General Management/Preservation Issues

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MEMORANDUM FOR: Frank M. Malone, Director, Office of Multifamily Housing Preservation and Property Disposition, HMP

FROM: Harold A. Levy, Chief Attorney, Loan Management and Property Disposition Section, GHM

SUBJECT: Fort Heath Apartments
Project No. 023-038NI

This is in response to Audrey Hinton's memorandum dated July 22, 1991 requesting our opinion as to the treatment of partially assisted projects under the Emergency Low Income Housing Preservation Act of 1987 ("ELIHPA"), enacted as title II of the Housing and Community Development Act of 1987, and the Low Income Housing Preservation and Resident Homeownership Act of 1990 ("LIHPRHA"), enacted as subtitle A of title VI of the Cranston-Gonzalez National Affordable Housing Act.

Fort Heath Apartments (the "Project") is a noninsured project financed by a mortgage from the Massachusetts Housing Finance Agency ("MHFA") and is partially assisted under Section 236 of the National Housing Act. The MHFA mortgage covers the entire Project. Only a portion of the units in the Project receive the benefit of the Section 236 interest reduction subsidy and are reserved for low income use, but all of the units are subject to a MHFA regulatory agreement. Under the current regulatory agreement, Fort Heath Associates (the "Owner") is limited to receiving a 6% annual return on its equity in the entire Project. The Owner submitted to the Department a transition notice of intent, pursuant to Section 604 of LIHPRHA, on December 31, 1990, in order to preserve its option to proceed under the provisions of either ELIHPA or LIHPRHA. A letter to Kevin East, dated July 8, 1991, from Pamela Goodman, counsel to the Owner, informed the Department of the Owner's intention to retain the Project and request incentives under ELIHPA in exchange for maintaining the affordability restrictions on the Project for the remaining term of the mortgage. The letter requested an opinion from the Department, prior to the Owner exercising this option, as to whether the entire Project is eligible for Section 241 insurance, an incentive provided under both ELIHPA and LIHPRHA, or whether only the assisted portion of the Project may receive incentives.

The Project is one of many partially-assisted projects which may be eligible for incentives under ELIHPA and/or LIHPRHA. Moreover, there are many related issues which must be addressed in applying ELIHPA or LIHPRHA to a partially-assisted project. The primary issues pertaining to such projects are as follows:

1. Is the entire project taken into account in calculating the appraised value (under ELIHPA) or preservation value and preservation equity (under LIHPRHA)?

2. Are the allowable distributions (under ELIHPA) or the annual authorized return and aggregate preservation rents (under LIHPRHA) to be calculated for the entire project or the assisted units only?

3. With respect to projects whose owners elect to retain the project in exchange for incentives, would HUD provide incentives, and impose low income affordability restrictions, with respect to the assisted units only?

4. With respect to projects which are to be sold pursuant to the plan of action, would HUD provide incentives, and impose low income affordability restrictions, with respect to the assisted units only?

5. How would the maximum amount of a Section 241(f) loan for a partially-assisted project be calculated?

We will address these issues in turn.[1]

I Calculation of Preservation Value or Appraised Value

Under Section 225(b)(1) of ELIHPA, the Secretary may approve a plan of action that includes incentives only upon finding that the package of incentives "is necessary to provide a fair return to the owner." LIHPRHA provides a more detailed scheme for establishing the amount of the incentives to be provided. Under Section 213, appraisals are commissioned to determine the value of "the property" both at its highest and best use as residential rental housing and at its highest and best use without limitation

1 There are additional questions which will have to be addressed at some point with respect to partially assisted projects. Some of these concern the treatment of unassisted units that are subsidized under a State program and the use of capital improvement loan proceeds to rehabilitate unassisted units. Since it is not necessary to resolve such issues in order to process the plan of action for the Project in question, we are deferring consideration of such issues.

on use. The Conference Report to the LIHPRHA legislation makes clear the purpose for these valuations:

> "The valuation process is designed primarily to determine what economic result an owner might have achieved by prepaying the existing HUD-assisted

> mortgage, ending the affordability restrictions on the housing and converting the project to alternative use (i.e., market rate rental housing, condominiums or nonresidential housing.)"

H. Conf. Rep. No. 101-943, 101st Cong., 2nd Sess. 461 (1990). Clearly, cases could arise in which the owner's inability to terminate the affordability restrictions on the assisted units would have a detrimental effect on the appraised value of the unassisted units. For example, if the highest and best use of the project is as non-rental property, the existence of restrictions requiring the continued use of the assisted units as low- and moderate-income rental housing would prevent the conversion of the project to such other use.

Of course, circumstances could exist in which the value of the unassisted units is not held down by the continuation of affordability restrictions on the assisted units. For example, if all of the assisted units were located in a physically separate location from the unassisted units, and it were feasible to release the unassisted units as security under the mortgage, there would be no justification for compensating the owner for the market value of the unassisted units. However, we understand that in most cases the unassisted units are not located in separate buildings from the assisted units.

Moreover, even in cases where the highest and best use of the project is as market rate rental housing, a separate valuation of the assisted units is not feasible where, as is typically the case, the assisted units are dispersed among the unassisted units.

Therefore, on the basis of the evident legislative intent behind both ELIHPA and LIHPRHA, we think that the determinations of appraised value upon which incentives are based should take into account the value of both assisted and unassisted units, unless it can be shown that the value of the unassisted units is unaffected by the continuation of low income affordability restrictions on the assisted units and that it is feasible to make a separate valuation of the assisted units only.

II Incentives and Affordability Restrictions Under "Extension" and "Transfer" Plans of Action

Perhaps the most difficult and most crucial issue concerning the treatment of partially assisted projects under ELIHPA and

LIHPRHA is whether incentives (principally Section 8 project-based assistance) should be provided with respect to all of the units in the project or with respect to the assisted units only, and likewise, whether low income affordability restrictions should be imposed on all units or the assisted units only.

The relevant statutory provisions of ELIHPA (see Sections 224, 225(b)) and LIHPRHA (see Sections 219, 222) use the terms "housing" and "eligible low income housing" when describing the units for which incentives would be provided and for which low income affordability restrictions would be maintained. Under both statutes, the term "eligible low income housing" is similarly defined as any "housing" financed by one of the enumerated types of mortgages or assistance. There is no clear indication that Congress considered whether a portion of a project could be considered "eligible low income housing" to the exclusion of the remainder of the project.

The strongest argument in favor of a position that incentives and "low income affordability restrictions" are inapplicable to unassisted units is that the overall purpose of both ELIHPA and LIHPRHA is to preserve the housing units which were "insured or assisted" under Section 221(d)(3) and Section 236, see Section 202(a)(1) of ELIHPA, and not to increase the stock of low- and moderate-income housing. The unassisted units in a Section 236 partially assisted project were never intended to serve as low-and moderate-income housing (except on a de facto basis due to market conditions) and have not been subject to HUD-imposed regulatory control. It could reasonably be argued that by providing incentives and imposing restrictions on such units, HUD would be transforming a housing preservation program into a program to expand the stock of affordable housing. This position is supported by the fact that the term "low income affordability restrictions" is defined in section 233(2) of ELIHPA and section 229(3) of LIHPRHA to mean limits imposed by regulation or regulatory agreement on tenant rents, rent contributions or income eligibility. Since the unassisted units are not restricted by regulation or regulatory agreement as to such matters, it can be reasonably argued that the "extension" or "maintenance" of low-income affordability restrictions would not pertain to such unassisted units.

As to the contrary viewpoint, perhaps the strongest argument in favor of a position that incentives and affordability restrictions are applicable to unassisted units is that, given the conclusion in part I of this memorandum that the owner is entitled generally to just compensation with respect to the entire project, providing the project income for such compensation through incentives for only a portion of the units would be a grossly inefficient use of Federal resources. For example, in a project where half of the units are assisted, provision of Section 8 funds for the assisted units only might

require Section 8 contract rents of 120% of Fair Market Rent, whereas provision of Section 8 funds for all of the units might require Section 8 contract rents of 110% of Fair Market Rent. In light of the requirement in Section 222(a)(1) of LIHPRHA and Section 225(b)(2) that HUD must take "due diligence" to ensure that "the package of incentives is, for the Federal Government, the least costly alternative that is consistent with the full achievement of the purposes" of the statute, it can be argued that Congress did not expect HUD to provide compensation for an entire project if affordability restrictions were being maintained for a portion of the project only.2

We do not think that either ELIHPA and LIHPRHA provides sufficient guidance to dictate one position or the other on this issue. We think that the absence of legislative guidance permits HUD to construe the statute as either authorizing the provision of incentives, and the imposition of low income affordability restrictions for the term of the plan of action, for the entire project, or as allowing HUD to provide incentives and impose low income affordability restrictions for a portion of the project only. We do not believe, however, that the choice can be made on a case-by-case basis at the owner's option, as suggested by the Owner's counsel, because there is no indication in either statute that Congress intended to give owners such choice.

We understand that your Office's position, from a policy standpoint, is that incentives should be provided, and low-income affordability restrictions imposed, with respect to the assisted units only. On the basis of the above analysis, we think that there is a valid legal basis for adopting this position.

Both ELIHPA and LIHPRHA list as incentives the provision of financing for capital improvements through a direct loan under the capital improvement loan program or through insurance of a Section 241 rehabilitation loan. It would generally not be feasible to repair only the assisted units in a project; that is, maintaining the assisted units in good repair and condition will generally require that the unassisted units and common facilities be repaired as well. Therefore, notwithstanding your general

2 If this position is adopted, the unassisted units would be included in the "proportionality" requirement of section 225(b)(3)(F) of ELIHPA and section 222(a)(2)(F) of LIHPRHA. Unassisted units that are occupied by tenants of very low, lower and moderate income (including those with incomes above 95 percent of median area income) would count towards the establishing the proportions of very low, lower and moderate income tenants that must occupy the project for the term of the plan of action.

position that incentives should be provided, and low-income affordability restrictions imposed, with respect to assisted units only, we think that you could at the same time determine that repair financing may be provided with respect to the entire project.

Finally, it has been suggested that LIHPRHA provides a basis for concluding that incentives and affordability restrictions apply in "extension" plans of action only to the assisted units, while incentives and affordability restrictions could be applied to the entire project in "transfer" plans of action. We see no basis for making this distinction. Section 222, which establishes criteria for approval of a plan of action involving incentives, is equally applicable to both "extension" and "transfer plans of action. See section 220(d)(1).

III Allowable Distributions, Annual Authorized Return and Aggregate Preservation Rents

Under Section 224(a)(1) and (2) of ELIHPA, the owner may receive an increase in the allowable distribution or other measures to increase the rate of return on investment, and revisions to the method of calculating equity. Likewise, Section 214 of LIHPRHA establishes an annual authorized return equal to 8 percent of the preservation equity, which is defined in Section 229(8) for purposes of determining the annual authorized return as the preservation value less debt secured by the property. The higher level of return on equity permitted under these provisions (along with the provision of Section 241(f) equity take-out loans) is the means by which owners are compensated for being deprived of their right to prepay their mortgages and convert their projects to more lucrative use.

The literal language of Section 229(8) would seem to require that, in cases where the preservation value is calculated with respect to the entire project pursuant to our analysis in part I above, the annual authorized return should likewise be calculated with respect to the entire project. However, this approach ignores the functional purpose of calculating the annual authorized return, which is to establish a component that is factored into the calculation of Section 8 contract rents for those assisted units that will be subsidized with Section 8. Rental income for unassisted units in a partially assisted Section 236 project and beyond HUD's control and are unpredictable as well. If your Office adopts the position that incentives will be provided, and low-income affordability restrictions imposed, with respect to the assisted units only, it would make no functional sense to ascribe an annual authorized return with respect to the unassisted (and hence unregulated) units.

Section 214(b) of LIHPRHA directs the Secretary to determines the aggregate preservation rents for each project appraised under Section 213. The aggregate preservation rents are determined solely for the purpose of comparison with the Federal cost limits. Subsections 214(b)(1) and (b)(2) of the statute define the aggregate preservation rents as the "gross potential income for the project" that would be required to support the following costs: the annual authorized return (for extension preservation rents) or debt service on the acquisition loan (for transfer preservation rents); debt service on the rehabilitation loan and federally assisted mortgage, project operating expenses and adequate reserves. Since, under your Office's policy position, the annual authorized return would be calculated for the assisted units only, the aggregate preservation rents would likewise be calculated with respect to the assisted units only. This outcome is consistent with the overall purpose of the aggregate preservation rents, which is to measure the cost of preserving each project under LIHPRHA as low- and moderate-income housing against the Federal cost limit "benchmark." Since you propose to adopt a position that would preserve only the assisted units, it is appropriate to measure the cost of preserving those units only.

IV Section 241(f) Loan Amount

Section 241(f), as enacted by ELIHPA, provides that an equity loan insured under that section shall be limited to an amount equal to 90 percent of the value of the equity in the project, provided that the Secretary, in making the determination of equity, "shall take into account that rental income for the project may rise within limits established by section 225(b) of ELIHPA ...." On the basis of our analysis in Part I of this memorandum, the equity on which the Section 241(f) loan for a partially assisted project would be based would be the equity of the entire project. Under ELIHPA, the degree to which HUD's estimate of the rental income for the project may require a lower loan amount may depend on whether or not HUD provides incentives for the entire project. If, as you propose, HUD provides Section 8 assistance (at 100% percent of FMR) for the assisted units only, the maximum loan amount may be lower than if HUD also provides Section 8 assistance at the same contract rents for unassisted units as well.

Likewise, under LIHPRHA, the maximum loan amount for a Section 241(f) equity loan is the lesser of 70 percent of preservation equity or the amount that can be supported by the project on the basis of an 8 percent return on preservation equity; a Section 241(f) acquisition loan is generally limited to 95 percent of the preservation equity. Thus, in the case of an equity loan, the "70 percent of preservation equity" test would, in most cases, be based on the preservation equity of the entire project; however, HUD's estimate of the amount that can be

supported on the basis of the annual authorized return would have to take into account the fact that the unassisted units would not receive incentives. This may very well result in a lower loan amount than would be the case if all of the units were to receive incentives. On the other hand, in the case of a preservation loan the estimate of project income is not factored into the establishment of a maximum loan amount, and thus HUD's decision not to provide incentives for the unassisted units would not result in a reduction of the amount of the loan.