## Conclusion

While none of the statutes, regulations or policies discussed in the notice is new, the notice provides a comprehensive review of the rules that PHAs should follow to live up to HUD's promise of providing safe, decent, and sanitary housing for everyone, regardless of race, color, national origin, disability, sex, religion or familial status. The guidance also identifies the places in which public participation is required, providing advocates an opportunity to push for equitable communities and to hold PHAs accountable to the families and communities that they serve. ■

# Los Angeles Tenants Settle Section 250 Prepayment Litigation on Favorable Terms

On June 16, 2011, residents of the Holiday Venice apartments, a 246-unit federally subsidized development in Los Angeles, settled a longstanding lawsuit against the Department of Housing and Urban Development (HUD) and the owners of the development. The lawsuit, filed June 1, 2009, challenged the prepayment of the development's HUD-subsidized mortgages as a violation of Section 250 of the National Housing Act.[1] The terms of the settlement include the owners' commitment to 20 years of extended affordability restrictions under the project-based Section 8 program, specific tenant purchase rights in the event the owners choose to sell the development and an ongoing agreement for the owners to subsidize a portion of the rent for certain households.

## Factual Background

Located less than a mile from the Pacific Ocean, Holiday Venice has served as a critical foundation for the diverse community that comprises the historic Oakwood neighborhood of Venice. Originally constructed in the early 1970s by the nonprofit Project Action, the scattered site development consists of 15 buildings on 14 separate properties. The buildings were developed utilizing HUD's Section 236 program, which provided federal mortgage insurance and interest reduction payments in exchange for certain affordability restrictions and eligibility limits restricting occupancy to low-income tenants. These restrictions were contained in recorded regulatory agreements that ran coterminously with the 40-year mortgages. Because the project was originally developed by a nonprofit, the Section 236 rules required the loan documents to contain a provision prohibiting prepayment of the mortgages, and the associated release of the regulatory agreements, for the full 40-year mortgage term without prior HUD approval.

Upon a loan default by Project Action in the late 1970s, HUD assumed the mortgages and shortly thereafter the properties began receiving project-based Section 8 rental assistance for all of the units under HUD's Loan Management Set Aside program. Though the properties were subsequently sold to a private owner in the early 1980s, HUD required that the prepayment prohibition be carried forward in new regulatory agreements. In December 1998, HUD approved another transfer of physical assets and the current owners, New Venice Partners, purchased Holiday Venice. Once again, after the tenants and community

[1]Holiday Venice Tenant Action Comm. et al. v. Donovan, No. 09cv3912 (C.D. Cal. filed June 1, 2009).

allies had highlighted the issue, HUD required that the assumption agreements incorporate the provision prohibiting prepayment without HUD approval.

## Legal Background

Enacted in 1983, Section 250 of the National Housing Act states unequivocally that where HUD approval is required for mortgage prepayment, the Secretary shall not accept the offer unless, inter alia, "the Secretary has determined that such project is *no longer meeting a need for rental housing for lower income families in the area*."[2] Notwithstanding this statute's apparently clear language, HUD has established a process for owners to prepay and recapitalize. HUD's most recent policy pronouncement is Notice H 2006-11, "Prepayments Subject to Section 250(a) of the National Housing Act."[3] In this notice, HUD claims the authority to approve a prepayment "in order to recapitalize a property," but will do so "only if the owner agrees to execute a Use Agreement that ensures that the project will continue to be maintained as rental housing for lower income families in the area until at least the date the original mortgage would have terminated had it not been prepaid." The rationale is that the former regulatory agreement is no longer needed because it will be replaced by a new Use Agreement.[4] The Notice also states that the Use Agreement must "require the same affordability and rental restrictions as those that were in place before the prepayment and minimize the threat of a negative impact on current and future low-income tenants."

Despite Notice H 2006-11's requirement to maintain the same affordability and rental restrictions, HUD's form Use Agreement for Section 250 prepayments of Section 236 properties (form HUD-93142) falls short of maintaining the same restrictions that bind the property under the Section 236 regulations and regulatory agreement. One potentially harmful difference between the Section 236 rules and form HUD-93142 is the allowance in the latter of rent increases up to 30% of 80% of area median income, unadjusted for household size. In some cases, this rent limit is so much higher than the former budget-based rents, and even market rents in many cases, as to be meaningless. In a few cases, as in Holiday Venice, it is significantly lower than the rents that tenants are already paying, thus rendering the rent limits contained in the Use Agreement incomprehensible.[5] The income eligibility rules contained in form HUD-93142 also differ from those of the Section 236 program, as the former fail to explicitly include household size and high-cost housing adjustments. This conflict results in previously eligible applicants becoming ineligible as over-income in some high-cost-to-income locations, such as Los Angeles, and in previously over-income applicants becoming eligible in other lower-cost-to-income locations, such as Minneapolis. Other differences created by substituting the new Use Agreement include: good cause eviction protections are limited only to current, not future, tenants; tenants lose the right to organize, review and comment on owner policies; and residents lose maintenance assurances afforded by HUD inspection and enforcement under the Real Estate Assessment Center program.

## Prepayment Approved and Lawsuit Filed

In August 2008, the Holiday Venice tenants received notice that the owners intended to prepay the mortgages, which were set to naturally mature in 2011 and 2015. In meetings aimed at garnering tenant support for the prepayment application, the owners conveyed that following prepayment they intended to enter into new long-term project-based Section 8 assistance contracts under HUD's Mark Up to Market Program that would keep the properties affordable. However, in correspondence between the tenants and HUD, the agency made it clear that entering into new Section 8 contracts would not be a condition of prepayment approval and that if the owners chose to do so, it would be as part of a voluntary and entirely separate transaction. Further preventing firm reliance on the promise of a new long-term contract was the fact that it was unclear whether the owners satisfied the eligibility requirements for HUD's Mark Up to Market Program.[6]

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[2]Codified at 12 U.S.C. § 1715z-15 (Westlaw June 21, 2011).

[3]Notice H 2006-11 replaced a similar Notice H 04-17 (Aug. 20, 2004) under the same title.

[4]Note that HUD's interpretation appears to directly contradict Section 250's text. The statute does not state that prepayment requests shall be denied unless the *regulatory agreement* is no longer serving a need, but that such requests shall be denied if the *housing itself* is no longer serving a need. Furthermore, the statute's legislative history also apparently contradicts HUD's interpretation. A prior version of Section 250 provided HUD the authority to grant a prepayment request where "the needs of lower income families in such project can more efficiently and effectively be met through other Federal housing assistance taking into account the remaining time the project could meet such needs." Congress specifically deleted this provision in a 1988 amendment of Section 250 (Pub. L. No. 100-242, tit. II, § 261, 101 Stat. 1878, 1890 (1988)), thus explicitly stripping HUD of the very kind of authority it continues to claim in Notice H 2006-11.

[5]Note that in the latter case, the Use Agreement itself will be internally inconsistent—one provision will state that rents cannot exceed 30% of 80% of AMI, but then the "initial rents" contained in Exhibit B will already violate that restriction.

[6]There are two renewal options under Mark Up to Market pursuant to HUD's Section 8 Renewal Policy Guide: the Option One-A Entitlement Eligibility and the Option One-B Discretionary Authority Eligibility. Under the Entitlement Eligibility, the property must not have a low- or moderate-income use restriction on the property, such as a property subject to Section 250 prepayment approval. Under the Discretionary Authority, projects that are not automatically eligible under Option One-A still may be approved by HUD if they meet one of three criteria: (1) tenants at the property are a "vulnerable population," as demonstrated by a majority of units rented to elderly, disabled or large families (five or more persons); (2) the property is in a low-vacancy rate area (less than 3%) and vouchers are difficult to use; or (3) the property is a high priority for the local community as demonstrated by contribution of state and local funds. Holiday Venice was clearly ineligible under Option One-A. It was questionable whether Option One-B was

Also, while the owners claimed it would be a 20-year contract, correspondence from the owners made clear that they felt they could terminate the contract at the five-year rent reassessment periods if not satisfied with the new rents.

Given the threat posed by prepayment, the tenants rejected the owners' request to support the prepayment application and instead, assisted by People Organized for Westside Renewal (POWER), launched an effort to oppose the application. Senator Barbara Boxer (D-CA) and Representative Jane Harman (D-CA) submitted a joint letter to HUD dated December 1, 2008, urging that the prepayment be denied. The tenants also submitted numerous Freedom of Information Act (FOIA) requests to HUD to obtain relevant project documents, but were rebuffed for more than six months.

In May 2009, the tenants learned via informal communication with HUD that the prepayment request had been approved two months earlier. Shortly thereafter, the Holiday Venice Tenant Association (HVTAC), Venice Community Housing Corporation (a local nonprofit community development corporation) and an individual resident filed suit in federal court naming HUD and the owners as defendants. Among the key claims included in the complaint[7] were that HUD's approval of the prepayment request violated Section 250 of the National Housing Act, since Holiday Venice continued to meet a low-income housing need in the area, and that HUD's Notice 2006-11 violated both the statute and rulemaking requirements. The complaint alleged that both the prepayment approval at Holiday Venice and the issuance of Notice H 2006-11 were arbitrary and capricious, an abuse of discretion and contrary to law, thus entitling the plaintiffs to declaratory and injunctive relief under the Administrative Procedure Act.

The plaintiffs also recorded lis pendens against all of the properties to prevent the owners from refinancing them in a manner that would introduce a new lender into the situation. Given the small remaining balances owed on the original mortgages, however, the owners did not need to seek third-party financing to prepay the mortgages, which they did in June 2009.

## Residual Receipts, New HAP Contracts, Mixed Families

While the formal litigation proceeded, a number of developments occurred that impacted the course of the lawsuit. An analysis by the plaintiffs' counsel of project rents compared with reasonable estimates of project costs predicted unusually large "residual receipts" balances in project accounts. Residual receipts are funds that remain after operating costs, reserves, debt service and the limited dividend to owners are subtracted from the tenant rents and HUD subsidy received by the owners. While it is not abnormal for efficiently managed projects to have built up some residual receipts toward the end of the mortgage term, the numbers at issue with Holiday Venice were high enough to suggest the likelihood of HUD error in its processing of rent increase requests over the years.

For properties built in the early 1970s, HUD's multifamily asset management guidebook takes the position that residual receipts are to be released to the owner upon termination of a mortgage.[8] Thus, the Holiday Venice prepayment would have the functional effect of releasing any excessive residual receipts to the owners. The plaintiffs thus filed an amended complaint on September 1, 2009, adding claims seeking the restitution of any residual receipts released to the owners as a result of the unlawful prepayment. HUD's answer to the complaint verified that prior to prepayment, the residual receipts accounts contained approximately $7.8 million.

On January 1, 2010, HUD and the owners entered into new 20-year Section 8 housing assistance payment (HAP) contracts. While this eliminated many of the harms relating to the deficiencies of form HUD-93142 that originally motivated the lawsuit, it simultaneously raised other concerns. First, the contracts were renewed under HUD's Mark Up to Market program, by which HUD approves rent increases to levels up to and, in some cases, exceeding 150% of Section 8 Fair Market Rents. While these dramatic rent increases did not negatively affect most Section 8 households, which continued to pay only 30% of adjusted household income, they did pose a serious threat to a certain subset of Holiday Venice households. These households, or "mixed families," as they are referred to by HUD regulations,[9] are those in which not every member claims eligible immigration status for purposes of Section 8 assistance. For such mixed families, the regulations set forth a calculation that prorates the Section 8 assistance based on the proportion of household members claiming eligible immigration status.[10] Thus, for these households, a dramatic markup in the contract rents would lead to significant increases in the tenant rent burden. For example, for one such Holiday Venice family, the monthly tenant rent would have increased more than 70%, from $526 to $909.

When 17 mixed families at Holiday Venice received notices of such rent increases purporting to take effect on May 1, 2010, the plaintiffs prepared a temporary restraining order (TRO) application seeking to prevent the rent increases. The owners' Mark Up to Market application had been processed under HUD's Option One-A, for which the owners were clearly ineligible prior to prepayment. Thus, the core argument in the TRO application was that

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available, and whether any of its three discretionary criteria applied.

[7]Other claims included alleged violations of the Fair Housing Act, 42 U.S.C. §§ 3601 *et seq*., the national housing goals, 12 U.S.C. § 1701t, and California's statute requiring advance notice of certain housing conversion actions, Cal. Gov't Code § 65863.10 (Westlaw June 21, 2011).

[8]*See* HUD, Multifamily Asset Management and Project Servicing 4350.1, Ch. 25 ("Residual Receipts").

[9]*See* 24 C.F.R. § 5.504 (2010).

[10]§ 5.520 (2010).

an illegal prepayment led to an illegal markup in contract rents. Prior to filing the TRO application, the plaintiffs' counsel reached an agreement with the owners' counsel on April 29, 2010, to enter into a stipulated agreement that the owners would not raise the rents on the mixed households until a preliminary injunction motion was filed and decided by the court.

The plaintiffs' counsel filed the preliminary injunction motion on May 10, 2010, which, although never argued, had the effect of causing HUD to rethink its approval of the new Housing Assistance Payments (HAP) contracts under Option One-A. On June 4, 2010, HUD sent the owners a letter requiring them to reapply under HUD's discretionary Option One-B. During the period of reprocessing the contract, with the new Section 8 contract in question, the owners' counsel and the tenants' counsel entered into settlement negotiations. By October 2010, when tenants learned that HUD had approved the Option One-B application, the framework for a settlement was largely in place.

## Settlement Agreement

The settlement agreement entered into by the plaintiffs, the owners and HUD clarifies language in the HAP contracts regarding permissible grounds for termination and makes clear that the owners cannot terminate if they are not satisfied with the rent levels at the five-year reassessment periods. Furthermore, the agreement provides tenants with a right of first refusal in the event that the owners offer the development for sale, receive an unsolicited offer, or the HAP contracts are expected to be terminated for any reason (such as congressional failure to appropriate sufficient funds). Other provisions of the settlement require the owners to conduct a comprehensive capital needs assessment and to fund reasonable project reserves. The owners are also required to acknowledge a tenant liaison selected by the tenant association and to consult with that representative on all proposed rehabilitation work. The agreement further includes a modest payment by the owners to the tenant association to help educate the residents about the settlement and to be used for other purposes consistent with their bylaws.

A key sticking point in negotiating the settlement was resolution of the mixed families issue. Relatively early on, the owners agreed to subsidize a portion of their monthly rents to offset any increased rent obligation that would accrue as a result of the marked-up contract. However, it was unclear whether such payments would then be counted as household income, thus decreasing the total amount of Section 8 assistance for those families. Toward the end of 2010, after months of negotiation on this issue, HUD agreed that, for the sole purpose of resolving the litigation, the agency would consider such payments to be in settlement of personal or property losses as referred to in 24 C.F.R. § 5.609(c)(3) and thus not included in annual household income.

Absent from the settlement agreement was any requirement that the owners return any of the residual receipts funds or, as had been requested, that HUD change its practices regarding residual receipts or audit local offices to determine whether similar issues exist with respect to other properties. Nor did HUD agree to any of the broader policy demands of the plaintiffs, such as to change its Section 250 policy, for example, to require a commitment of extended affordability *prior to* granting a prepayment request. Similarly, while it would no longer be a problem at Holiday Venice with the new long-term HAP contracts in place, HUD refused to amend the form HUD-93142 Use Agreement to fix any of its deficiencies for future prepayment situations. Thus, these issues remain for future reform.[11]

With the mixed family issue resolved, however, and the guarantee that all 246 households could remain under extended affordability restrictions, the litigation wound to a close. After finalizing issues relating to the scope of the release and attorneys' fees, the HVTAC membership approved the settlement in April 2011, and the agreement was officially executed by the plaintiffs in May 2011. HUD signed the agreement in early June 2011, and with the owners' signature on June 16, 2011, the settlement became effective.

## Conclusion

The Holiday Venice experience demonstrates the importance of a litigation strategy to force HUD and owners to make the specific commitments necessary to preserve scarce affordable housing resources. Because of the persistent efforts of tenant leaders, organizers, community allies and legal advocates, hundreds of current and future low-income households now have the opportunity to remain in their community, one which has struggled to prevent the displacing effects of gentrification for many years.

The tenants were represented pro bono by lead counsel Locke Lord Bissell & Liddell, LLP, Public Counsel (Los Angeles), and the Housing Preservation Project (St. Paul). ■

[11]For an in-depth review of recapitalization challenges facing the HUD-assisted stock and the needed HUD reforms, *see* NHLP, *Recapitalizing the HUD-Assisted Housing Stock: Part One*, 40 Hous. L. Bull. 1, 6 (Jan. 2010); NHLP, *Recapitalizing the HUD-Assisted Housing Stock: Part Two*, 40 Hous. L. Bull. 43, 55 (Feb. 2010).