

## Tax Credit Project Damaged by Fire During Construction Offers Lessons in Recovery, Transaction Structuring

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IN REAL ESTATE PROJECTS using federal tax credits, most eyes are focused on structuring the transaction, building the project, and setting up mechanisms to ensure adequate compliance during the recapture period.

But what happens if a disaster like a fire or hurricane destroys or damages the project during construction, or before the end of the compliance period? What then? Can the tax credits be preserved? Will there be enough insurance proceeds to rebuild the project?

Participants in the Court Square Center mixed-use real estate project in Memphis, TN found out the answers from actual experience. Fortunately, they appear headed toward a successful conclusion as the result of solid decisions and actions made before and after a catastrophic fire.

Three of the deal participants – co-developer Bill Whitman, attorney Jerry Breed, and historic preservation consultant John Tess – described the project, fire, and response, and offered advice to others, on a panel during the National Housing & Rehabilitation Association's recent 2008 Fall Forum conference in Boston, MA. Whitman is with Telesis Corp. in Washington, DC. Breed is a partner with the law firm of Powell Goldstein LLP in its Washington, DC office. Tess, based in Portland, OR, is president of Heritage Consulting Group LLC.

### Large Mixed-Use Project

Court Square Center, the subject of an earlier article by the Tax Credit Advisor (see October 2006, p. 1) is a large, complex real estate project in downtown Memphis. Telesis Corp. is a co-developer primarily managing the development process. The other co-developer is CGI & Partners Court Square Center, LLC, managing members of which are John Basek, Yorke Lawson, and William Chandler.

The speakers noted it had taken several years to structure the transaction and secure all the financing, which included \$19.3 million in expected equity to be generated by federal new markets and historic rehabilitation tax credits. New market tax credit allocations totaling \$40.6 million were received from four separate community development entities (CDEs), including Columbia, MD-based Enterprise Community Investment, Inc., and New York-based National Development Council. US Bank Community Development Corporation was and remains the historic and new markets credit equity investor.

Among the other sources were a \$10.5 million first mortgage from a bank, a HUD-guaranteed Section 108 section mortgage from the city, a third mortgage funded from a brownfield grant, and developer funds.

Original plans called for the historic rehabilitation of three adjacent buildings into a single mixed-use development of roughly 200,000 gross square feet containing commercial offices, retail outlets, and 77 market-rate apartments. The three buildings were the 21-story Lincoln American Towers (formerly Columbian Mutual Towers), completed in 1926; five-story Lowenstein building (1885); and seven-story Court Annex

building (1898).

The commercial space in the development was largely pre-leased, and still is. Whitman said commercial use will be about 35%.

Construction was underway for two months when fire struck and ravaged the buildings, during one night in early October 2006. The Court Annex building was so badly damaged the remains were demolished; the other two buildings were heavily damaged but survived. The cause of the disaster was a fire – later ruled accidental – that started in and destroyed an historic church three blocks away. “The embers from that fire blew onto our building,” said Whitman.

### **Insurance Policy**

“Now what do you do?” Whitman asked.

First, he said, “we got out the insurance policy” the lender had required the sponsors to buy (premium about \$375,000) “and began to understand it.”

He said \$50 million worth of insurance was purchased, in a builder’s risk policy and umbrella, from an insurance company.

Whitman noted the sponsors first discovered that the \$50 million was not an amount of blanket coverage, but rather an overarching figure comprised of multiple, smaller “sub-limits” of coverage on different cost elements. There were sub-limits, each with a dollar amount of maximum coverage, for each building shell, the project’s hard costs, soft costs, and for business interruption.

The insurance coverage amount included \$7.5 million worth against the loss of historic and new markets tax credits. “We were fortunate enough, or smart enough, to actually insure the tax credits,” explained Whitman, noting the project hadn’t yet earned historic credits nor had the historic tax credit equity been collected by the time the fire struck. “In this case,” he said, “we realized an immediate loss of all the tax credits that would have been associated with that [destroyed Court Annex] building. There was no way to get them back, they were gone.”

Whitman indicated the sponsors quickly hired an insurance adjuster to help them understand their policy, formulate the amount of their claim request, submit the claim, and guide them through the claims process with the insurer. The developer’s contractor helped by estimating the value of the building shells and the replacement cost.

He indicated the sponsors moved quickly to assure their investor, and regularly communicated with the investor and others on all aspects of the recovery and rebuilding process to instill comfort that things were moving steadily forward and that the project would be completed.

Whitman said the insurance company was cooperative and didn’t fight the claim request. Still, it took about a year to collect the final check. “These claims do not proceed quickly,” he noted.

The insurance proceeds will be spent on “replacement property,” that is paying to build a new replacement building to be constructed where the Court Annex building once stood.

Breed said insurance proceeds received as the result of a casualty event like a fire aren’t taxable income to the recipients, provided they are used to replace or restore the building within a certain proscribed time period. On the other hand, he noted the amount of the insurance proceeds spent to replace a building isn’t added to the original basis

amount of the building for purposes of the tax credits.

### **Revision of Project**

Whitman said that until the sponsors found out the size of the insurance settlement, they couldn't refinance the entire project nor develop a design or development budget for the third replacement building. He noted the revised total development cost for the project is about \$51 million, excluding the cost of the new building, about more \$4 million than the original total development cost.

Whitman said the sponsors re-closed the financing on the two surviving historic buildings. He noted the first mortgage, which hadn't yet been funded, was reduced by \$2.5 million when it was re-closed due to the fall-out of the Court Annex building from the original development, but the lender held the original rate. All the other original funding sources for the project were maintained.

Whitman noted a proposed design for the third building, to be smaller than the original, has been submitted to the National Park Service for approval. Even though the new building won't be eligible for historic credits, the Park Service contended it has a right of design approval. One of two original historic tax credit applications to the Park Service covered both the Lowenstein and Court Annex buildings (the second was for the tower alone), and the project is in an historic district.

Tess said the Park Service set out some "fairly modest" requirements for the new building, indicating they wanted some "echoes" of the original structure but provided flexibility.

Whitman said construction resumed on the tower building shortly after the fire, and the tower should be placed in service by year-end 2007. He anticipated the Lowenstein building will be placed in service by year-end 2008, and the third building by year-end 2008 or early 2009.

The development is still expected to qualify for historic tax credits for the tower and Lowenstein buildings. However, the investor's equity contribution for the historic credits was reduced because of the loss of anticipated credits for the Court Annex building.

Similarly, the project will still benefit from new markets tax credits – CDEs took back just 10% of the original NMTC authority they had allocated toward the project. This reduction was triggered by the reduction in NMTC-enhanced historic equity to the highly leveraged project, and the fact that the insurance check was written directly to the project rather than being channeled first through a fund affiliated with the CDE and then to the project, in which case the insurance proceeds would have been "enhanced" by NMTCs. This lost portion of NMTC benefit is equal to the lost portion of NMTC-enhanced historic tax equity that was to go to the CDE and then to the project.

Breed advised others, in a similar circumstance, in order to retain the full original leveraged benefits from new markets tax credits, to try to see if it is possible to use the insurance proceeds to make a leveraged loan to the fund, which in turn would go to the project, rather than having the check go directly to the project.

### **Advice to Others**

The speakers also offered other advice to developers in structuring tax credit projects or to recover from casualty events during or after construction.

Whitman advised the purchase upfront of “adequate” business interruption coverage – two years at least, not just one – “because it can take a long time to put a deal like this back together. If your loss happens at the end of construction or after you’ve already started to occupy a building, it can take you more than a year.”

He also advised sponsors, after receiving word that their new insurance policy has been approved, to review their own notes and to confirm with the insurer that the final underwriting for the policy and its terms and conditions jibes with what the developer thinks he is getting.

Whitman also recommended that developers “pay close attention” to the sub-limits in their policy, and purchase insurance coverage against the loss of tax credits. “Not everybody will give you tax credit insurance, but ask for it,” he noted.

Finally, Whitman suggested that for very large projects, developers retain a “very good insurance advisor” to help them purchase insurance coverage. And, if a disaster hits their project, to hire an insurance adjuster afterwards to help with the claims process. “It’s a parallel universe,” Whitman said. “The insurance business talks a language of their own. You’ve got to have an expert on your side. They will take a huge burden off your shoulder, and do the job that you can’t.”

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