwithstanding that these agreements were negotiated in direct reliance on the then-existing state of the law (including the economic substance doctrine).[119] The end result in effectively every LIHTC project—including those negotiated decades ago—would be to allow the general partner to self-trigger its ROFR and capture every cent of appreciation, even though the limited partner investors put up 99% or more of the capital for the project.

Moreover, Section 303(b)(3) would allow the nonprofits to unilaterally trigger their ROFRs notwithstanding any contractual consent or blocking rights held by the limited partner investors. But without the protection provided by those rights—which are especially critical in the context of agreements that include below-market ROFRs—many investors would have never committed millions of dollars of capital to LIHTC projects, or would have insisted on more generous terms before investing. By nullifying these critical contractual protections that were a precondition to multi-million-dollar investment decisions, Section 303(b)(3) goes "too far" in "frustrat[ing] distinct investment-backed expectations."[120]

The Supreme Court has previously struck down legislation under the Takings Clause on the ground that it "substantially interfere[d]" with "reasonable investment-backed expectations."[121] One such case was *Pennsylvania Coal Co. v. Mahon*, which involved a statute that "destroy[ed] previously existing rights of property and contract."[122] In *Pennsylvania Coal*, a coal company sold surface rights to certain parcels of property but reserved rights to mine coal from those same parcels. The Court held that a statute functionally eliminating the company's reserved mining rights amounted to a taking, because by "mak[ing] it commercially impracticable to mine certain coal," the statute had "nearly the same effect for constitutional purposes as appropriating or destroying" the claimant's reserved rights.[123] In other words, the company had a reasonable expectation that it had, and would continue to have, the right to mine on the relevant properties, yet the legislation effectively destroyed its reserved rights. This so substantially interfered with the company's "distinct investment-backed expectations" that the Court concluded that the government had violated the Takings Clause.[124]

Here, too, the limited partner investors entered into LIHTC partnership agreements while expressly retaining valuable contractual rights for themselves: namely, the right to ensure that a nonprofit general partner cannot purchase the entire project at a below-market price unless the limited partners have consented to the transaction, and unless the nonprofit meets each of the well-established criteria for triggering a ROFR. Yet Section 303(b)(3) would "destroy [those] previously existing rights of . . . contract."[125] As in *Pennsylvania Coal*, enacting S.1703 would "so frustrate distinct investment-backed expectations as to amount to a taking."[126]

The Supreme Court invoked similar principles in *Eastern Enterprises v. Apfel*, which held that provisions of the Coal Industry Retiree Health Benefit Act violated the Takings Clause because they "substantially interfere[d]" with "reasonable investment-backed expectations."[127] The statute at issue imposed significant retroactive liability on Eastern Enterprises, which was forced to pay $50 to $100 million into a health benefit fund for coal miners based on conduct that occurred "some 30 to 50 years before the statute's enactment, without any regard to responsibilities Eastern accepted under any benefit plan the company itself adopted."[128]

The Court concluded that the statute "substantially interfere[d] with Eastern's reasonable investment-backed expectations" because "the extent of Eastern's retroactive liability" under the law was "substantial," "particularly far reaching," and not "justified."[129] In particular, the statute impermissibly "attache[d] new legal consequences" to a "relationship completed before its enactment."[130] Moreover, "[t]he distance into the past that the Act reaches back to impose a liability on Eastern and the magnitude of that liability raise substantial questions of fairness."[131] This severe retroactive liability was far out of line with any reasonable expectations Eastern might have had, because the provisions were "not calibrated either to Eastern's past actions or to any agreement—implicit or otherwise—by the company."[132] The Court thus held that the "Constitution [did] not permit" a scheme that so severely interfered with Eastern's reasonable and distinct investment-backed expectations.[133]

The same reasoning that led the Court to find a taking in *Eastern Enterprises* applies with full force to Section 303(b)(3) of S.1703. The "extent of [investors'] retroactive liability" under Section 303(b)(3) would be "substantial"[134] because its enactment would eliminate valuable contractual rights that grow out of

119 *See Penn Central*, 438 U.S. at 127.

120 *Lucas*, 505 U.S. at 1015; *Penn Central*, 438 U.S. at 127.

121 *Eastern Enterprises*, 524 U.S. at 532.

122 260 U.S. at 413; *see Penn Central*, 438 U.S. at 127 (citing *Pennsylvania Coal* as "the leading case" for the proposition that a statute "may so frustrate distinct investment-backed expectations as to amount to a taking").

123 *Pennsylvania Coal*, 260 U.S. at 414-15.

124 *Penn Central*, 438 U.S. at 127.

125 *Pennsylvania Coal*, 260 U.S. at 413.

126 *Penn Central*, 438 U.S. at 127.

127 524 U.S. at 532.

128 *Id.* at 531.

129 *Id.* at 532, 534-35.

130 *Id.* at 532 (quoting *Landgraf*, 511 U.S. at 270).

131 *Id.* at 534.

132 *Id.* at 536.

133 *Id.*

134 *Id.* at 532.

long-settled transactions, and it would strip the limited partner investors of any upside potential from their investments or any consent rights for capital events. As in *Eastern Enterprises*, moreover, the Act "attaches new legal consequences" to contractual agreements "completed before its enactment."[135] And, with respect to the reasonableness of investors' expectations, Section 303(b)(3)'s elimination of the limits on the exercise of ROFR rights is "not calibrated" to "any agreement—implicit or otherwise"—that the investors accepted when they entered the project.[136] To the contrary, the investors had every reason to believe that ROFRs would be applied consistent with the longstanding, common-law meaning of that term, and that the investors would: (1) retain upside potential in their projects if a ROFR was not exercised and (2) retain their highly valuable contractual rights to consent to any disposition of the property. As in *Eastern Enterprises*, S.1703 "imposes [] a disproportionate and severely retroactive burden upon" investors, and "the Constitution does not permit" such a law to stand.[137]

Finally, the *character* of the governmental action also raises serious Takings Clause concerns. S.1703 would "single out" investors "to bear a burden that is substantial in amount [and] . . . unrelated to any commitment the [investors] made or to any injury they caused."[138] If the government requires certain individuals to forfeit their property for the benefit of the public, "the governmental action implicate[s] fundamental principles of fairness underlying the Takings Clause."[139] After all, the fundamental purpose of the Takings Clause is to "bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole."[140] If Congress wants to help nonprofit groups promote access to affordable housing, it can fund them directly or develop some other mechanism to support their work that does not involve retroactively stripping important terms from long-settled partnership agreements and forcing limited partner investors to bear the entire burden of funding these policy goals.

3. No Public Purpose Justifies the Taking S.1703 Would Effect

S.1703's gutting of the ROFR provision of Section 42(i)(7) is not justified by a public purpose. "The protection of private property in the Fifth Amendment presupposes that it is wanted for public use."[141] As the Supreme Court has explained, "it has long been accepted that the sovereign may not take the property of A for the sole purpose of transferring it to another private party B, even though A is paid just compensation."[142] Here, S.1703 would do little more than effectuate a wealth transfer from limited partners to general partners in LIHTC projects by ensuring that the general partners are able to capture all of the appreciation in a project's value.

The proponents of S.1703 have asserted that the Act is intended to serve the public purpose of "increas[ing] investment in affordable housing and provid[ing] more resources and stronger protections for at-risk groups."[143] But even if that is a valid public purpose in the abstract, the Takings Clause still requires a fit between ends and means. Even if it is acting in pursuit of legitimate policy goals, the government may not "forc[e] some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole."[144] A "strong public desire to improve the public condition is not enough to warrant achieving that desire by a shorter cut than the constitutional way of paying for the change."[145] Even if the proponents of S.1703 could establish that it serves a legitimate public purpose, the government would still be required to pay just compensation to investors for the destruction of their valuable property and contract rights, which would be well into the hundreds of millions of dollars.

C. The Act's Purported Clarification Regarding the Scope of ROFRs Is Incompatible with the Longstanding Economic Substance Doctrine

Wholly apart from the constitutional defects discussed above, the "clarification" in Section 303(b)(3) would also contravene longstanding principles of tax law on which the business community has relied for decades.

The "economic substance" doctrine is a foundational principle of U.S. tax law. Under the economic substance doctrine, a transaction that has no economic substance apart from its tax implications will not be eligible for the claimed tax benefits.[146] A transaction will be deemed to have economic substance only when it 1) "has a substantial purpose (apart from Federal income tax effects)," *and* 2) "changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position."[147] Thus, when two partners enter into a business arrangement, each must have some purpose for engaging in the transaction *apart* from any tax benefits if they are to be *eligible* for any tax benefits. That is, both partners must have "really and truly intended to join

135 *Id.*

136 *Id.* at 536.

137 *Id.*

138 *Id.* at 537.

139 *Id.*

140 *Armstrong*, 364 U.S. at 49; *see also Palazzolo*, 533 U.S. at 617-18; *Lingle*, 544 U.S. at 537; *Ark. Game & Fish Comm'n*, 568 U.S. at 31.

141 *Pennsylvania Coal*, 260 U.S. at 415.

142 Kelo v. City of New London, Conn., 545 U.S. 469, 477 (2005); *see also* Thompson v. Consolidated Gas Corp., 300 U.S. 55, 80 (1937) ("To be sure, the Court's cases have repeatedly stated that 'one person's property may not be taken for the benefit of another private person without a justifying public purpose, even though compensation be paid.'"); Hawaii Hous. Auth. v. Midkiff, 467 U.S. 229, 241 (1984); Cincinnati v. Vester, 281 U.S. 439, 447 (1930); Madisonville Traction Co. v. St. Bernard Mining Co., 196 U.S. 239, 251–252 (1905); Fallbrook Irrigation District v. Bradley, 164 U.S. 112, 159 (1896).

143 Press Release, *Cantwell, DelBene, Bipartisan Colleagues Introduce New Legislation to Combat Affordable Housing Crisis*, Maria Cantwell, United States Senator for Washington (June 4, 2019), https://bit.ly/31HVzPz.

144 *Armstrong*, 364 U.S. at 49.

145 *Pennsylvania Coal*, 260 U.S. at 416.

146 *See* 26 U.S.C. § 7701(o)(5)(A).

147 26 U.S.C. § 7701(o)(1).

together for the purpose of carrying on business and sharing of profits or losses or both."[148]

Two critical indicia of whether a person is actually a partner in a business enterprise (rather than a mere lender) are whether there is "meaningful downside risk" and "meaningful upside potential."[149] Those considerations help inform whether the party has "a true interest in profit and loss," thereby making it eligible for the tax benefits to which owners of property are entitled.[150] For example, in *Historic Boardwalk Hall*, the Third Circuit held that an investor was not eligible to claim historic preservation tax credits as the owner of a project when another company held an option to purchase the property in question at a below-market price. As the court explained, "although in form [the investor] had the potential to receive the fair market value of its interest . . . in reality [the investor] could never expect to share in any upside."[151] That was because, "[e]ven if there were an upside," the option holder "could exercise its Consent Option, and cut [the investor] out by paying a purchase price unrelated to any fair market value."[152]

Section 303(b)(3) of S.1703 flouts the economic substance doctrine. By retroactively removing the core requirements for triggering a ROFR, it would leave the nonprofits with an option to unilaterally buy out their limited partner investors at a below-market price. This would mean that the nonprofit effectively owns all of the non-tax economic value of the project—including any appreciation in the property's value—and the investors' participation would be for the sole purpose of claiming tax credits and depreciation losses. A limited partner with no upside potential is a partner in name only, according to the economic substance doctrine, and is therefore not entitled to the tax benefits sought.

Furthermore, current tax regulations provide that "losses, deductions, or credits" arising from a LIHTC project "may be limited or disallowed under other provisions of the Code or principles of tax law," including the "'sham' or 'economic substance' analysis."[153] Thus, if the "clarification" in Section 303(b)(3) were to become law, it could jeopardize investors' ability to claim LIHTC tax credits and thereby chill much-needed investment in such projects.

Finally, S.1703's disregard for the economic substance doctrine would also make the legislation vulnerable to another type of takings claim. In *Lucas v. South Carolina Coastal Council*, the Supreme Court held that a per se taking of property occurs when a regulation "denies all economically beneficial or productive uses" of the property.[154] If Section 303(b)(3) is enacted, it would effectively strip limited partner investors of any upside potential in their LIHTC projects. The end result would be that the sole value lies in the investors' ability to obtain various tax benefits. But the economic substance doctrine is clear that merely entering into a transaction for tax purposes does not constitute an economically beneficial or productive use of property; the taxpayer must instead have some non-tax-related purpose for engaging in the transaction. Under *Lucas*, the investor would suffer a taking of its property because it would be left with no "economically beneficial or productive uses" of its ownership interest apart from tax consequences.

* * *

Congress made a deliberate policy choice in 1989 to use a ROFR rather than a purchase option in Section 42(i)(7) precisely to avoid creating an arrangement that would violate the economic substance doctrine. Yet Section 303(b)(3) of S.1703 now seeks to achieve the exact same outcome that Congress rejected in 1989 through a "clarification" that would in fact rewrite the statute retroactively. Congress had it right in 1989. Section 303(b)(3) would force limited partner investors into transactions that lack any economic substance apart from their tax implications, thereby running headlong into the economic substance doctrine and jeopardizing investors' ability to claim LIHTC tax credits. This legislation fails to comport with longstanding, foundational principles of tax law, and should not be enacted for this reason in addition to its constitutional infirmities.

III. Conclusion

Sections 303(b)(3) and (c)(2) of S.1703 would make significant changes to the terms of complex partnership agreements that were negotiated and finalized decades ago. This would retroactively strip investors of their valuable contract and property rights in violation of the Due Process and Takings Clauses of the U.S. Constitution, and it would leave the investors in business ventures that lack any non-tax-related economic substance, threatening the tax benefits to which they would otherwise be entitled. If enacted, S.1703 would almost certainly face meritorious constitutional challenges from the entities whose property has been taken without due process or just compensation.

148 Comm'r v. Tower, 327 U.S. 280, 287 (1946); *see also* Frank Lyon Co. v. United States, 435 U.S. 561 (1978).

149 *Historic Boardwalk Hall*, 694 F.3d at 454-55.

150 *Id.*

151 *Id.* at 460.

152 *Id.*; *see also* Ronald A. Shellan, *Thinking About Year Fifteen of a Low-Income Housing Tax Credit Partnership*, J. Affordable Housing & Community Development at 94, 97 (Fall 2001) (noting that "IRS personnel in private discussions have indicated that they view a right of first refusal as different from an option and may well attack an option as being outside the safe-harbor provisions found in section 42(i)(7)").

153 26 C.F.R. §1.42-4(b).

154 505 U.S. at 1015-16.