



MEMORANDUM

TO: Charles Williams, HUD Deputy Assistant Secretary for Multifamily Housing

FROM: James R. Grow, NHLP, on behalf of the National Preservation Working Group

RE: Issues Raised by HUD's May 31, 2006 Guidance on Foreclosure and Property Disposition

DATE: July 28, 2006

614 Grand Avenue, Suite 320
Oakland, California 94610
Telephone: 510-251-9400
Fax: 510-451-2300
nhlp@nhlp.org

During our discussion with you at the National Preservation Working Group meeting in Washington on July 14, we agreed to provide you with this memorandum summarizing the concerns raised. You indicated that the Department was evaluating these issues, and would consider these comments in developing revisions to the May 31 guidance.

Background. Because an essential ingredient of preserving and improving HUD multifamily properties facing foreclosure or other disposition is retention of the project-based Section 8 contract, Congress enacted Section 311 of the FY 2006 HUD Appropriations bill, which generally requires HUD to maintain project-based Section 8 contracts when selling properties at foreclosure or from the HUD inventory. Pub. L. No. 109-115, 119 Stat. 2936, § 311 (2005). This provision redirects prior HUD policy, which was generally to terminate contracts prior to or at foreclosure. Because the Department's May 31 guidance substantially limits the applicability of Section 311 in cases where retention is still appropriate, we recommend the following revisions to further the preservation goal. While we understand that Section 311 may not require all of the revisions suggested below, adopting them would substantially improve the disposition and preservation process.

Recommended policy revisions.

- In determining the "feasibility" of retaining project-based assistance, the May 31 guidance requires that existing Section 8 contract rents be sufficient to carry both the operating costs and any debt service on needed repairs, irrespective of other available funding sources and any adjustments ordinarily available (p. 6); while HUD may sell such a property with Section 8, it need not do so (p.8). Where foreclosure will be used to determine the long-term owner of the property, we recommend a more flexible definition of feasibility to permit consideration of other resources (including Section 8 contract rent adjustments to support needed rehabilitation).

Washington Office

The May 31 policy will impede preservation of the many properties requiring significant rehabilitation, since Section 8 rents alone may be below-market and incapable of supporting additional rehabilitation debt service and normal operating expenses, and because the infeasibility determination usually precedes the identification of other available federal, state and local resources. In addition, because the policy elsewhere limits contract rent adjustments to OCAF, rather than those normally available under HUD policies implementing Section 524 of MAHRAA (at p. 5), feasibility determinations will be unnecessarily pessimistic.

We understand that in certain situations disposition planning should consciously foster HUD acquisition of title and resale to competent preservation purchasers, which may require low contract rents at the time of the foreclosure bidding, other bid conditions and requirements, and HUD practices tailored to fit an overall plan. In fact, we usually support such an approach, because it creates the time necessary to develop a more appropriate responsive preservation plan, with no jeopardy to the Section 8 contract. However, as we discussed, in a particular case, if foreclosure is in fact the point where the long-term purchaser of a property will be determined, then the contract rents should be adjustable *after* the sale to ensure that appropriate resources can be obtained for rehabilitation and operations. We especially appreciated your willingness to consider our recommendation on this vital point.

We therefore recommend that preservation purchasers, whether at foreclosure or from the HUD-owned inventory, be able to obtain such rent adjustments under Section 524 (under Mark Up to Market or Budget) during the term of their long-term commitment. (As part of the feasibility determination, HUD's disposition planning should include a market study to determine area market rents for standard housing, establishing the likely Section 8 contract rent limits.) If such rent adjustments are not possible in the context of a 20-year contract required as part of a foreclosure sale, we recommend a short-term renewal contract at current rents, with a requirement that the purchaser execute a long-term renewal with rents adjusted under Section 524. Such purchasers should also provide enforceable commitments to the necessary rehabilitation and to seek and obtain any additional resources needed to support the plan (bond financing, tax credits, other state and locally provided or administered resources, etc.). We also recommend that such purchasers secure a tenant endorsement for their plans, to ensure appropriate responsiveness to tenant and project needs, which should be facilitated by improving the tenant and community consultation process as recommended *infra*. (Both the property disposition statute, 12 U.S.C. § 1701z-11(c)(1)(C) and (c)(2)(D), and MAHRAA support tenant involvement in transfer decisions.)

Any proposed "infeasibility" finding should be addressed similarly through an improved consultation process, permitting correction of any oversights in identifying available preservation resources. Where "infeasibility" is found, HUD should consider all other options (*e.g.*, under Sec. 311, Section 8(bb), the contract, or Section 318) to transfer the contract to another property and preserve affordable units in the community.

- The policy is silent on the circumstances where HUD will bid in its mortgage debt and other advances, exercise mortgagee-in-possession rights, and seek to acquire title. HUD should establish conditions at the foreclosure sale and pursue bid practices that maximize the potential for acquiring title and re-selling the property under a responsive preservation plan.

As just discussed, HUD acquisition of title is often best-suited to enable local preservation strategies outside the accelerated foreclosure auction process. As recommended *infra*, HUD should pursue pre-foreclosure planning that engages consultation with residents, local governments and prospective preservation purchasers, with a goal of determining appropriate preservation options. Where HUD acquisition is determined appropriate to ensure transfer to a responsible purchaser with adequate capacity and resources for implementing an appropriate preservation plan, HUD should establish conditions at the foreclosure sale and pursue bid practices that maximize potential for acquiring title and re-selling the property accordingly. Taking interim action to stabilize such properties through exercise of mortgagee-in-possession rights may also be essential.

- The policy permits “deteriorated neighborhood conditions” or “local land use plans” to justify an infeasibility determination (p. 7). Such determinations should not alone suffice to override preservation via retention of the contract.

Although certainly certain serious environmental conditions that cannot be remedied in a cost-effective fashion could justify an infeasibility determination, neighborhood conditions should not alone suffice, since improvement of the subject property under responsible ownership, in conjunction with other local efforts, may often serve as a catalyst for neighborhood stabilization. At the very least, such proposed findings warrant thorough examination through the more timely resident and local consultation process we recommend elsewhere.

- The policy permits Section 8 assistance to flow to purchasers only after substandard conditions are remedied (p. 5). We recommend that the proceeds flow immediately to preservation purchasers or be escrowed for payment once defective conditions are remedied.

While we support the Department’s objective not to pay defaulting owners for substandard housing, we recommend that the policy consider the needs of responsible preservation purchasers for cash flow to finance repairs under an approved rehabilitation plan while being held harmless from any unsatisfactory REAC findings attributable to the previous owner. So long as specified progress on the plan is achieved, purchasers should be able to receive assistance payments without being penalized by a 2530 flag resulting from the prior owner’s REAC score. At the very least, abated payments should be escrowed so that they can be released as units and common areas are brought into compliance, while holding the preservation purchaser harmless from the prior unsatisfactory REAC score.

- The policy requires consultation with residents only *after* HUD has made its decision (pp. 7-8). Consultation with residents should start when foreclosure, abatement, or termination is first proposed, certainly *before* HUD has made its decision about the appropriate course of action, and continue throughout the process.

In order to reach responsive decisions, the Department's consultation with residents and the local community should commence at the front-end of foreclosure planning (just as in the case of planning disposition from the HUD-owned inventory), and continue at major steps throughout the foreclosure and disposition planning process (including major proposed decisions and any replacement subsidy or relocation planning). Like the Department, residents and local communities have a huge stake in these decisions, and much to contribute to their resolution. Comments should first be solicited when foreclosure or contract enforcement actions are being considered, and Field office staff should remain available to meet with residents and local partners throughout the planning and implementation process. More timely consultation will promote better planning and results, and reduce the potential for unnecessary conflict.

- The policy covers just Section 8, not other similar subsidies (p. 4). Retention of similar project-based assistance should be included in the policy.

Although Section 311 requires the retention of only project-based Section 8, certainly the most common assistance of this type, some similarly situated properties have other assistance that should be treated similarly (e.g., Section 202 PRAC, Rent Supplement, Section 236 RAP). Although it may not be statutorily required, retention of these resources is also central to preservation efforts.

- HUD's current policies to abate or terminate Section 8 contracts before foreclosure processing remain unaffected by the guidance (at p.4). Congress' goal in retaining project-based assistance requires that HUD take appropriate steps to preserve contracts on troubled properties prior to foreclosure.

In some cases, the Department's actions to abate or terminate a contract prior to placing the property into foreclosure leaves no Section 8 contract to maintain because the contract authority has already been used for vouchers. While we understand that there may be specific situations where immediate abatement and relocation of residents may be essential to protecting their health and safety, in most situations we believe that earlier intervention and broader consultation can alleviate these problems. Wherever possible, we recommend that the Department take appropriate steps to ensure that project-based contracts remain in effect prior to foreclosure, subject to contractual abatement remedies necessary to assist relocation for imminent major threats to tenants' health and safety.

- The new policy disallowing staged abatements of project-based Section 8 contracts should not also preclude staged relocations (p. 9).

While the administrative need to no longer allow the staged abatement of Section 8 contracts is perhaps understandable, a staged relocation process may be desirable in certain market settings so as not to flood the market with Section 8 Tenant Protection Vouchers that cannot be efficiently absorbed. In the event of a necessary relocation effort (under Sec. VI of the May 31 guidance), we urge that the Field Office and Property Disposition Center consult with ULGs and the local PHA, as well as the tenants, to implement the relocation process and timeline so that tenants can effectively secure appropriate relocation housing.

- The policy states that the Department will not consider the costs of repair in establishing the market value of the property to be paid by cities exercising a right of first refusal (p. 10). Normal industry standards for market valuation should apply.

In many cases, this policy will discourage cities from participating as partners in developing a responsive disposition strategy. We believe that it results from an incorrect interpretation of the Reconciliation Act, which prohibits below-market sales or up-front grants (with grandfathered exceptions) unless backed by appropriations, which have not yet materialized. While the Act does indicate that valuations cannot reflect HUD-imposed affordability restrictions (which include *rehabilitation* requirements), this does not mean that ordinary marketplace behavior, which must factor in *repairs to market standards* (at least to code requirements) in order to permit property to be legally rented, should not govern the appraisal process that determines market value. Normal industry standards for market valuation should apply. Reconciliation only affects valuations reflecting those HUD rehabilitation requirements that exceed normal industry standards. Otherwise, the Department is forcing cities to pay twice to make properties habitable – first in the undiscounted sales price and then in the rehabilitation plan. Given scarce resources, few cities would find such projects feasible.

- The policy apparently implements HUD's position on purchaser qualifications under Section 219 announced in proposed regulations last year. We recommend HUD adopt stronger requirements, as recommended in comments by NPWG members in that rulemaking.

The May 31 guidance indicates that HUD will follow the proposal announced in the proposed rules implementing Section 219. Prominent in our comments were at least two points: that a prospective purchaser's performance outside the subject jurisdiction is certainly relevant to the determination, and that more than self-certification should be required. These deficiencies should be addressed in both the final rule and revised guidance.

- Where the Section 8 contract will be terminated, the policy limits the number of tenant protection vouchers to those necessary “to assist all eligible current [project-based Section 8] residents” (p.8). Vouchers should be made available to replace all units assisted under the contract, whether occupied or not, as well as for those tenants in units without Section 8 assistance.

The Administration has sought Congressional approval for this shift in policy, which has not yet been granted. Until Congress acts, HUD must continue its prior policy of long-standing, as expressed in HUD Notice PIH 2001-41, to provide vouchers to replace subsidies for the full number of affordable housing units being lost as a result of the decision, as well as those needed to protect unassisted residents facing loss of affordability protections via foreclosure.

We very much appreciated the opportunity to meet with you and to provide these comments. Please feel free to contact me if you have any questions, or for a meeting to discuss these important issues.