

Legal Opinion: GCH-0042

Index: 2.700, 2.705

Subject: Ownership of Funds in Residual Receipts Account

February 20, 1992

MEMORANDUM FOR: John P. Dellera, Regional Counsel, 2G

FROM: Robert S. Kenison, Associate General Counsel
Office of Assisted Housing and Community Development, GCH

SUBJECT: Marine Terrace, Project No. 012-35376
Ownership of Funds in Residual Receipts Account

This is in response to your memorandum of September 12, 1991, to Acting Associate General Counsel Heaton Nash regarding the captioned project.

The owner of the captioned FHA-insured, 100 percent section 8 project intends to sell the project and retire the FHA insured mortgage in the sale transaction. The issue has arisen as to whether HUD or the limited distribution owner has a right to the \$6,000,000 in the project's residual receipts account.

The project was originally processed pursuant to the HUD state agency section 8 regulations at Part 883. The HUD notice of project selection was issued in 1979 and the Agreement to Enter into a Housing Assistance Payments Contract (AHAP) pursuant to Part 883 was signed on September 26, 1979. Subsequently, it was determined that state agency funding was not available.

On August 20, 1980, the AHAP executed pursuant to Part 883 was terminated by mutual agreement of HUD and the owner. We understand that no new notice of project selection was issued, but AHAP pursuant to HUD section 8 substantial rehabilitation regulations at Part 881 was signed on August 27, 1980.

On March 20, 1980, a significant revision in HUD section 8 substantial rehabilitation regulations became effective.

Prior to the March 20 revision the only HUD control over the residual receipts account or limitation on distributions in FHA insured section 8 substantial rehabilitation projects was contained in the FHA regulations and insured loan documents. The FHA regulations and insured loan documents required that funds in the residual receipts account could be used only for project related costs except for a distribution to the owner of up to six percent per annum of the owner's original equity investment.

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The March 20, 1980, revision added sections 881.205 and

881.601. Section 881.205(b)(2) permitted a distribution of 10 percent and provided that "Upon termination of the Contract, any excess funds must be remitted to HUD."

Section 881.205(g) provided that the provisions of this section would apply to FHA-insured projects instead of the applicable mortgage insurance program provisions. Section 881.601(e) provided that excess funds must be deposited in a residual receipts account and "withdrawals from this account will be made only for project purposes and with the approval of HUD." It also indicated that the provisions 881.601(e) would apply instead of the otherwise applicable FHA provisions.

On April 11, 1990, Assistant General Counsel David R. Cooper issued the attached letter opinion. It provides that upon the retirement of the FHA insured loan the FHA regulations and contract documents permit the project owner to retain the funds contained in the residual receipts account. The owner is relying upon this opinion to support his position that he is entitled to the funds in the residual receipts account.

Applicability of Subparts E and F of the Revised Regulations

The March 20, 1980, revision to the section 8 substantial rehabilitation regulations at section 881.104 states that the revised regulations apply "to all proposals for which a notification of selection was not issued before March 20, 1980, except that "subparts E (housing assistance payments contract) and F (management) apply to all projects for which an Agreement was not executed before the (March 20, 1980) effective date of the revision."

There is no provision for transferring a signed AHAP from the jurisdiction of one part of the HUD section 8 regulations to another. When the project was changed from the jurisdiction of the part 883 regulations to the part 881 regulations the contractual relationship between the owner and HUD ended. That contractual relationship began anew when the AHAP pursuant to part 881 was signed.

The fact that the initial AHAP pursuant to HUD regulations at Part 883 was terminated by the mutual consent of HUD and the project owner; that a new AHAP pursuant to Part 881 was signed on August 28, 1980; and that no new notification of selection was issued subsequent to the one originally issued in 1979, makes the captioned project subject to the provisions of subparts E and F of the revised section 8 substantial rehabilitation regulations.

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Inapplicability of Subpart B of the Revised Regulations

On December 12, 1979, I issued the attached opinion to all HUD regional and area counsel. The owner cites it as substantiating his claim to the funds in the residual receipts account.

The opinion deals with the revised section 8 new construction regulations effective on November 5, 1979. The section 8 new construction (Part 880) and substantial rehabilitation (Part 881) regulations are similar in regard to the issues addressed herein and the December 12 opinion has equal application to section 8 substantial rehabilitation projects.

The last paragraph in the opinion states that:

"A question has arisen concerning the applicability of provisions concerning limitations on distributions (section 880.205) in the case of projects where a notification of selection of preliminary proposal was issued before the effective date of the regulations, but the agreement (AHAP) was not executed by that date. The general rule is that only subparts E and F apply to such projects. Section §880.601(e), use of project funds, which is in subpart F, provides that project funds must be used for distribution in accordance with section 880.205 and for other stated purposes. We interpret this section to mean that project funds must be used for distributions in accordance with section 880.205 only for projects subject to subpart B. Accordingly, for projects where the agreement is executed on or after the effective date of the regulations and where the notification of selection was issued before the date, the provisions on limitations on distributions do not apply even though they are referred to in subpart F."

The rationale used in the December 12 opinion which withholds imposition of the limitation on distributions in section 881.205(e) would also apply to the section 881.205(e) provision that "upon termination of the contract, any excess funds must be remitted to HUD." Section 881.205(e) does not apply to the captioned project because section 881.205 is located in subpart B.

Use of Residual Receipts Funds Prior to Termination of The HAP

The residual receipts account is addressed in section 881.601(e) independent of any reference to section 881.205. Section 881.601 is located in subpart F making the captioned project subject to section 881.601(e).

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The HAP contract in the captioned project will expire in 2002. Section 881.601(e)(3) states that "in the case of HUD-insured projects, the provisions of this paragraph will apply instead of the otherwise applicable mortgage insurance provisions." Section 881.601(e)(1) prohibits withdrawal from the residual receipts account except for project purposes upon HUD approval.

The funds in the residual receipts account must continue to be used for section 8 project purposes for the duration of the HAP contract regardless of the proposed retirement of the FHA insured

mortgage.

Ownership of the Residual Receipts Funds Upon Expiration of the HAP

Section 881.601(e) states that "project funds must be used for the benefit of the project ... and to provide distributions to the owner...any remaining project funds (after payment of project expenses, funding of reserves and payment of the owner distribution) must be deposited with the mortgagee or other HUD-approved depository in an interest-bearing residual receipts account. Withdrawals from this account will be made only for project purposes and with the approval of HUD."

This section 881.601(e) regulation of the residual receipts account is independent of any reference to the disposition of project accounts contained in section 881.205 and applies to the captioned project.

Prior to the March 20, 1980 revision, Part 881 did not regulate the residual receipts account. Section 881.601(e) expressly places new constraints upon the funds in the residual receipts account.

When the AHAP on the captioned project was signed, the owner and HUD knew that the 6 percent FHA limitation on distribution would be applicable. The owner bargained for and received a potential return of 6 percent on his equity investment. It was never intended or contemplated that the residual receipts account would amass a 6 million dollar surplus.

A FHA insured project with 100 percent section 8 rent subsidy is substantially different from other FHA insured projects. In a 100 percent section 8 project HUD guarantees that the owner will receive the subsidized rent for each unit occupied by an eligible tenant and provides vacancy payments for unoccupied units. The section 8 HAP contract has substantial value and is often pledged to lenders or bond trustees to obtain more favorable financing. The funds accumulated in the residual receipts are derived from the section 8 rent subsidy.

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In a FHA insured project with partial or no section 8 subsidy, the owner has no HUD guarantee in regard to the rent payments on the unsubsidized units. The owner is subject to the market contingencies faced by other private market landlords in regard to the unsubsidized units. The owner must attract tenants able to pay market rate rent, collect the entire rent from the market rate tenants, and bear the total financial burden of vacant market rate units. The funds accumulated in the residual receipts account are typically derived from both the market rate tenants as well as the assisted tenants.

HUD recognizes these differences and makes sections 881.205 and 881.601 applicable only to 100 percent section 8 projects.

The funds in the captioned 100 percent section 8 project were totally provided by the section 8 subsidized rents. The owner bargained for and received a FHA insured section 8 subsidized project which permitted him to receive up to a 6 percent return on his equity contribution. If the owner were allowed to retain the funds in the residual receipts account, his return on equity would be far in excess of the agreed 6 percent.

Section 881.601 states that the section 8 provisions apply instead of the otherwise applicable FHA provisions. The fact that the FHA provisions permit the owner to retain the proceeds of the residual receipts fund upon retirement of the FHA insured mortgage, has no effect upon the section 8 requirements.

HUD regulations at section 881.601 do not address the ownership of the funds in the residual receipts account at the expiration of the HAP contract. However, since the funds are entirely derived from HUD; the owner has already received his 6 percent bargained for return on equity; and, the funds are no longer needed for their original propose, it is reasonable to require that the funds be returned to HUD.

If you have any questions concerning this memorandum, please contact Joe Bacus at 458-0996.