

LOCAL INITIATIVES SUPPORT CORPORATION

# PRESERVATION OF AFFORDABLE RURAL HOUSING

A Practitioners' Guide to the  
Section 515 Program



**Fannie Mae  
Foundation**

**LISC**

Affordable Housing  
Preservation Initiative

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Cover Photo: Rose Garden Apartments in Auburn, Alabama.  
Photo by Billie Brown



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Published by Local Initiatives Support Corporation

**Fannie Mae  
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**LISC**  
*Helping neighbors  
build communities*

## ACKNOWLEDGMENTS

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No information in this guide is intended to be specific advice to any person or organization in connection with any actual or potential dispute, problem or question. LISC strongly advises anyone reading this guide to consider pursuing independent legal advice that addresses the specific situation at issue.

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# FOREWORD

The RHS inventory of 269,000 affordable rental apartments subsidized through the Section 515 program, a major program created in 1962 to finance affordable rental housing in rural areas, serves as an important resource to rural communities throughout the U.S. and to the low-income people who live in them. The 2004 Comprehensive Property Assessment prepared for RHS analyzing these 10,000 properties around the country concludes that while this portfolio is generally in decent condition, the stock as a whole faces significant recapitalization and long-term viability challenges. The release of this assessment, together with its significant policy implications, and the release of the Interim Final Rule for RHS's entire multifamily program, suggests that significant changes may lie ahead for the 515 program. In assessing the different proposals for the future of the program, however, it will be important to understand how the 515 affordable rental program works today – and in what ways the current structure and operation of the program complicate efforts to provide a permanent resource of affordable rental housing in rural areas of the United States.

This handbook is a compilation of articles intended to describe the 515 program as it exists today. Although each section was written to address a separate issue of interest, together they provide a broad overview of the program as a whole. This is intended to help nonprofit organizations that have an interest in serving the needs of rural communities and the low-income people who live in them improve their understanding of the rules of the 515 program, practical issues confronting owners, managers, and tenants, and some of the recent thinking and practice in the field.

**Chapter 1** describes the Section 515 Rental Housing Direct Mortgage program of the Rural Housing Service, including its history, function, regulatory scheme, characteristics of the existing stock, and programmatic trends.

**Chapter 2**, based to a large extent on interviews with experts in the field, discusses major obstacles to the preservation of RHS Section 515 properties and strategies for overcoming these obstacles.

**Chapter 3** provides a comprehensive explanation of funds available to nonprofit development organizations undertaking the acquisition and/or rehabilitation of Section 515 properties, including funds available through RHS and other sources.

**Chapter 4** discusses and analyzes the current legal framework surrounding prepayment and preservation of Section 515 properties and relevant case law.

**Chapter 5** describes current efforts to facilitate Section 515 preservation transactions through the transfer process, with a particular focus on the principles and potential impacts of Administrative Notice 4010.

The Section 515 program is already in the midst of significant change, and there is every indication that even more significant scrutiny, analysis, debate, and change are in store in the months and years ahead. Hopefully this guide will help to inform that process, and will contribute to a strong, effective program for affordable rural rental housing that can endure for many generations to come.

Vincent F. O'Donnell  
Vice President of Preservation  
Local Initiatives Support Corporation  
March, 2005

## CHAPTER ONE

## OVERVIEW

Leslie Strauss

**H**undreds of thousands of rural Americans are in danger of losing the homes they rent. Almost 10,000 projects encompassing about 269,000 units have mortgages financed through the U.S. Department of Agriculture's (USDA's) Section 515 Rural Rental Housing program that are at risk of prepayment. After prepaying a government-restricted mortgage, a property owner may be able to raise rents, displacing low-income tenants. Armed with an understanding of USDA's prepayment process, nonprofit organizations can preserve these units for their originally intended occupants.

This manual is written for community-based nonprofit organizations with some basic knowledge of affordable rural housing development, though not necessarily any knowledge of rural rental housing preservation. It provides background information about rural rental housing and the Section 515 program including current legal and regulatory issues, explains challenges to preserving Section 515 units, details the process of transferring ownership to a nonprofit, and describes resources available to help.

Section 515 is a major program used to finance affordable rental housing in rural areas, but it is not the only one. USDA's Section 514 loan and 516 grant programs fund the development of housing for farmworkers, and U.S. Department of Housing and Urban Development (HUD) programs can be used in rural areas as well. Prepayment has seldom been a concern for farmworker housing developments, perhaps because their owners are far less likely than Section 515 owners to be profit-motivated developers. HUD-financed projects are a concern on a far greater scale, with many hundreds of thousands of units nationwide subject to prepayment and even more facing expiration of their restrictive use mortgages. There seem to be no data indicating how many of these HUD units are in rural areas. While this manual focuses on Section 515, much of the information it presents would be useful for

a nonprofit or public body seeking to acquire a HUD-financed property. For more information about issues relating to preservation of HUD-assisted property, see LISC's *Stemming the Tide: A Handbook on Preserving Subsidized Multifamily Housing* and a forthcoming guide from LISC on recapitalization of affordable rental properties by nonprofit owners.

Rural Rental Housing Need<sup>1</sup>

More than 5.5 million households in nonmetropolitan parts of the United States (about one-quarter of all nonmetro households) rent their homes. They suffer some of the worst housing problems in the country, including high cost burdens and poor physical conditions.

The gap between housing costs and incomes is the most significant problem. More than one-third of rural renters (about 1.9 million households) are cost burdened – that is, they pay more than 30 percent of their income for housing. Over 900,000 rural rental households (10.4 percent) live in severely or moderately inadequate housing. A total of 2.4 million rural renter households experience housing problems.

People with low incomes are particularly likely to have housing problems. HUD defines worst case needs households as renters who are very low-income, extremely cost burdened, and/or inadequately housed, and who do not receive government housing assistance.<sup>2</sup> More than one million rural renter households meet this definition, and 92 percent of them are severely cost burdened, paying more than 50 percent of their income for housing costs.

Over the past 40 years, the USDA's Section 515 program has created more than half a million decent, affordable rental units in rural areas. Without this successful program, current need would be far higher. Yet many existing Section 515 units are at risk of becoming unavailable to the low-income families they were built to house.

## The Section 515 Program

### Program History

Created in 1962, Section 515 enables USDA to make deeply subsidized loans directly to the developers of rural rental and cooperative housing. The program has very rarely been used for cooperative housing, and its few coop units are unlikely to be subject to prepayment, so that part of the program is not addressed in this guide.

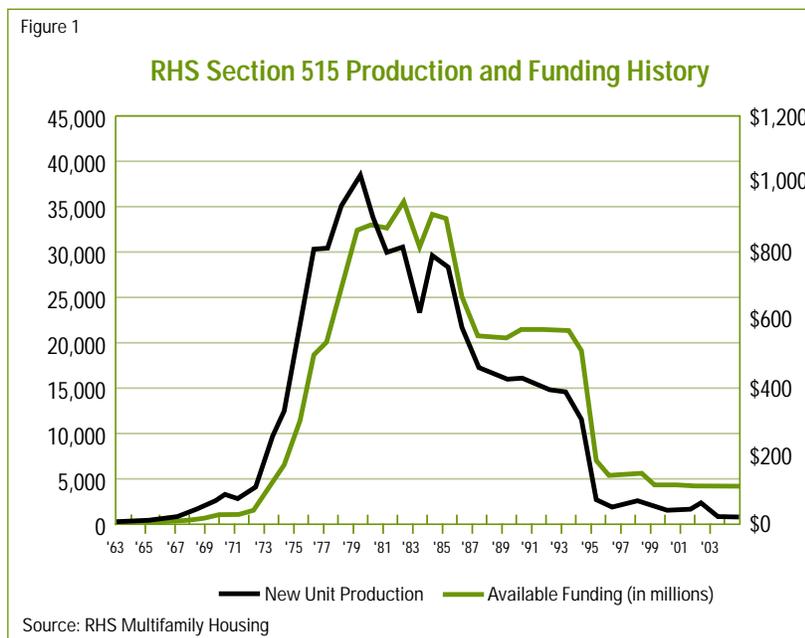
The Section 515 program was originally under the jurisdiction of USDA's Farmers Home Administration (FmHA), which was replaced in the mid-1990s by USDA's new Rural Economic and Community Development "mission area" and the Rural Housing and Community Development Service. Those names were soon shortened to USDA Rural Development (RD) and the Rural Housing Service (RHS).

USDA staff in Rural Development field offices around the country administer the RHS housing programs, including Section 515, in addition to programs of the Rural Business-Cooperative Service (RBS) and Rural Utility Service (RUS). Applications for Section 515 funding, and for prepayment, are initially submitted to local or state offices.

Section 515 program implementation started slowly, with two loans in 1963 producing a total of 24 units. Production escalated rapidly, peaking in 1979 with 1,645 loans yielding 38,650 units. Annual production declined through the 1980s, however, and then dropped precipitously when Congress cut program funding from \$512 million in 1994 to \$183 million in 1995 (see Figure 1). The reduction was due primarily to concerns about a handful of program abuses described in a Government Accountability Office report.<sup>3</sup> USDA made changes to address the abuses, but production never again reached the levels of the 1970's and funding levels remained low. In 2004 Section 515 produced only 902 units, while 2,812 units from the Section 515 portfolio were prepaid and thus left the program.

### How the Program Works

Section 515 provides loans directly to developers of rural rental housing. Currently, the loans have thirty-year terms and are amortized over fifty years. Almost all types of development entities are eligible: for-profit and nonprofit corporations, partnerships, public agencies, individuals, and others. Interest Credit subsidy is provided on loans to nonprofit entities and to those for-profit entities that agree to operate on a limited-profit basis. The subsidy lowers the effective interest rate to only one percent. (Loans made before August 1, 1968 and not refinanced after that date have "Plan I" Interest Credit with a three percent interest rate.) Program funds can be used to buy and improve land and to provide necessary facilities such as water and waste disposal systems, as well as to develop buildings.



Rental units funded under Section 515 must be occupied by very low-, low-, and moderate-income families; elderly persons; and persons with handicaps and disabilities. Very low-income is defined as below 50 percent of the area median income (AMI); low-income is between 50 and 80 percent of AMI; and moderate income is capped at \$5,500 above the low-

income limit. (This is different from HUD's definition of moderate income.) People living in substandard housing are given first priority for tenancy. When Section 521 Rental Assistance (described in Chapter 3) is used, top priority is given to very low-income households.

Every year USDA develops a list, based on need, of "designated places" where new Section 515 developments may be located. Applicants compete for the limited pool of Section 515 dollars. Technically, USDA Rural Development state directors have authority to approve loans up to \$1.5 million, while requests for larger amounts are reviewed by the national office. In practice, however, in the last several years the national office has reviewed and ranked all applications because a very limited amount of funding has been available for new construction.

In the 1960s and 1970s, Section 515 was often the only source of development financing used in rural rental projects. As the availability of funds fell over time, developers of rental housing, like others, commonly combined two or more financing sources. After the Low Income Housing Tax Credit program was created in 1986, it became a popular addition to Section 515 funding.

Section 515's ability to reach the very lowest income rural residents was enhanced in 1978 when the Section 521 Rental Assistance (RA) program, authorized in 1974, began operations. While Section 515 loans with Interest Credit resulted in somewhat lower rents, the impact was not sufficient to allow properties to serve very low-income households.

The availability of RA to eligible tenants, however, subsidizes their rent to the point that they do not pay more than 30 percent of income for rent, with the balance paid by RHS. RA is tied to projects, not tenants.

### Characteristics of Existing Stock

According to RHS data available as of November 1, 2003, the total portfolio of the Section 515 program consists of 15,899 properties containing 434,296 units.

According to other RHS data as of January 2003, 92 percent of the units are occupied. Seventy-two percent of the tenants are white non-Hispanic and 17 percent are African-American non-Hispanic. Nine percent are Hispanic, one percent are American Indian or Alaskan Native, and the remaining one percent are Asian/Pacific Islander, mixed, or unknown (see Figure 2).<sup>4</sup>

Almost half of all tenants (44 percent) are women who live alone. Just over one-third of the tenants (36 percent) are elderly, and another 21 percent have disabilities. The average annual income of all tenants is only \$9,365, and the average income of those who receive Section 521 Rental Assistance is \$7,311. Reflecting program requirements, 93 percent of tenant households have very low incomes, below 50 percent of AMI. Another six percent have low incomes, between 50 and 80 percent of AMI.

Three-quarters of all tenants (74 percent) receive rent subsidies, with the majority (58 percent of all tenants,

or 78 percent of those with rent subsidies) relying on RHS Section 521 Rental Assistance. One of every five tenants (20 percent) pays more than 30 percent of income for rent.

The income level of the Section 515 rural tenant population is comparable to that of tenants nationwide who receive Section 8 Housing Choice Vouchers and those who live in public housing: voucher holders' mean income was about \$10,000 in 2000<sup>5</sup> and public housing residents' was \$9,531.<sup>6</sup>

The family composition of the three groups varies more. Sixteen percent of Section 8 recipients are elderly, 15 percent have disabilities, and almost three-quarters (61 percent) are families with children.<sup>7</sup> Forty-three percent of U.S. public housing residents are children. About a third of public housing households are elderly (31 percent) and another third include at least one member with a disability (32 percent).

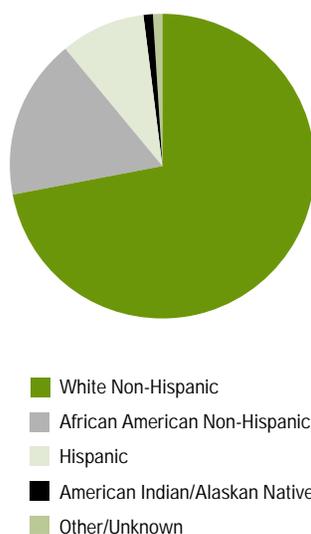
### Units at Risk

According to *Rural Rental Housing – Comprehensive Property Assessment and Portfolio Analysis* (Comprehensive Property Assessment) prepared for RD by ICF Consulting and released in November, 2004, there are approximately 9,698 properties in the Section 515 portfolio, representing about 269,000 units, that were constructed before 1989

and therefore eligible for prepayment.<sup>8</sup> A 2002 report by the Government Accountability Office (GAO) indicated that the owners of about 104,500 units in 3,872 properties could be considered likely to prepay within the next 8 years.<sup>9</sup> GAO assumed that nonprofit organizations or public entities would not prepay mortgages on properties they owned, that properties heavily dependent on rental assistance would be unlikely to prepay unless located in a growing area where rents could be raised to maintain cash flow, and that developments in counties with declining populations would be unlikely to prepay because demand for housing was likely to be low. However, the Comprehensive Property Assessment estimates that there are only 1,648 properties, consisting of about 46,000 units, for which prepayment is economically viable. This disparity is based in part on analysis in the Assessment of market conditions and individual

Figure 2

### Heads of 515 Households by Race



property finances not analyzed by GAO. On the other hand, the Assessment did not include interviews with owners, some of whom might seek to prepay for personal reasons even if there is some cost to do so.

## RHS Prepayment Rules<sup>10</sup>

The ability to prepay a Section 515 mortgage, and the process for doing so, are governed by statutes and RHS regulations. Mortgages made after December 15, 1989 cannot be prepaid during their terms. Mortgages financed before December 21, 1979 can be prepaid only if the owners decline RHS incentives to stay in the program and RHS determines that the prepayment has no adverse impact on minority housing opportunities. Projects with Interest Credit subsidy or Rental Assistance approved between December 21, 1979 and December 15, 1989 are subject to twenty-year use restrictions, and those without either subsidy are subject to fifteen-year restrictions. Legislation in 1992 imposed the pre-1979 requirements on mortgages initiated between 1979 and 1989.

The date of the mortgage documents determines whether a loan was made on or after December 15, 1989. Determining whether a project was financed before or after December 21, 1979 is more difficult, however. Based on the language of the statute, USDA considers the relevant date to be the date it issued its Form AD-622 committing a loan for the project, not the date the loan actually closed. USDA Rural Development and the property owner have this information, but it is not provided in the mortgage documents in the public record.

The restrictions applicable to a loan approved before December 21, 1979 change if a consolidation or re-amortization of the loan occurs, or if the loan is transferred to and assumed by a new borrower. The date of that action, rather than of the original commitment or mortgage, determines what restrictions apply to the property.<sup>11</sup>

USDA began developing revisions to its entire multifamily regulatory scheme in the mid 1990s, finally publishing an Interim Rule on November 26, 2004, which took effect on February 24, 2005 (3560 Interim Final Rule, see *Regulatory Changes* below).<sup>12</sup> Parts of the property transfer process were clarified in RHS Administrative Notice (AN) 4010, issued on September 23, 2004<sup>13</sup> and described in more detail in Chapter 5. This notice is intended to clarify the transfer process, make the process more transparent and efficient and clarify servicing authorities available to RHS State Offices.

The prepayment and preservation process is administered by the Rural Housing Service's Office of Rural Housing Preservation (OHRP), located in the agency's Washington, D.C. national office.

## Transfers to Nonprofits

Although RHS regulations focus on agency involvement in prepayment requests, many owners are willing to sell their Section 515 properties to nonprofits without going through the prepayment process. As explained in Chapter 2, agency-sanctioned transfers follow a less explicitly defined path than prepayment requests, but may provide the best opportunity for preserving these units. Details on the transfer process, and recent changes in RHS transfer procedures, are discussed in Chapter 5.

## Trends and Possible Changes

Since September of 2004 several significant policy changes and proposals have emerged, which together could significantly alter the Section 515 program. The only clear trends regarding Section 515 preservation seem to be increases in the issue's importance and in the uncertainty surrounding it. Every year more units become eligible for prepayment, and aging properties are in increasingly urgent need of repair and rehabilitation. Lawsuits consider a variety of legal theories and create pressures on USDA to avoid potential liability for court-awarded damages. Owners seek ways to divest themselves of their properties without going through the formal prepayment process. A broad range of legislation has been introduced in Congress to protect tenants while allowing owners to sell their properties, but there has been no significant legislative or regulatory change since the early 1990s.

## Regulatory Changes

In developing what ultimately became the 3560 Interim Rule, in June 2003 RHS published a Proposed Rule to streamline the regulations for its multifamily housing programs (Sections 515, 514/516, and 521). RHS reported receiving over 3,000 comments on the Proposed Rule, and issued the 3560 Interim Rule that combines 14 previously separate regulations into a single 146-page regulation supplemented by multifamily housing handbooks on loan origination (HB-1-3560), asset management (HB-2-3560), and project servicing (HB-3-3560). The Interim Final Rule took effect on February 24, 2005.

The Interim Final Rule includes a lengthy section on prepayment and preservation, in addition to sections covering many other topics. The main changes are:<sup>14</sup>

**1. Administration.** The rules clarify the authority of the national Office of Rural Housing Preservation to coordinate, direct, and monitor preservation activities.

**2. Nonprofits.** A broader definition makes it easier for regional and national organizations to qualify for both transfers and mandatory sales.

**3. Owner prepayment requests.** Application paperwork is simplified.

**4. Notice to tenants.** Tenants will receive a series of notices during the prepayment process, rather than a single notice.

**5. Incentive offers.** If an owner accepts incentives but has not received them within 15 months, the owner has several options, including resuming the prepayment process.

**6. Minority impact.** In its required determination of prepayment's impact on minorities, the agency must consider how minorities will be affected who are either in the project, on the waitlist, or in the market area. Impact on minorities should be "disproportionate" to trigger a response – a new requirement that does not match the statutory language.

**7. Letters of Priority Entitlement (LOPEs).** Tenants now have up to one year to request letters giving them priority access to other Section 515 properties.

**8. Restrictive use provisions.** Owners have a new option to prepay, but agree to restrictive use provisions for 10 years and then offer the project for sale to nonprofits and public agencies.

**9. Enforcement of restrictive use provisions.** The rules are now more explicit that tenants can enforce these protections through legal action.

**10. Owner payoff in response to agency acceleration of the loan.** Where the agency suspects the owner may have defaulted in a deliberate effort to circumvent the prepayment process, the agency will consider alternatives to accelerating the loan.

### **Comprehensive Property Assessment**

During 2003, USDA Rural Development contracted with ICF Consulting to engage a research team to conduct a Comprehensive Property Assessment of its Section 515 portfolio. The researchers considered several aspects of the properties:

- They surveyed a representative sample of 333 properties to determine their physical condition, future physical needs, and financial status;
- They examined the local markets for the properties and their equity value; and
- They considered policy issues relating to the structure and management of the program, the financing of the developments, and the use of rental assistance.

The analysis and conclusions of the Assessment have been presented by RHS and its consultants to lawmakers and housing advocacy groups, and are expected to have a strong influence on future RHS policy initiatives. Its major findings are:

- The portfolio is serving a truly needy population, and presents no serious, immediate health and safety problems; revitalization is in the public interest;
- Two-thirds of the stock is not physically sustainable without additional resources;
- Rent increases alone cannot solve recapitalization needs;
- Owners of about 10 percent of the properties are likely to prepay, if given the opportunity; and
- Debt restructuring and private investment can significantly reduce the total public cost of portfolio revitalization, relative to a scenario using Rental Assistance alone.

Its recommendations include:

- Strengthening debt restructuring tools;
- Creating five financial restructuring templates intended to streamline restructuring transactions and leverage private investment;
- Creating a new Office of Portfolio Revitalization with new statutory authorities and a new regulatory structure;
- Streamlining prepayment procedures, while strengthening tenant protections;
- Standardizing legal documents; and
- Providing new guidance, training and technical assistance.

### **Funding**

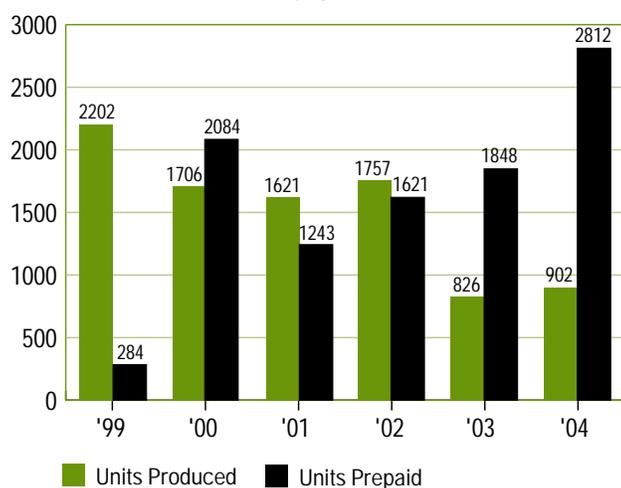
Since 1999, loss of affordable units due to prepayment nearly equals production of new Section 515 units, as Figure 2 shows. As noted earlier, funding for the Section 515 program has dropped sharply, and there are no strong signs that it will increase in the near future. In its Fiscal Year 2006 budget proposal, the Administration proposed reducing 515 program funding to \$27 million from the 2005 level of \$100 million, with all funding dedicated to repair and preservation and none for new construction. Congress rejected a similar restriction on new construction in the FY 2005 RHS budget.

Even the \$116.5 million appropriated in FY 2004 was insufficient to cover necessary costs of even a very small new construction program as well as the maintenance of existing stock and incentives to avoid prepayment. The Housing Assistance Council estimates that the \$592 million appropriated for Rental Assistance in FY 2004 fell \$22 million short of the amount needed merely to renew expiring contracts, and that \$100 million of new Section 515 funding is needed to develop at least one new project in each state, \$50 million for necessary portfolio maintenance, and \$25 million for equity loans to prepaying owners. Thus a total of \$175 million would cover minimal

previously received significant funding. Section 521 Rental Assistance would be funded at \$650 million, enough to renew all expiring contracts.<sup>16</sup> By focusing on tenant protections and omitting funding for payment of owner incentives, the budget implies that RD intends to allow prepayments at a significant pace, as contemplated in the Comprehensive Property Assessment. RHS has indicated that a legislative package implementing many of the recommendations in the CPA, providing details for the new tenant protection voucher program, and establishing a comprehensive ten-year portfolio revitalization program will be submitted to Congress in the spring of 2005.

Figure 3

### Section 515 Prepayment and Production



Source: RHS Multifamily Housing

It is worth noting that in 2002 the Housing Subcommittee of the House Committee on Financial Services Committee narrowly rejected an amendment that would have eliminated prepayment restrictions on Section 515 properties, largely because of Subcommittee concerns that there was inadequate funding for tenant protection vouchers at that time. Observers believe a similar proposal could be re-introduced, especially in the wake of the prepayment litigation discussed in Chapter 4. Several other legislative proposals to increase the resources available for preservation are summarized in Chapter 3.

## Chapter 1 Notes

<sup>1</sup> Based on Housing Assistance Council analysis of the 2001 American Housing Survey and the 2000 Census of Population and Housing.

<sup>2</sup> Kathryn P. Nelson, Jill Khadduri, Marge Martin, Mark D. Shroder, Barry L. Steffen, and David Hardiman, Rental Housing Assistance – *The Worsening Crisis: A Report to Congress on Worst Case Housing Needs* (Washington, DC: U.S. Department of Housing and Urban Development, 2000), p. 2.

<sup>3</sup> Government Accountability Office, *Rural Rental Housing: Excessive Profits and Program Abuses in Multifamily Housing*, GAO/T-RCED-92-63 (Washington, DC 1992).

<sup>4</sup> USDA Rural Housing Service, “Results of the 2003 Multi-Family Housing Annual Fair Housing Occupancy Report”, unnumbered letter dated July 18, 2003. The word “tenants” is used here to mean “tenant households.” RHS data reflect the characteristics of heads of household.

essential activities under Section 515.<sup>15</sup> As noted above, the need for affordable rental housing in rural areas far exceeds this minimum.

Financing for the existing portfolio is needed as well. Anecdotally, the portfolio as a whole – though not every building – is suffering from the effects of deferred maintenance. The 2005 appropriation level does not include enough Rental Assistance to renew expiring contracts, assist tenants in newly constructed Section 515 units, and meet other needs such as preservation incentives. Compounding the shortfall, in 2004 Congress reduced the dollar amount for RA by changing contracts from five years to four. The need to provide funds for the fifth year will simply be deferred to a later date.

The Administration’s budget proposal for Fiscal Year 2006 provides \$214 million in new funding to protect tenants affected by mortgage prepayments through the Section 542 voucher program, which has never

<sup>5</sup> Barbara Sard and Will Fischer, “Frequently Asked Questions about the Administration’s Fiscal Year 2005 Housing Voucher Proposal” (Washington, DC: Center on Budget and Policy Priorities, 2004), 1.

<sup>6</sup> Council of Large Public Housing Authorities, “A Portrait of Public Housing Residents.”

<sup>7</sup> Center on Budget and Policy Priorities, “Introduction to the Housing Voucher Program” (Washington, DC, 2003), 1.

<sup>8</sup> ICF Consulting, et. al., *Rural Rental Housing—Comprehensive Property Assessment and Portfolio Analysis: Final Study Report, November 2004*. Available online at [www.icfconsulting.com](http://www.icfconsulting.com).

<sup>9</sup> Government Accountability Office, *Multifamily Rural Housing: Prepayment Potential and Long-Term Rehabilitation Needs for Section 515 Properties*, GAO-02-397 (Washington, DC: 2002).

<sup>10</sup> Most of the information in this subsection is from National Housing Law Project, *RHCDS (FmHA) Housing Programs: Tenants’ and Purchasers’ Rights* (2d ed.) (Oakland, Calif.: 1995), Chapter 15.

<sup>11</sup> 7 C.F.R. 1965.65(c)(1), 1965.68(c)(7) and 1965.70(d)(8).

<sup>12</sup> Interim Rule, 7 CFR Part 1806, 1822, 1902, 1925, 1930, 1940, 1942, 1944, 1951, 1955, 1956, 1965, 3560, and 3565, Federal Register, Vol. 69, No. 227, p. 69032, November 26, 2004.

<sup>13</sup> See RD AN No. 4010 (1965-B), September 23, 2004.

<sup>14</sup> Timothy L. Thompson of the Housing Preservation Project provided this summary of the revised regulation.

<sup>15</sup> Housing Assistance Council, *Renters Beware: An Analysis of the Administration’s Proposed Fiscal Year 2005 Rural Housing Budget* (Washington, DC: 2004).

<sup>16</sup> *Budget of the United States Government, Fiscal Year 2006 – Appendix* (Washington, DC: U.S. Government Printing Office, 2005). Available at <http://www.whitehouse.gov/omb/budget/fy2006>.

## CHAPTER TWO

## KEEPING SECTION 515 PROPERTIES AFFORDABLE: CHALLENGES AND POSSIBLE SOLUTIONS

Lindley Higgins, Ph.D

### Overview

The Section 515 program is intended to provide decent, affordable housing for low-income rural residents. As the program has evolved, two significant issues have come to have a growing impact: the aging of the Section 515 properties, and the growing desire on the part of owners either to sell the property or to pre-pay their Section 515 mortgages and thereby terminate their obligations to manage their properties as affordable under RHS rules. In recent years, many owners and preservation advocates attempting to transfer these properties (either as affordable housing resources or for other purposes) and to recapitalize them have become frustrated by what they perceive to be reduced RD staff and funding levels, complex program rules, lengthy processing times, and uneven and unpredictable application of program requirements. As this handbook is going to press, however, RHS is striving to address a number of these procedural issues at the same time it is attempting to address the aging and slow deterioration of the portfolio as a whole. But while many of the problems cited in this chapter by both buyers and prospective sellers are being addressed by recent and proposed reforms, it is still important for those seeking to preserve 515 properties to understand historic problems and perceptions.

A successful Section 515 preservation transaction should provide some reasonable incentive to both sellers and purchasers, finance appropriate property repairs and improvements, and incorporate some assurance of the property's long-term accessibility to low-income residents. But because many rural rental properties experience little or no increase in market value over time and because the debt on a 50-year, one percent mortgage decreases very slowly, an appraised market value that a buyer is willing to pay for a property may barely cover existing debt and transaction costs, leaving little for property repairs

and improvements, much less any remaining cash for the seller. As a condition for approval of the transaction, RHS may sometimes require minimum property repairs, and may also restrict the total cash payment to the seller. Further, necessary improvements rarely increase the property's appraised value in an amount equal to their cost. These circumstances generally mean that, in addition to compromises by both buyers and sellers, low cost financing or additional subsidies are often necessary.

Overcoming the barriers to preservation requires the cooperation of the current owners, potential buyers, financial institutions, and public officials. However, despite the difficulties, many organizations have been successful in keeping Section 515 properties affordable. This chapter, based on interviews with rural housing practitioners, provides an overview of the challenges facing those who wish to preserve the affordability of Section 515 housing. The chapter provides a discussion of some of the financial challenges to maintaining affordability, describes some obstacles associated with historic USDA organizational, regulatory and process issues, and relates some possible strategies for dealing with these challenges.

The challenge of preserving affordability can become more difficult as properties age. Many Section 515 properties were built with cost containment as a driving factor, and although they have been subject to stringent RHS inspection requirements, some properties need significant capital improvements, to the point where rehabilitation expenses may exceed the value of the property. The 2004 Comprehensive Property Assessment commissioned by RHS found that most properties are facing significant replacement needs, but have inadequate replacement reserves.<sup>1</sup> Preservation can also be more difficult if the original RHS affordability restrictions on the property have expired, since profit-motivated investors are willing to

pay more for a property that can generate higher rent revenues. As detailed in Chapter 4, RHS properties financed prior to 1979 had no restricted use period, while those financed after 1979 and before 1989 with RHS subsidies had a 20 year use period. Regardless, both the pre-1979 and 1979-1989 properties are subject to prepayment restrictions as a result of subsequent legislation.

A significant number of owners are seeking to terminate RHS's affordability requirements and rent the units at a market rate, as a result of improved market conditions. Some are approaching retirement age and are looking to get out of the business of managing properties altogether. Others want to dispose of properties with "phantom income," taxable income resulting when depreciation is exhausted and mortgage principal payments increase, forcing owners to pay taxes on a property's net revenue even when that revenue is needed to pay debt service.

### Financial Issues: Costs and Partners

The Section 515 program has evolved over time with regard to how it provides public financing for private ownership and management of rural rental properties. USDA's role was originally intended to be temporary, with borrowers encouraged to refinance their properties with private credit as soon as possible. As detailed in Chapter 4, from 1961 to 1968 RHS had two Section 515 loans: a 3 percent loan for nonprofit and public agencies and a "market rate" loan for profit-motivated entities. This changed in 1968, when Congress authorized the interest credit program. But until 1973, interest credit was only extended to nonprofit and public agencies, not for-profit entities. The problem of prepayment and loss of use restrictions arose in 1973, when USDA opened up the interest credit program to for-profit entities by changing the "credit elsewhere" requirement without changing the "graduation" requirement. This allowed for-profits to come into the program and leave at will.

Congress subsequently placed pre-payment restrictions on the Section 515 loans to keep the properties affordable. Once an owner prepays a property's Section 515 loan in order to raise rents, the apartments are unlikely to be converted back to affordable housing without new subsidies. For those properties with a Section 521 rental subsidy, prepayment, whether or not there is a conversion to market rate housing, also means the permanent loss of that deep subsidy which enables very low income tenants to be served.

Keeping Section 515 properties affordable and well-maintained requires finding financial resources to address the rehabilitation needs and to provide equity to owners, either through equity loans as an incentive to forego prepayment, or through cash from sales as an incentive to transfer their property to a preservation-oriented buyer. Section 515 funding for the costs of both new construction and rehabilitation and refinancing or sale of existing properties has been declining over time while programmatic restrictions have increased. In addition, as the properties age, they become less attractive to investors and require increasing amounts of rehabilitation to keep them safe, sanitary, and competitive in the market.

Funding has declined for the Section 515 mortgage financing program at the same time that funding has tightened for two complementary direct operating assistance programs: RHS Section 521 Rental Assistance (RA) and HUD Section 8. Rental Assistance funds are indexed only to keep up with inflation and have not kept up with increasing demand.<sup>2</sup> According to the Government Accountability Office, 58 percent of Section 515 units receive USDA RA subsidy and another 14 percent receive HUD project or tenant-based Section 8 rental subsidies.<sup>3</sup> For the remaining 28 percent of households, new project-based Section 8 contracts have not been available since 1981. HUD Section 8 Voucher assistance for tenants has also failed to keep up with demand and is less available in rural areas. Where available, Section 8 Vouchers may be used as "Project-Based Vouchers," but there are limits on the number of units that can be supported in any given project. The availability of RA or Section 8 in a particular project provides the property with a guaranteed and steady source of revenue, making third-party financing to support recapitalization more feasible.

In order for a preservation transaction to qualify for enough new debt for acquisition, rehabilitation, and transaction costs, higher rents are required to pay additional debt service. The availability of additional rental subsidy can be critical, since there is otherwise no way to cushion the impact of necessary rent increases on current unassisted tenants. RHS and preservation-oriented buyers are extremely reluctant to confront existing unassisted tenants with large rent increases, but in the past RHS has been unable to commit to incremental RA until the end of a costly predevelopment process. RHS has been known to prohibit prepayment in the absence of additional RA, which technically "preserves" the project while leaving it vulnerable to future prepayment or physical deterioration.

Many practitioners have recommended the development of comprehensive, predictable RHS policies to encourage transfers to nonprofits, provide reasonable returns on equity investments, and reward asset management with appropriate fees and distributions. Practitioners have also encouraged RHS to engage with owners in more robust capital planning, incorporating costs of initial repairs, schedules for future repair needs, and recapitalization of and regular contributions to replacement reserves. Improving long-term capital planning was a central element to the 2004 Comprehensive Property Assessment.

Recently RHS has allowed nonprofits to receive an annual asset management fee, which could provide a valuable incentive for organizations that support long-term preservation of Section 515 properties but cannot afford to subsidize the cost of managing unprofitable properties. Unfortunately the guidance<sup>4</sup> is not specific with regard to fee levels, and field practice is not uniform.

### **The Challenge of Small Properties**

Rural multi-family dwellings tend not to have as many units as their urban counterparts. In fiscal year 2001, the average size of an RHS property was 27 units.<sup>5</sup> Many of these properties are owned by small operators – the “Mom & Pop” ownership model is common. While there are few units per development, fixed transaction costs make the per-unit cost of transfer very high. Fixed transaction costs include financing fees and the need to perform due diligence on legal, environmental, architectural, and engineering matters. For transactions that can take an extended period to close and require multiple partners for success, these costs can be very high and make the transaction less attractive and less feasible. Further, because Section 515 loan funds cannot be used for developers’ fees, other sources of financing, such as Low Income Housing Tax Credits (LIHTC), must be used to cover development expenses and LIHTC, in particular, is not suitable for very small projects.

Affordable housing practitioners have attempted to address the high per-unit cost of transactions by “bundling” properties across locations. However, properties cannot be bundled across state lines because each of the state RHS offices applies regulations and allocates resources somewhat differently. Also, the actual due diligence on individual properties varies in duration, complicating coordination for funding decisions and the closing process.

One solution to the high per-unit cost of transactions would be to allow bundling to occur not just across locations, but across properties that are reaching the end of their restricted use periods at slightly different times. Developments that are built in stages may have portions that reach the end of their use restrictions in different years. But as long as the units are to be kept affordable, it may make sense to bundle these projects, allowing them to be refinanced prior to the end of their restricted use period.

### **Finding Lending and Investor Partners**

The financial incentives for purchasing Section 515 projects are not attractive enough for many for-profit investors to induce them to purchase in a voluntary sale. Any available return on investment is capped by regulation at eight percent. (Ironically, in the prepayment context RHS can approve a higher return as an incentive for an existing owner to remain in the program.) But unlike HUD’s treatment of subsidized rental properties, which recognizes an owner’s limited dividend in budget-based rent-setting, thus providing at least some assurance of a return, RHS does not uniformly adjust rents to assure a minimum profit to the owner.

Finding a willing third-party lending partner is difficult for a number of reasons. First, there are both fewer banks and fewer multifamily housing properties in rural areas, making it somewhat more difficult to identify multifamily lending expertise for a particular project. Second, the complexity and small size of the deals means they will cost the bank as much as a larger transaction to process, but generate smaller fees, making them less attractive. A third issue affecting the ability to find lending partners is the difficulty in persuading RHS to provide assurances to a private bank that it would provide additional resources if a workout were to become necessary.

The secondary markets have had limited success with Section 515 projects for many of the same reasons, but they are attempting to become more involved in the creation and use of mortgage products. Both Fannie Mae and Freddie Mac have recently emphasized their desire to buy supplementary loans on Section 515 properties (see the Adirondack Apartments case below), and have actively pursued strategies to streamline and reduce duplication of underwriting activities common to RHS in order to speed transaction times and reduce costs.

## Adirondack Apartments: First Section 515 Property to Use Fannie Mae Financing

Adirondack Apartments is a 22-year old, 40-unit family apartment complex in the rural New York community of Saranac Lake. The property was owned by a limited partnership, financed by a RHS Section 515 loan. All 40 units had HUD project-based Section 8 subsidies. Volunteers of America (VOA) agreed to purchase and rehabilitate Adirondack Apartments in 2000, as part of its commitment to preserving affordable housing.

Initially, VOA saw Low Income Housing Tax credits as a key resource, but one tax credit cycle in New York had closed and the next was too far off. So instead, VOA worked with the nonprofit National Affordable Housing Preservation Associates, the law firm Goulston and Storrs, and the national offices of RHS and Fannie Mae to develop a financing model whereby RHS would subordinate its first security position to a loan made by a Fannie Mae Delegated Underwriter/Servicer (DUS).<sup>6</sup> The DUS would get the advantage of a successful track record by RHS of servicing such properties, reducing the amount of servicing fees the property would have to carry. RHS reduced the interest rate on its debt to one percent.

Capri Capital agreed to participate as the lender. Negotiations between the partners took three years to complete, and the property finally closed in December 2003, with Fannie Mae purchasing Capri's loan. The HUD project-based Section 8 contract was transferred and will cover debt service, rehabilitation and a higher annual reserve deposit. VOA was also able to secure an \$80,000 weatherization grant from the State of New York.

Underwriting new capital for Section 515 projects can also be problematic. Lenders and investors are legitimately concerned with the long-term economic viability of a property that depends upon RHS rental assistance. The amount of rental subsidy available each year is subject to Congressional appropriations, and while appropriations for RA have been consistent, they are not guaranteed. Some lenders may underwrite only the RA or project-based Section 8 under contract, assuming no renewal, and in 2003 Congress reduced RA contract renewal terms from five years to four, further exacerbating this problem. Similar underwriting problems exist for project-based Section 8 contracts, project-based Vouchers, and projects heavily dependent on Section 8 tenant Vouchers.<sup>7</sup>

### Legal and Regulatory Issues: RHS Structure and Regulations

The ability of RHS to support preservation activities in the Section 515 program is made difficult by a number of structural and regulatory issues. USDA is a large agency with offices in all 50 states and a decentralized structure that administers a wide variety of programs in addition to rural housing.

#### USDA Organizational Issues

One impediment to consistent preservation program implementation and to the implementation of transactions involving multiple properties is the decentralized structure of USDA and the manner in which authorities are spread throughout the organization.

The Section 515 program is a national program administered by RHS in Washington, D.C. However, operational authority is delegated to state level offices, with state RD housing program directors responsible to state RD directors who administer a variety of RD programs and who report to the Under Secretary for Rural Development, rather than the RHS administrator. Coordination among states and consistency in the interpretation and application of program requirements is difficult to achieve within this framework. This can be further complicated when individual properties in a portfolio fall under the jurisdiction of more than one local RD office.

Some practitioners feel that many state and regional USDA staff may not be adequately prepared to undertake a Section 515 preservation transaction. The deals are very complicated and state level staff – who must administer a wide variety of programs – are not consistently well-versed in the regulations governing Section 515 transactions or in real estate financing mechanisms. Some staff also lack familiarity with the differences between nonprofit and profit-motivated organizations, and may have a bias toward one or the other without fully understanding the financial needs or advantages of either type.

#### Regulatory and Process Issues

The implementation of RHS regulations is made more complex by differences in their interpretation by the various offices, which may be a result of both the discretion given to state RHS offices and the vagueness of the regulations and Administrative Notices

themselves. State directors administer the program, and they, and sometimes even regional directors, may interpret the regulations differently, resulting in different assessments of when waivers are required or whether certain actions are even permitted. Thus, the exact interpretations of the regulations may vary from state-to-state, and even within states, and may vary between transactions and even with regard to different properties within the same transaction.

For example, RHS has an internal process that includes an analytical framework for analyzing the level of financial assistance to be provided. However, this decision-making process has not been transparent or predictable, leaving purchasers with little information on what constitutes an acceptable or feasible transaction. As RHS attempts to rationalize the process and provide uniform guidance to its multiple approving offices, nonprofit developers are hoping that it does not become unnecessarily rigid and arbitrary.

USDA is working to update, streamline, and clarify its rules for the Section 515 program and has recently published a set of major revisions. First, an Administrative Notice (AN) on Section 515 transfers, AN No. 4010, was issued on September 23, 2004. AN 4010 replaces transfer and assumption guidance provided in the expired AN 3767 (1965-B) and attempts to make the transfer of Section 515 properties simpler, quicker, and more predictable. Chapter 5 contains a more detailed analysis on this Notice.

In addition, as noted in Chapter 1, RHS has recently issued the 3650 Interim Final Rule (effective February 24, 2005). This new framework reduces the amount of material in formal regulations and issues three Handbooks to supplement the new, condensed regulations. Even with the finalization of the regulations in 2005, RHS faces an ongoing challenge in appropriately allocating scarce resources, making the program more responsive to current market dynamics, and striking an appropriate balance between uniform practice and local interpretation.

While there are significant differences in how the rules and requirements of preservation transactions are interpreted within RD and by other project participants, it may be useful to develop a few basic models for Section 515 transactions. The publication of a number of “best practices” would help to create some basic concepts around which participants could fashion specific deals. On December 28, 2004 RHS issued AN 4036, which calls for proposals to

restructure portfolios of 515 properties as a demonstration of new revitalization concepts discussed in the Comprehensive Property Assessment. This Notice authorizes State Directors to issue conditional commitments of RHS resources, which could reduce much of the uncertainty faced by practitioners regarding what resources will be available to a transaction. If successful, this demonstration program could identify additional innovative transaction models, serving as examples of innovative practices endorsed by RHS to owners, buyers, and RD staff at various levels. As RD state directors begin to see how deals can be structured, they may be more amenable to allowing some “boilerplate” aspects of the transactions to be approved without delay.

Directly responding to this expressed need, Fannie Mae and RHS have agreed on a common approach when a DUS lender will provide new senior debt on a property. This approach involves close coordination with regard to underwriting standards, appraisals, physical needs assessments, environmental review and timelines for processing.

## The Exit Tax

The “exit tax” to be paid upon sale of a property is a major issue affecting owners, especially in the case of properties that have experienced little appreciation in value. The typical investor of a subsidized property expected to receive tax benefits from rapid depreciation in the early years of operation, followed by a partial recouping of those tax benefits by the government if the property were sold in later years. Over time, however, many investors never received the full benefits expected, because of changes in marginal income and capital gains tax rates, 1986 tax reform provisions that eliminated investors’ ability to deduct losses and, in some cases, an absence of expected cash flow. Nevertheless, the investor will be taxed on the amount by which accumulated depreciation exceeds cumulative mortgage principal paid (the “exit tax”). Unless cash from sale exceeds the exit tax liability, the investor has little incentive to sell, despite the property’s need for new ownership and new recapitalization resources.

Although the exit tax is itself a consequence of tax deductions taken for losses and depreciation in previous years, it represents a significant obstacle to sale of many affordable rental properties, leading to disinvestment and deterioration. Legislation has been introduced to provide exit tax relief for affordable rental properties, and a broad coalition of affordable housing groups is supporting its enactment.

Some Section 515 property owners or investor partners may choose to donate all or some of the legitimate market-appraised value of their property as part of a transfer to a nonprofit organization, generating a tax deduction that offsets their tax burden somewhat. Under this scenario, the charitable donation will only reduce taxable income by the value of the donation, which is likely to be less than the exit tax liability. However, some prospective nonprofit purchasers have been successful in using charitable donations as a mechanism to receive the individual ownership interests of limited partners, which can simplify subsequent negotiations for completing a property transfer.

The structure and phasing of these transactions can be complicated, particularly if tax credits are being used. For example, at least one nonprofit purchaser has been told that it is prohibited from re-selling property to a for-profit entity within a five-year period, despite the need to do so simply to facilitate the use of Low Income Housing Tax Credits. According to RD practice in some offices, a nonprofit organization that acquires a property in order to allow the seller to realize the charitable donation benefit, and then immediately transfers the property to a limited partnership that can utilize tax credits, would be barred from doing business with RD for five years.

RD has agreed, however, in a case in Virginia, to allow a limited liability corporation (LLC), 100 percent owned by the nonprofit, to purchase the property. In this case, the LLC is legally considered a “disregarded entity” and it takes on the tax status of its owner, a 501(c)(3) nonprofit, allowing the seller to realize the charitable donation benefit. The nonprofit then allows the for-profit organizations that comprise the members of the LLC that are seeking the tax credits to enter the LLC, making it a for-profit LLC without that transaction being construed by RD as a sale.

The Community Development Trust (CDT), created with LISC support in 1999, offers another option to sellers facing exit taxes. Operating as an Umbrella Partnership Real Estate Investment Trust (UPREIT), CDT offers owners shares in its REIT in exchange for their ownership interests in the properties they are selling. Under IRS rules, this type of transfer is similar to a “like-kind exchange,” in that it is not a taxable event the way a sale of the real estate itself would be. Sellers defer exit taxes on their sale until such time as they redeem their shares, which they can do subject to their exchange agreement with CDT and their own tax planning. In the event the seller should die before redeeming the shares, their taxable basis is “stepped

up,” meaning their heirs will have no exit taxes upon sale of the shares.

## Chapter 2 Notes

<sup>1</sup> ICF Consulting, “Rural Rental Housing — Comprehensive Property Assessment and Portfolio Analysis Final Study Report — Appendix: Market Assessment Report,” November 2004. Pages 39-45.

<sup>2</sup> Council for Affordable Rural Housing, Position Paper by the Council for Affordable and Rural Housing on the Aging Section 515 Rural Housing Portfolio, March 10, 2003. Page 17.

<sup>3</sup> Government Accountability Office, *Multifamily Rural Housing: Prepayment Potential and Long-Term Rehabilitation Needs for Section 515 Properties*. [GAO Study]

<sup>4</sup> RD Instruction 1930-C, Exhibit B, XII A6 permits asset management fees for nonprofits and cooperatives, without specifying amounts or specific permitted uses of funds. The new consolidated interim rule, at 7 CFR 3560.303, lists permissible owner expense categories but does not provide guidance on allowed amounts.

<sup>5</sup> GAO Study, p.5

<sup>6</sup> Fannie Mae/RHS Section 515 Preservation Pilot Addendum To Fannie Mae’s Manual.

<sup>7</sup> For more detail, see *Stemming the Tide: A Handbook on Preserving Subsidized Multifamily Housing*, and *Renewal Options for Expiring Project-Based Section 8 Contracts*, both available at <http://www.lisc.org/resources>.

## CHAPTER THREE

## RESOURCES FOR SECTION 515 PRESERVATION

Leslie Strauss

**A**lmost any financing source that can be used for any other multifamily housing development can be used for preservation. Logical sources include the Section 515 program itself and the Low Income Housing Tax Credit (LIHTC), but there are other possibilities as well. This chapter describes some of them and provides suggestions for seeking additional information.

This chapter focuses on federal resources because a catalog of state programs is beyond the scope of this guide. Some of these federal programs are administered by federal agencies, including most obviously USDA Rural Development and HUD. Other federal funds reach rural areas through state government agencies. For example, Community Development Block Grant funds for non-entitlement areas are allocated to state governments (in all states except Hawaii). HOME Investment Partnership Program funds are provided to “participating jurisdictions” (PJs) and for most rural areas the relevant PJ is the state. Low Income Housing Tax Credits are administered by state housing finance agencies as well.

The assistance presently available to developers and owners of rental housing does not alone reduce costs enough to make units affordable for the lowest-income rural residents. Additional aid must often be provided to help cover rent costs, and must be considered in plans to preserve any rental development. This chapter includes resources for rental assistance as well as for building costs.

### Section 515 Rental Housing Loans

A nonprofit acquiring a property with an existing Section 515 mortgage can assume that mortgage and/or receive a new Section 515 mortgage to finance acquisition and rehabilitation of the structures. Loans are for up to 30 years at an effective one percent

interest rate, but amortized at a 50 year rate. The maturity date and amortization of existing loans can also be extended to reduce debt service.

To be eligible for a new Section 515 loan, a borrower must be unable to obtain mortgage credit from another lender at a cost that is low enough for the developer to keep rents affordable to low- and moderate-income tenants. A loan to a nonprofit organization or public body may be for up to 100 percent of the appraised value or development cost, whichever is less, plus two percent initial operating capital. Individuals, partnerships, limited partnerships, or for-profit corporations operating on a limited-profit basis are also eligible for Section 515 financing, but the terms are less generous.

Section 515 financing can be used for cooperatively owned units as well as for rental units. Very few co-ops have been developed under Section 515, however, and the authors are not aware of any Section 515 rental properties that have been converted to co-ops using additional Section 515 funding.

### Section 538 Rental Housing Loan Guarantees

The Section 538 program enables RHS to guarantee loans made by private lenders for the development of affordable rural rental housing. The program is intended to serve higher income residents than the Section 515 – tenants can have incomes up to 115 percent of area median income – and therefore Section 538 properties are not eligible for Section 521 Rental Assistance. Borrowers compete for Section 538 guarantees under the terms of a notice of funding availability published in the *Federal Register* each year.

The maximum term of a guaranteed loan is the lesser of 40 years or the remaining economic life of the project. RHS has the authority to impose a maximum

interest rate, but the FY 2004 NOFA announced that the agency would accept “the best rate negotiated between the lender and prospective borrower.” RHS is required to provide interest credit, reducing the interest rate to the Treasury rate, for at least 20 percent of the loans guaranteed each year.

The Section 538 program regulations are separate from those for the Section 515 and 514/516 programs. They are compiled in 7 CFR Part 3565 and can be accessed through Appendix A to the agency’s staff handbook for Section 538 located on the USDA Rural Development website, <http://www.rurdev.usda.gov/regs/>.

### Section 514/516 Loans and Grants for Farmworker Rental Housing

If an existing Section 515 project were occupied by farmworkers, Section 514 loans and Section 516 grants could be used to purchase and rehabilitate it. Nonprofit organizations and public agencies are eligible for both loans and grants (as are Indian tribes and associations of farmworkers). Limited partnerships with nonprofit general partners, farmers, associations of farmers, and family farm corporations are eligible for loans only. All 514/516 developments must be operated on a nonprofit basis.

Section 514 loans are for 33 years at one percent interest. A Section 516 grant may cover up to 90 percent of the development cost for a project. The rest of the cost may be (and usually is) provided by a Section 514 loan. The majority of non-partnership and non-farmer loan recipients receive grants.

Like funds for RHS’s other multifamily housing programs, Section 514/516 monies are distributed competitively. Demand for the funds exceeds supply, though the shortfall is no longer as serious as it was in the mid 1990s. An annual Notice of Funds Available invites preapplications, which are submitted to USDA Rural Development state offices. They are scored by state offices, then ranked nationally.

Rental Assistance can be used in Section 514/516 developments, though it is RHS’s policy to attempt to use less than a 90 percent grant when RA is provided. Also, when a Section 514 loan is being used to leverage other funding, RA is available only if the total interest cost does not exceed the cost of using 100 percent RHS loan financing.

RHS regulations for the farm labor housing programs were recently revised along with the Section 515 rules, as described in Chapter 1.

### Section 533 Housing Preservation Grant Program

The Housing Preservation Grant (HPG) program does not fund acquisition, but HPG funds could be used to repair or rehabilitate rental buildings once acquired. The grants are competitive and are made available in areas where there is a concentration of need. “Sponsors” (grant recipients) may be nonprofit organizations, Indian tribes, units of local government, or state agencies.

Each USDA RD state office administers its own HPG program, including the annual competition. In addition, each state director has the authority to interchange funds between HPG and the Section 504 grant program, which funds repairs for low-income elderly homeowners.

The program regulations are at 7 CFR 1944 Part N, available as Instruction 1944-D on the USDA Rural Development website, <http://www.rurdev.usda.gov/regs/>.

### Rental Assistance Programs

As noted above, given the subsidies currently available for buildings, rental assistance is an essential part of making housing affordable for low- and extremely low-income rural residents. The cost of rental assistance has become a political issue, however. Rising housing costs and the need to both renew existing subsidies and also provide new ones have pushed expenditures for HUD vouchers and USDA’s Section 521 Rental Assistance program ever higher. Those seeking to preserve rental housing must compete for an inadequate, and potentially shrinking, pool of rental subsidy funds.

#### USDA Section 521

The Section 521 Rental Assistance (RA) program pays the property owner the difference between 30 percent of a tenant’s income and the monthly rental rate, including the cost of all utilities and services. Until federal Fiscal Year 2004, RA contracts between RHS and owners were for five years; beginning with FY 2004, Congress reduced the cost of RA in the USDA appropriations bill by changing contracts to four years. RA contracts are renewable, so the change simply defers the need to provide additional funds.

Rental Assistance is available only for multifamily properties financed by USDA’s Section 514/516 (farm labor housing) or Section 515 programs. Not all Section 514/516 or 515 properties have Rental Assistance, however. In fact, 20 percent of tenants in

Section 515 units not only do not have RA, but are paying more than 30 percent of their incomes for rent. As noted above, RA funding consistently falls short of the need.

### HUD Section 8 Assistance

HUD has historically provided Section 8 subsidies in two broad forms – tenant-based (the Housing Choice Voucher program) and project-based Section 8. Like Section 521 RA, Section 8 provides payments to participating owners on behalf of very low-income tenants (those with incomes below 50 percent of AMI). Tenants must rent homes that meet HUD’s housing quality standards (HQS).

Vouchers are administered by public housing agencies and Indian housing authorities under one-year contracts with HUD. These agencies provide portable vouchers to specific renters. Each local housing authority establishes a payment standard, which is closely related to the area Fair Market Rent (FMR) established by HUD, and pays property owners the difference between 30 percent of tenants’ income and the payment standard. A tenant can choose a home with rent above the payment standard and pay the additional amount him/herself, or find a home with rent below the payment standard but still pay 30 percent of income.

A tenant with a voucher can continue to rent a unit in a former Section 515 property where the mortgage has been prepaid, so long as it meets HUD’s quality standards and the tenant share does not exceed 40 percent of income. Current law provides new Section 8 vouchers for unassisted tenants to prevent or mitigate displacement from properties where HUD subsidies are being terminated, but no similar authority currently exists for tenants of prepaid Section 515 properties. Even when vouchers are available, the scarcity of affordable rental units in rural areas may make it impossible for tenants to use their vouchers.

Some Section 515 properties may also have non-portable project-based assistance contracts between the property owner and HUD’s Office of Housing. These contracts provide subsidy directly to the owner so long as the units covered by the contract are occupied by income-eligible tenants. The tenant pays 30 percent of income and HUD provides the remainder of the rent at the payment level stipulated in the contract (which is subject to annual adjustment by HUD). These project-based assistance contracts were typically written for 20 or 30 years, but can generally be extended (at the owner’s option) at expiration, subject to the availability of annual appropriations. Upon renewal, rents are set according to a variety of options, which may include

marking levels up to market (in strong markets), reducing rents to local market levels (in weak markets), or continuation of existing rents with an operating cost adjustment factor or at a level needed to support HUD-approved operating expenses (“budget-based rents”).<sup>1</sup>

### State Rental Assistance

Just as some states provide funding for property acquisition and rehabilitation, some provide assistance for renters. Housing trust funds can be used for this purpose, or a state legislature may appropriate monies for rental assistance.

### HUD’s HOME and CDBG Programs

The HOME Investment Partnerships Program provides federal funds to states, local governments, and Indian tribes. A recipient of HOME funding is a “participating jurisdiction” (PJ). In most rural areas, the relevant PJ is the state, although for a rural place in an urban area it might be the county, and in some places rural counties or other local governments have formed consortia to become PJs themselves.

Each PJ conducts a consolidated planning process to determine how its HOME funds will be spent. Consolidated Plans are developed every five years and updated annually. While PJs are permitted to use HOME funds for numerous housing purposes including acquisition, rehabilitation, and tenant-based rental assistance, an activity not included in a Consolidated Plan cannot be funded.

PJs must set aside a minimum of 15 percent of their HOME funds for the housing efforts of community housing development organizations (CHDOs), local nonprofit organizations with community representation on their boards and the capacity to do housing work. Up to another five percent of each PJ’s funds may be used for CHDO operating expenses. Many local nonprofit organizations have been certified as CHDOs by their PJs.

HOME restricts tenant incomes to a greater extent than Section 515 does. At least 90 percent of HOME funds used for rental housing must be invested in affordable units that are occupied by families whose incomes are at or below 60 percent of area median income (AMI), and the remaining ten percent of tenants must have incomes at or below 80 percent of AMI. When funding sources are combined, the most restrictive provisions must be used in order to remain in compliance. Also, HOME funds used for rehabilitation or acquisition of existing rental housing require that housing must remain affordable for at least five to 15 years depending on cost; for new construction, the minimum affordability term is

20 years. Many PJs require longer affordability terms. HUD's CDBG program also provides flexible funds to state and local governments for projects that benefit low-to moderate-income populations, prevent or eliminate blight or meet other community development needs. CDBG funds for cities with populations of less than 50,000 and counties with populations of less than 200,000 are allocated at the state level. These funds are distributed from the state to a local government for application to specific, eligible projects, which may include housing rehabilitation and direct assistance to nonprofits.

More information about HOME and CDBG should be available from the administrative entity of the relevant participating jurisdiction – usually the same housing finance agency that runs the Low Income Housing Tax Credit program – or from a HUD field office.

## State Resources

Most states operate housing programs with state funds that could be used for rental housing preservation. Many states issue tax-exempt revenue bonds or general obligation bonds to finance housing development programs. Other states rely on legislative appropriations. In addition, some states have their own tax credit programs, similar to the federal Low Income Housing Tax Credit. Information about state-specific preservation resources, including state housing finance agency preferences for preservation projects in the allocation of Low Income Housing Tax Credits, is compiled by the National Housing Trust and can be found at [www.nhtinc.org](http://www.nhtinc.org).

Housing trust funds may be a good source of dedicated housing funds at the state, county, or local level. According to the Housing Trust Fund Project at the Center for Community Change, more than 350 trust funds now exist. They are established by legislation or ordinance and receive on-going revenues from dedicated sources of public funding such as taxes, fees, or loan repayments. The money is then available for affordable housing needs. The specifics vary among funds.

## Low Income Housing Tax Credit

Funds raised from investors through the Low Income Housing Tax Credit can be used for acquisition and substantial rehabilitation of rental units. The tax credit attracts for-profit entities to the development of affordable housing by reducing federal income taxes in exchange for investments in low-income rental housing. A for-profit or nonprofit developer partners with an investor to develop the property and often manages it as well.

Federal tax credits restrict rents and tenant eligibility for 15 years, and many states now have extended use restrictions in force for 30 years or more. If tax credit financing is used along with another program, such as Section 515, that has a longer restrictive use period, then the development is bound by the longer requirements.

Each state must set aside at least ten percent of its credit allocation for projects developed by nonprofits. Nonprofits have used this program successfully to develop new rental housing in rural areas, although it presents more challenges than a loan or grant program. Some have found that the small scale of most rural projects makes the tax credit program not cost-effective, since it requires relatively fixed transaction costs for professionals such as attorneys and syndicators. On the other hand, some nonprofit groups with limited multifamily experience have learned from working with the for-profit developers who often undertake tax credit deals with nonprofit partners.

It should be noted that the owners of tax credit properties are limited partnerships. Such entities cannot assume a mortgage or ownership under RHS's prepayment rules. A limited partnership can, however, purchase property from an owner that wishes to divest itself of ownership without going through the prepayment process.

The use of tax credits is also complicated by RHS restrictions on tenant displacement. The tax credit program sets a ceiling on the income of those who can rent units in the funded property, and that ceiling (no more than 60% of median income) differs from that of Section 515 (80% of median). Further, despite the very low average income of Section 515 residents, some tenants who met RHS' income guidelines on admission may now have higher incomes. When the income of the existing tenants is above the Tax Credit ceiling, RHS rules prohibit the higher income tenants from being displaced. The limited partnership that controls the tax credit would have to defer some of the benefits of the credit until natural turnover occurs and lower income tenants can be found to replace the higher income ones. The deferral of the credit reduces financial benefits to the limited partnership. The income limit also narrows the market of potential renters.

In most states, state housing finance agencies administer the tax credit program, and can be located through their association, the National Council of State Housing Agencies, at [www.ncsha.org](http://www.ncsha.org).

## Housing Intermediaries

Intermediary organizations, which receive funding from one or many sources and pass it through to others, may be able to assist housing preservation efforts. A specific type of intermediary, a Community Development Financial Institution (CDFI), provides funding for housing, community facilities, economic development, and financial services for low-income households and local businesses. According to the website of the Treasury Department's CDFI Fund, which certifies CDFIs, these entities include community development banks, credit unions, loan funds, venture capital funds, and microenterprise loan funds, among others. In addition to financing resources, some are also equipped to provide training and hands-on technical assistance. As of February 1, 2005 the CDFI Fund had certified 740 CDFIs. Lists of these entities, along with other information, are at [www.cdfifund.gov](http://www.cdfifund.gov).

A few of the available intermediary loan funds are described below. Others are summarized in the October 2004 issue of *Affordable Housing Finance* magazine.<sup>2</sup>

### LISC

Local Initiatives Support Corporation (LISC) is dedicated to helping local nonprofit development organizations transform distressed neighborhoods into healthy communities of choice and opportunity – good places to work, do business, and raise children. LISC provides technical assistance and loans for predevelopment, acquisition, and construction expenses at competitive rates. Since 1980, LISC has marshaled more than \$6 billion to help 2,400 CDCs build or rehabilitate more than 158,000 affordable homes and almost 23 million square feet of retail, community, and educational space in more than 300 urban and rural communities nationwide.

LISC's Affordable Housing Preservation Initiative works to keep affordable rental properties safe, in good repair, and available to low-income families by providing support to local LISC offices, housing authorities, community development corporations, and other nonprofits. LISC provides technical and financing assistance to help affordable housing advocates identify preservation opportunities, assess their own capacity to develop, own and manage large-scale multifamily properties, and identify resources to build their capacity to preserve at-risk units. Preservation staff also provides project-specific assistance identifying technical transaction issues and providing project analysis and financing

recommendations to promote a more effective development process and financing structure. From 2001 through 2004, LISC committed \$38 million in financial support and technical assistance for 100 preservation projects, enabling more than 16,500 low-income families to remain in their homes. For more information about LISC, see [www.lisc.org](http://www.lisc.org).

### The Housing Assistance Council

The Housing Assistance Council (HAC) makes predevelopment loans for affordable housing in rural areas. These loans are not limited to preservation situations, but can be used in a rural preservation project. Eligible purposes include acquisition and construction. HAC loans are generally between \$100,000 and \$250,000, with terms up to three years in length, a below-market interest rate (five percent in October 2004), and a service fee of one percent. Nonprofits and public bodies are eligible to borrow from HAC. Borrowers, as well as other entities working to provide or preserve affordable housing in rural places, are eligible for technical assistance from HAC. The organization also provides training sessions, a national rural housing conference every two years, and dozens of publications on rural housing topics. More information is available at [www.ruralhome.org](http://www.ruralhome.org).

### National Housing Trust

The National Housing Trust (NHT) is a nonprofit organization dedicated to the preservation of affordable rental housing. NHT's affiliate, the NHT Community Development Fund (NHTCDF), provides predevelopment and bridge financing to nonprofits working to preserve and improve affordable multifamily housing properties. Loans are for terms of 12 to 60 months with interest at a below-market rate and a one percent origination fee. Interest rates on predevelopment loans have typically been four percent to six percent, and on bridge loans typically seven percent. An applicant must demonstrate its capacity to complete the project.

NHTCDF offers interim development loans of up to \$250,000. They can be used for bridge financing, bond underwriting, bond counsel, environmental consultants, legal fees associated with permanent financing, rehabilitation, and similar items. Predevelopment loans from NHTCDF are available for up to \$150,000 and can be used for predevelopment expenses such as earnest money deposits, purchase deposits, architect/engineer costs, environmental consultants, finance and development consultants, tax credit consultants, finance related fees (e.g., tax credit reservation fees or loan origination fees), market

studies, and project-related sponsor overhead. More information is available at [www.nhtinc.org](http://www.nhtinc.org).

### **Neighborhood Reinvestment**

The Neighborhood Reinvestment Corporation is a national housing intermediary that receives most of its budget from annual Congressional appropriations. Neighborhood Reinvestment provides support to nonprofit development organizations through its NeighborWorks® Network of over 230 community-based organizations, and provides training for nonprofit organizations through the NeighborWorks® Training Institute. Services provided by Neighborhood Reinvestment also include a Multifamily Initiative and a Rural Initiative.

Local nonprofits that are members of the Neighborhood Reinvestment Corporation's NeighborWorks® network's Multifamily Initiative are eligible for financing from the Neighborhood Capital Corporation (NCC). NCC makes short-term loans for predevelopment and acquisition costs associated with taking ownership of, redeveloping, or constructing projects of at least ten units that are affordable to families under 80 percent of median income. At least 51 percent of the units in a project must be rental. Predevelopment loans may be up to \$410,000 in some circumstances, and interim development loans of over \$1 million are available when the National Housing Trust is participating.

Members of the NeighborWorks® Multifamily Initiative may also receive development grants, technical assistance, and asset management support. While non-members may not obtain loans or other benefits directly, they may partner with members who are eligible. More information is available at [www.nw.org](http://www.nw.org).

### **Mercy Loan Fund**

The Mercy Loan Fund (MLF), a subsidiary of Mercy Housing, was formed in 1983 with the goal of supporting the mission of Mercy Housing by making loans for affordable housing developments, when conventional financing is not possible or affordable. The mission of Mercy Housing is to create and strengthen healthy communities through the provision of quality, affordable, service-enriched housing for individuals and families who are economically poor. MLF is certified by the U.S. Treasury Department as a Community Development Financial Institution (CDFI), and lends nationally. Loan products include acquisition, construction, predevelopment, tax credit bridge loans and permanent first mortgages for multifamily rental properties (for up to \$3 million for a

term of up to 30 years). For more information, see [www.mercyhousing.org](http://www.mercyhousing.org)

### **Community Development Trust**

LISC provided the initial seed capital to create the Community Development Trust (CDT) to further LISC's broad support for community development initiatives and finance. CDT helps nonprofits acquire properties where owners face significant exit tax issues.

CDT makes long-term equity investments in properties and provides a secondary market for permanent fixed-rate mortgages. Under its Equity Program, CDT invests "tax advantaged" equity in low-, moderate- and mixed-income multifamily properties to help preserve long-term affordability. CDT is structured as an Umbrella Partnership Real Estate Investment Trust, which could provide certain tax deferrals to owners that exchange ownership interests in their property for an interest in CDT. CDT's preservation efforts will help to maintain the affordability of many at-risk affordable housing projects which might otherwise convert to market. CDT works with local sponsor partners, both nonprofits and for profits, together with state housing finance agencies and other finance partners, to restructure properties to assure affordability and project stabilization. CDT's equity can be combined with tax-exempt financing and tax credits to provide capital for rehabilitation and to increase the financial viability of projects while they are maintained as affordable housing. More information is available at <http://www.cdt.biz>.

### **Enterprise Foundation**

The Enterprise Foundation is national community development intermediary that provides financing and technical assistance to community-based nonprofit groups. Enterprise supports preservation activities through a partnership with the National Housing Trust (see above) called NHT/Enterprise (see above). For more information see [www.enterprisefoundation.org](http://www.enterprisefoundation.org).

### **Housing Partnership Network**

The Housing Partnership Network is a peer network and business cooperative of 84 affordable housing nonprofits that operate on a citywide or regional basis. The founding members formed the Housing Partnership Network in 1990 to share knowledge and spread innovation among peer organizations, to shape policy, and to create new social enterprises to strengthen their businesses and achieve their missions. The Network's affiliated Housing Partnership Fund provides financing for projects of member groups. For more information visit [www.housingpartnership.net](http://www.housingpartnership.net).

## Federal Home Loan Bank Programs

Federal Home Loan Bank (FHLB) programs encourage banks, thrifts, and others that are members of the FHLB system to finance affordable housing and community development. To use these programs, generally a nonprofit or public agency structures a deal and then seeks the involvement of an FHLB member institution. The FHLB member must be the applicant.

Each of the 12 regional Federal Home Loan Banks (FHLBanks) administers the programs described below, so details including requirements and preferences vary among the regions. Each FHLBank also determines how many application periods it will have each year, and when applications will be due.

The Affordable Housing Program (AHP) subsidizes the interest rate on loans and provides direct subsidies to FHLBank System member institutions engaged in lending for long-term, very low-, low- and moderate-income housing. The funds can be used to finance the purchase or rehabilitation of rental housing if at least 20 percent of the units will be occupied by and affordable for very low-income households for at least 15 years. Most of the regional banks have established priorities for projects in rural areas.

Community Investment Program (CIP) loans from FHLBanks are intended to encourage and assist member institutions in undertaking community-oriented mortgage lending. They can be used for acquisition or rehabilitation of rental housing for families with incomes up to 115 percent of the area median income.

Finally, a Federal Home Loan Bank may issue a standby letter of credit (LOC) guaranteeing that a member institution or a nonmember mortgagee will repay a debt it owes to a third party. Collateral must be provided to secure each LOC. Typical standby LOC transactions include credit enhanced, tax-exempt housing bonds where the LOC provides a guarantee of repayment to investors, which in turn reduces the risk of the investment and the interest rate paid to investors by the developer.

More information on these programs can be found on the Federal Housing Finance Board's web site at [www.fhfb.gov/FHLB/FHLBPS\\_index.htm](http://www.fhfb.gov/FHLB/FHLBPS_index.htm).

## Other Private Financing

While there are many reasons why the development and preservation of affordable rental housing can be unattractive to commercial bank lenders, especially those in rural areas, banks and savings and loan institutions should not be overlooked as sources of preservation funding. As noted above, the Rural Housing Service's Section 538 guarantee program and the Federal Home Loan Bank programs are ways to encourage private lenders to participate in affordable housing financing. The Community Reinvestment Act (CRA) can be useful as well.

CRA is not a program, but a federal law that requires financial institutions to help meet the credit needs of their communities, including low- and moderate-income neighborhoods. Every federally insured financial institution receives a CRA rating as part of a periodic review conducted by one of four regulatory agencies. There are no penalties for receiving a low rating, although the rating is taken into account when a lender applies to merge with another lender or to open, close, or relocate a branch office. The majority of lenders are rated "satisfactory." Still, many lenders do value their CRA ratings, if only for their public relations value.

Foundations are another potential source of non-government funding for preservation. As the loss of affordable rental properties has gained greater recognition, several foundations have explored ways support preservation activity. For example, the John D. and Catherine T. MacArthur Foundation announced its \$50 million Window of Opportunity initiative in late 2003, and has focused on providing program-related investments to high-output nonprofits with a preservation focus. MacArthur has also provided funding to leverage commercial sources of lending for high-risk preservation transactions. For more information, see the MacArthur Foundation website at [www.macfound.org](http://www.macfound.org).

## Possible New Resources

As preservation becomes an increasingly important issue, and as advocates for low- and extremely low-income renters work to ensure their needs are met in a context that increasingly focuses on homeownership-based housing policies, new targeted programs are being developed. It is difficult, of course, to predict the odds of any new program being adopted while most domestic social programs are shrinking.

## Chapter 3 Notes

**Preservation Demonstration.** A new \$3 million demonstration rural housing preservation program was enacted in the HUD Appropriations bill for fiscal year 2005. Nonprofit intermediary organizations and state housing agencies are eligible for grants to be used as revolving loan funds for rural rental housing preservation. A Notice of Funding Availability (NOFA) will be issued in the spring of 2005 for this resource.

**Affordable Housing Preservation Act.** Senator James Jeffords introduced a bill in the 108th Congress (S. 2692) that would have provided matching funds to states and localities that allocate their own funds for rental housing preservation, including Section 515 projects. The federal match could be up to twice as much as the state or local contribution. Fifty-year use restrictions would be required. Representative Jerrold Nadler introduced a similar bill in the 108th Congress, the Housing Preservation Matching Grant Act, that would apply only to HUD-financed rental housing. Similar bills are expected to be re-introduced on the 109th Congress.

**National Housing Trust Fund.** More than 5,300 organizations and local leaders have endorsed the adoption of a National Housing Trust Fund to build, rehabilitate, and preserve 1.5 million affordable homes over the next decade. Most of the funds would be targeted to families with the lowest incomes, and 75 percent of the trust fund's monies would be used for rental housing. Several versions were introduced in the 108th Congress, and the effort is expected to continue in the 109th. More information is available at [www.nhtf.org](http://www.nhtf.org).

**Rural Rental Housing Act.** Introduced as in the 108th Congress by Representatives Artur Davis and Rubén Hinojosa and cosponsored by six others, the Rural Rental Housing Act would fund the acquisition, rehabilitation, and construction of rental units in rural places.

**Affordable Housing Preservation Tax Relief Act.** Representatives Jim Ramstad and Ben Cardin introduced H.R. 3485 in the 108th Congress, which proposed exit tax relief to encourage the preservation of certain multifamily rental housing. A coalition of affordable housing advocates has carefully reviewed this legislation and made recommendations intended to make the legislation more effective and workable in practice. This coalition will likely support the introduction of revised legislation in the 109th Congress.

<sup>1</sup> See discussion of Section 8 renewal options in LISC's *Stemming the Tide*, Chapter 2. Available online at [www.lisc.org/resources](http://www.lisc.org/resources).

<sup>2</sup> "Bridge financing for nonprofit-controlled acquisitions," *Affordable Housing Finance*, Vol. 12, No. 10, October 2004, p. 48.

## CHAPTER FOUR

## SECTION 515 LEGAL ISSUES

Gideon Anders, Timothy L. Thompson and Christine R. Goepfert

## Evolution of Prepayment Restrictions

## Origin of Section 515 Prepayment Issue

**W**hen the Rural Rental Housing, or Section 515, loan program was first implemented in 1962, the Rural Housing Service (RHS, formerly Farmers Home Administration (FmHA)) charged different interest rates to nonprofit or public agencies than it charged private borrowers. The former received three percent loans, while the latter received “market rate” loans, which were typically in the range of five to seven percent. At the time, RHS did not require any of its borrowers to serve low-income households for any specified period of time because its staff generally believed that long-term use restrictions were not necessary. Nonprofit and public agencies, which received below-market interest rate loans, were expected to operate their projects for the term of the loans as a means of fulfilling their public purpose. While there were no similar expectations with respect to private owners, the prepayment of those loans was not viewed as having a substantial adverse impact on residents because the RHS market-rate loan would be replaced by a private market-rate loan with a comparable, or only slightly higher, interest rate. Thus, rents would not be increased significantly and residents would not likely be displaced.

In 1968, Congress supplemented the below market interest rate program with the Interest Credit<sup>1</sup> subsidy which, depending on resident income, reduced the owner’s effective interest rate to one percent. When this subsidy came about, RHS made no changes with respect to the owners’ obligations to maintain the housing as affordable housing for any period of time. Since only nonprofit and public agencies qualified for the Interest Credit subsidies, RHS did not see any need to place use restrictions on borrowers and it continued to operate the program under the same assumptions that it had for the first six years.

The origin of the prepayment problem dates to 1972, when RHS sought to increase the production of Section 515 housing by allowing private for-profit developers to qualify for Interest Credit loans. Unfortunately, when RHS amended its regulations to allow for-profit developers to enter the subsidized loan program, it failed to place use restrictions on the owners as HUD had done on its housing programs, meaning an explicit statement of the duty to continue to operate the housing for the benefit of low and moderate-income tenants. Simultaneously, it failed to restrict the private owners’ right to prepay their loans. Thus private developers, who entered the subsidized program after 1972, could construct and rent up projects and subsequently prepay their RHS loans at any time.

Few owners prepaid their loans in the early and mid-1970s because there were few incentives to do so. Generally, property values were not rising dramatically at that time and market conditions did not permit owners to charge higher rents. Moreover, many of the new owners, who were tax-motivated individuals, partnerships or limited partnerships, had a disincentive to prepay during the first years of their loans. The tax code, which provided deductions for accelerated depreciation of subsidized housing, penalized owners if they ceased to operate the projects for the benefit of low- and moderate-income families during the loans’ early years.

## Chronology of Statutory Restrictions

The use and prepayment restrictions that are currently applicable to RHS rental housing were imposed by Congress over a six year period that involved considerable lobbying by resident and owner representatives. A brief review of that history is useful to fully understand the nature of the restrictions that are currently in place.

Prepayments under the RHS program began to increase by the late 1970s and the resulting

displacement began to draw public attention. For example, in Fiscal Year 1978, 104 RHS loans were prepaid, compared to only 18 in Fiscal Year 1970.<sup>2</sup> In 1979, after litigation failed to stem the growing number of prepayments and resulting resident displacement,<sup>3</sup> resident advocates were successful in persuading Congress to adopt legislation that placed 15- or 20-year<sup>4</sup> use restrictions on all projects financed by RHS after December 21, 1979. That legislation also prohibited owners of projects with more than ten units that were financed prior to that date from prepaying their loans until the expiration of 15 or 20 years<sup>5</sup> from the date the loan was made, unless displaced residents were provided affordable decent alternative housing.<sup>6</sup>

Builders and owners of Section 515 projects reacted negatively to the retroactive restrictions that were enacted in 1979. In 1980, these developers successfully lobbied for the repeal of these retroactive restrictions<sup>7</sup> again freeing owners of projects financed prior to 1979 to prepay their loans.

Increased real estate values in certain parts of the country, coupled with the diminishing value of tax shelters established in the early 1970s, caused prepayments to increase dramatically by the mid-1980s. Unlike prepayments of the mid- to late-1970s, those that occurred in the mid-1980s were drawing greater attention because projects whose loans were being prepaid were larger and the impact on residents and communities was more noticeable. Although efforts were again made to stop prepayments and displacement through judicial action,<sup>8</sup> resident advocates once more focused their attention on Congress, which placed a moratorium on all RHS prepayments in October of 1986.

With some minor lapses, this moratorium remained in effect until February of 1988,<sup>9</sup> when Congress adopted the Emergency Low Income Housing Preservation Act of 1987 (ELIHPA). ELIHPA required RHS to offer incentives to encourage owners, who were considering prepayment of their RHS loans, to remain in the program. It also placed restrictions on the prepayment rights of owners whose loans were financed prior to December 21, 1979, (hereafter “pre-1979 projects”) but who did not accept the incentives.<sup>10</sup> Generally these restrictions limit the owners’ right to prepay their loans whenever the prepayments will have a material affect on minority housing opportunities, by requiring them to offer to sell the project to a nonprofit or public agency. If no purchase offer is made within 180 days, the owners may prepay their loans. If the prepayment will not affect minority housing opportunities, ELIHPA authorizes prepayment only if current residents will

not be displaced or it is shown that there is adequate alternative affordable housing available in the community to which the residents can move.<sup>11</sup>

In 1989, Congress adopted legislation that precluded prepayment of projects approved after December 15, 1989.<sup>12</sup> Because RHS Section 515 loans are made for a term of 30 to 50 years (varying according to statutory and regulatory provisions), the legislation effectively established a 30-50-year use restriction on all projects financed after that date.

In 1992, Congress extended the prepayment restrictions that were placed on projects financed prior to December 21, 1979 to projects financed between December 21, 1979, and December 15, 1989 (hereafter “post-1979 projects”).<sup>13</sup> Thus, when post-1979 projects reached the end of their 20-year restriction on prepayment, prepayments then became subject to the same potential restrictions as pre-1979 projects.

### **Pre-1979, Post-1979 and Post-1989 Projects**

When RHS implemented the prepayment restrictions that Congress imposed on the Section 515 program, it did not distinguish developments based on the date that the particular loan was closed. Instead, it used the loan approval date as the basis for determining which restrictions applied to the loan. Thus, a loan that was approved in October 1979 but did not close until January of 1980 was not subject to the post-1979 restrictions but was instead considered to be a pre-1979 loan. While the RHS categorization methodology may make sense with respect to RHS obligations to borrowers based on loan approval date, it makes it difficult for advocates to easily determine which restrictions apply to a particular project. This difficulty arises because the loan approval date is only known to RHS and is not generally accessible to the public, except through inquiries to the agency.

Effectively, pre-1979 and post-1979 developments are treated similarly with respect to owners’ restrictions on the right to prepay. The major difference between them is RHS’ capacity to extend incentives to post-1979 owners to discourage prepayment when the developments are still operating under use restrictions imposed by the 1979 legislation. For example, if an owner entered into an RHS subsidized loan in 1987, the 1979 legislation requires that the owner operate the housing for the benefit of low-income residents for 20 years, or until 2007. This does not preclude the owner from applying to prepay the loan prior to 2007 and, under certain circumstances, from actually prepaying the loans. However, RHS may not offer incentives to the owner to remain in the program and, if the owner is

allowed to prepay the loan, requires the owner to operate the housing for the benefit of low-income residents until 2007. Technically, the owner may then be required to sell the housing to a nonprofit or public agency because if there is an adverse impact on minorities, the mandatory sale requirement will apply. However, RHS has not clearly defined how this will be determined or how such a sale would be financed.

### Summary of Section 515 Properties and Restrictions

Project Type	Prepayment Restriction
Pre-1979 projects	may prepay at any time but subject to ELIHPA process
Post-1979 projects (1979-1989)	may prepay at any time subject to ELIHPA process but must maintain housing for low-income residents for first 20 years
Post-1989 projects	cannot prepay

#### Effect of Prepayment Restrictions

Implementation of the moratorium on prepayments and subsequent adoption of legislation have not stemmed the prepayment of RHS loans or resident displacement to the extent that resident advocates and others had expected. RHS did not believe that legislation to restrict prepayments was either necessary or desirable, and allowed prepayments to occur during short lapses in the prepayment moratorium in 1986 and 1987. In response to the 1987 legislation, RHS adopted interim regulations that, according to housing advocates, failed to conform to ELIHPA, left too many terms undefined, granted too much discretion to district and state staff, failed to prescribe in detail the obligations that RHS officials had in approving or disapproving loan prepayments, and failed to adequately address the connection between prepayment, foreclosure and graduation.<sup>14</sup> As a result, many housing advocates believe that few, if any, of the prepayments that were accepted by RHS under the interim regulations were processed in accordance with the regulations and in conformity with the legislation.<sup>15</sup>

Moreover, it is generally believed that the incentives RHS offered under the interim regulation had the effect of persuading some owners who had no intention of prepaying their loans to apply to prepay simply as a means of accessing the incentives.<sup>16</sup> While the process resulted in many owners formally agreeing to maintain their housing as part of the RHS housing stock for an additional 20 years, it is questionable whether the expenditures were necessary, considering some owners

would not have prepaid their loans under any circumstances.

As a result of litigation,<sup>17</sup> RHS revised its interim regulations in 1990 to bring them into compliance with the 1987 legislation; no other major changes were made until 1993 when RHS published final regulations for the program.<sup>18</sup> While substantially improved, these regulations still have major shortcomings. Most notably, they failed to properly incorporate the 1992 amendments to the legislation that subjected projects constructed between December 21, 1979, and December 15, 1989, to the same prepayment restrictions as projects financed prior to December 21, 1979.

As discussed later in this chapter, the 1993 regulations also never adequately defined what constitutes an “impact on minority housing opportunities,” nor did they preclude defaulting owners whose loans were accelerated from prepaying their loans without restrictions in response to the acceleration notice.

The lack of clarity in the RHS regulations was compounded by the fact that administration of the prepayment restrictions was left to each state office, which frequently interpreted the regulations differently. To address that issue, in 1992 Congress adopted legislation that required RHS to centralize the incentive and prepayment approval process in one preservation office.<sup>19</sup> However, RHS did not implement the legislation until 1998, when it formed the Office of Rural Housing Preservation and appointed two staff persons to handle all prepayment issues. While this has improved the process substantially, problems remain with the prepayment process, as described in the following section.

### Mortgage Prepayment Process

Owners seeking to prepay their Section 515 mortgages must apply in writing to RHS. The application involves a multi-step process designed to incorporate the twin goals of the RHS prepayment statute: inducing owners to accept incentives to stay in the program, or failing that, attaching restrictions on certain prepayments to protect tenants. The process is spelled out in the Interim Regulation at 7 C.F.R. § 3560.651-.750 and Chapter 15 of HB-3-3560 (internal agency handbook). A simplified version of this process is shown in Figure 4.

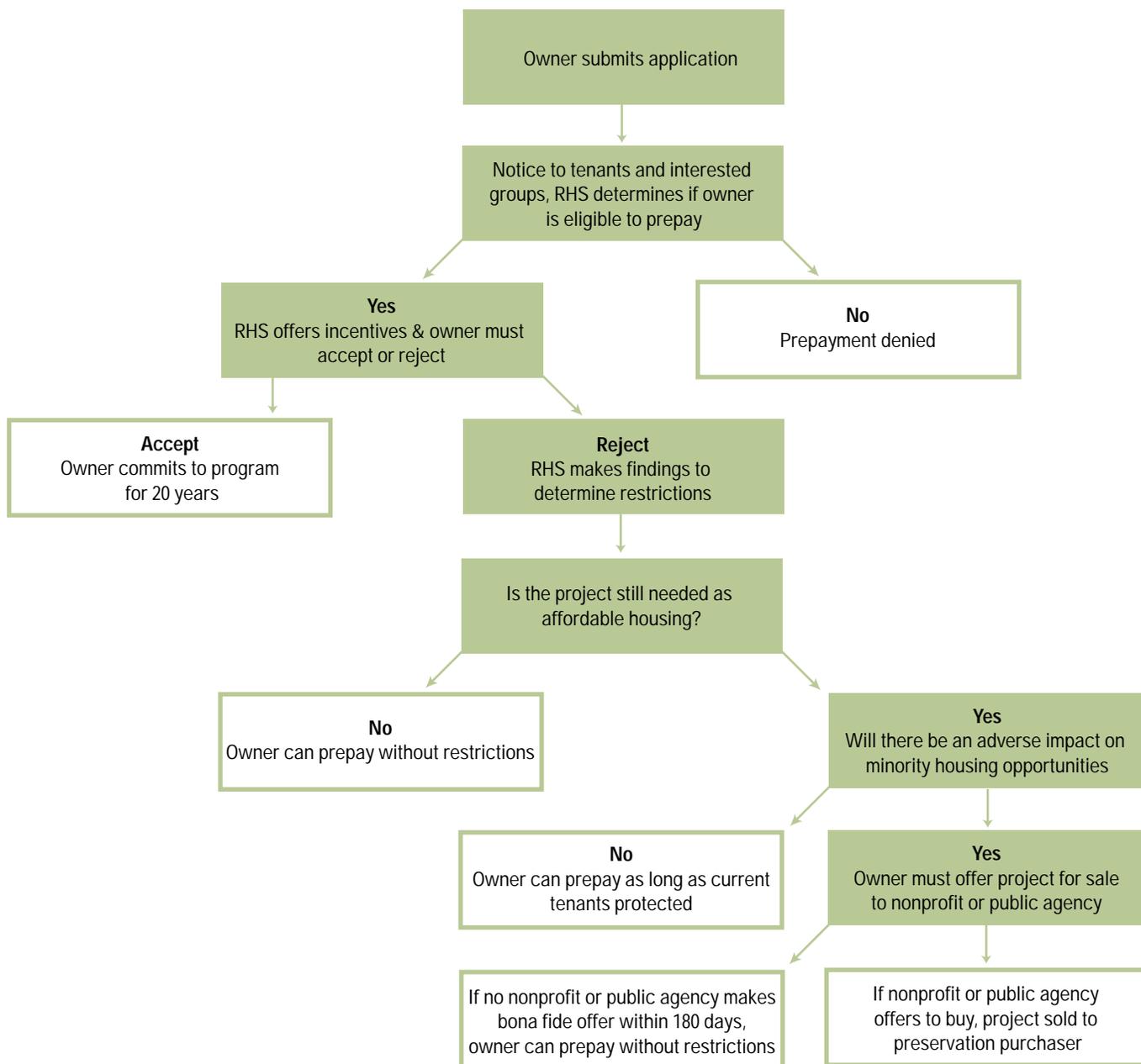
#### Owner Submits Application

RHS will provide the owner with instructions on what must be included in the prepayment application. As part of the application the owner must include a description of the loan to be prepaid and project name,

# PREPAYMENT APPLICATION PROCESS

This process has been simplified.

Figure 4



anticipated date of prepayment, documentation of its ability to prepay, and evidence that actions relating to prepayment under applicable state laws will be met (this can be important in those jurisdictions where state law requires a one year or longer notice requirement). The owner must also provide release of information forms to RHS as a part of its application packet. The owner must submit its application at least 180 days in anticipation of when it wants to prepay. Reviewing the application and prepayment report will

provide a quick snapshot of the situation for preservation advocates and can be obtained through a Freedom of Information Act (FOIA) request to RHS.

## Notifications

Once RHS determines that the owner's application is complete, RHS will send a notice to each tenant advising them of a date and place where tenants may meet with the agency to discuss the prepayment request, and also advise them that they have the right

to review information submitted by the owner in its prepayment request as well as provide the agency comments on the proposed prepayment. RHS' Servicing Office will then notify the National RHS office and nonprofit organizations and public bodies providing affordable housing or financial assistance to tenants, of the prepayment application. National or regional organizations interested in notice on all projects should contact the RHS National Office, whereas groups interested in only a particular state can sign up for the list with the state RHS office. It should be noted that the owner may also provide a prepayment request notice directly to the tenants and may establish a date and place to meet with the tenants. The agency and other providers of housing assistance for low income households are permitted to attend this meeting as well.

RHS regulations require the Servicing Office to notify tenants as decisions are made throughout the process.

#### **RHS Evaluation of Owner Ability to Prepay**

If RHS determines the owner lacks the ability to finance the prepayment, it will deny the owner's application (subject to the owner's right to appeal). In any event, the loan must be one eligible for prepayment (executed prior to December 15, 1989) and for those projects subject to restrictions, the owner must be willing to accept the continuance of such restrictions.

#### **RHS Offers Incentives**

If the owner can prepay, RHS must offer incentives to owners whose project is not subject to a remaining restrictive period (such as post-1979 projects still in the initial 20-year restrictive period). RHS will usually start with a general offer of incentives but will only go to the next step of developing a more specific offer if the owner indicates interest. When it does make the specific offer, RHS will first have to conduct an appraisal in order to determine if the owner has any equity in the project. Once the appraisal is done, RHS will make an offer to the owner which may contain one or more of the following: an equity loan based on current equity in the project, additional Rental Assistance (RA) for any tenants who may need it, an increase in the annual return on investment the owner is permitted to withdraw, the receipt of excess rents in the case of project-based Section 8 contracts, or conversion of market rate loans to interest credit plan loans. Available incentives include:

- Increase the owner's rate of return on the investment;
- Permit conversion of for-profit operation to limited-

profit operation, thereby making Interest Credit subsidies available (for-profit owners are not eligible for Interest Credit – which subsidizes the mortgage to a one percent interest rate – unless they agree to limit profits to an eight percent return on investment);

- Permit owners with project-based Section 8 assistance to receive rents in excess of the amounts needed to meet annual operating and maintenance expenses, debt service, and reserves;
- Provide owners with additional Rental Assistance on a priority basis; and
- Make subsequent loans for up to 90 percent of the difference between the project's appraised market value and the owner's equity.

The owner has 30 days to accept or reject the incentives. If the owner accepts the offer, RHS is obligated to provide the incentives, though depending upon the availability of funding, the owner's incentives may have to go on a waiting list. If the agency cannot fund the incentive within 15 months, the owner may sell the project, withdraw the prepayment request, obtain a third party equity loan, or stay on the list. If the owner chooses to withdraw the prepayment request, it may resubmit an updated prepayment request at any time thereafter. In return for receiving incentives, the owner must enter into an agreement to remain in the Section 515 program for 20 more years. Note that it is possible to combine an award of incentives with a transfer of the project to a purchaser committed to long-term preservation. The incentives, such as an equity loan or increased RA, can become part of the financial resources that make it possible to continue use of the property for affordable housing into the future.

Incentives cannot be offered to owners of "restricted loans." These are loans with restrictive use provisions still in place: loans entered into between 1979 and 1989 that are still in their 20-year restrictive period, and pre-1979 loans where restrictions were extended as a result of servicing actions. In such cases, RHS must make a reasonable effort to get the owner to agree to extend low-income use for 20 years, though in the absence of incentives to offer, it is not clear why such a prepaying owner would agree to extend.

Even where incentives apply, owners will frequently reject incentive offers because they simply do not desire to remain in the Section 515 program. For example, this may be true for elderly owners wishing to plan their estates. Where the owner does reject incentives, then RHS moves to the next step in the process.

## **RHS Makes Findings that Determine Restrictions**

At this stage RHS must make two key findings that will determine what restrictions, if any, will attach to the owner's prepayment.

### **1. Is the Project Still Needed as Low-Income Housing?**

RHS will determine whether there is a continued need for the housing. Although in most situations the community will still need the project as affordable housing, there are instances where circumstances may have changed. RHS guidelines provide that a determination that the housing is no longer needed can only be made where: (1) all tenants in the project could be currently relocated to a vacant affordable unit elsewhere in the market; and (2) it does not appear that additional subsidized housing will be needed during the time in which restrictive use provisions would otherwise apply (see below). Advocates must be alert to monitor such determinations by RHS, because such a finding not only means the project is likely lost as affordable but that tenants in need of low-income housing may have to move.

In evaluating whether there are sufficient vacant units elsewhere in the market, the market definition is critical. In Alabama, for example, an owner has repeatedly appealed decisions by RHS that its project was still needed. The owner argued that since he could point to vacant affordable units several counties away, its housing was not needed. RHS and the tenants rejected that position, pointing out that at the time the RHS regulation defined market area as "the community in which the project is located and those outlying rural areas which are impacted by the project (excluding all other established communities)." However, RHS recently redefined market area to include "outlying areas that will be impacted by the project, i.e., the area in which alternative, similar properties effectively compete with the subject property," which does not exclude other established communities. This definition would seem to expand the market area. On the other hand, RHS' handbook on the subject indicates this needs analysis must be based on comparable housing *in the local community*. In any event, if this test is properly applied, a finding that a project is no longer needed would be rare.

### **2. Will Minority Housing Opportunities be Materially Affected?**

Whether minorities in the project, on the waiting list, or in the market area will be disproportionately adversely affected by the loss of the affordable rental housing units is the second key evaluation RHS must make. As explained below, this becomes a critical decision for creating a possible preservation outcome.

It also appears to have been a factor that has not been consistently applied by RHS, despite the fact that in many rural areas, minority renters are in great need of affordable housing. In some areas, though, advocates have found that through their efforts, RHS staff have become more sensitive to this issue. In addition, the recent rapid emergence of immigrant populations in many previously homogeneous rural areas should lead to a wider application of this test.

Minorities will be most obviously affected where minorities currently live in the project or are on the project waitlist. In addition, however, RHS guidelines require staff to examine the percentage of minorities residing in other projects in the market area where displaced tenants are most likely to move, whether displaced minorities will be required to move to inconvenient locations, minorities on waitlists at other projects in the market area, and whether this will reduce the chance to gain good housing for minorities currently living in substandard housing. Advocates should make sure RHS considers all relevant data, including Census or other information which reflects the current composition of these communities. It is also important to monitor actively and to seek substantiation of the assumptions of RHS staff, such as the assumption that minorities are unlikely to want to reside in particular projects due to unit size or due to perceived historical preferences.

## **Impact of RHS Findings**

### ***Housing Not Needed***

If RHS finds the housing is no longer needed, the owner will be permitted to prepay without restrictive use provisions (controls on rents and income eligibility). As of the prepayment, all use restrictions and RA subsidies terminate, and following the passage of 180 days, the owner is free to increase rents, and tenants may either pay the increase or choose to move. In an effort to partially ease the hardship of displacement for tenants who will no longer be able to afford their apartment, RHS issues tenants a letter of priority entitlement (LOPE), which enables them to obtain priority status to move into vacant units in other Section 515 projects for up to one year following the prepayment acceptance notice date. Tenants should not be displaced to unaffordable housing because the conclusion that the housing is no longer needed necessarily implies that affordable housing is available elsewhere for affected tenants.

### ***Housing Needed, No Minority Impact***

If RHS finds the housing is needed, but that minority housing opportunities will not be materially affected, then RHS will authorize the owner to prepay and

withdraw from the program, provided the owner agrees to enter into restrictive use provisions that protect current tenants. Such provisions bind the owner and its successors and provide that those tenants occupying the project as of the prepayment will continue to be treated as if the project were still in the Section 515 program.

Most importantly, this means that such tenants will continue to enjoy low rents, and can expect that their rent will increase no more than it would were the owner still operating under the Section 515 program. Such protections continue as long as the tenant wishes to remain in the building. If necessary, RHS and the restrictive covenant authorize tenants to seek judicial enforcement of these protections.

Thus, any owner contemplating prepayment pursuant to this route must realize it will have to guarantee its existing tenants the same rent levels they have enjoyed without the rent subsidies the owner had received from RHS (which terminate upon prepayment). In some cases, owners have concluded that such financial gaps were untenable and have as a result withdrawn their prepayment applications. In other cases if owners have refused to abide by such restrictions RHS has denied the prepayment application. In still other cases, owners may rely on a continuation of existing project-based Section 8 contracts to fulfill their obligations, or they may seek to assist tenants in obtaining tenant-based Section 8 vouchers to cover the gap. The latter strategy, of course, only works where the local Section 8 program has vouchers available without a lengthy waitlist.

A few points should be made with respect to those prepaying projects that also have a project-based Section 8 contract. First, while the existence of a Section 8 contract is one factor in conducting the rental market analysis, the agency is not allowed to rely on the existence of this contract as a substitute for restrictive use provisions. Therefore, the agency must still make findings regarding the housing need and the material effect on minority housing opportunities regardless of the existence of the Section 8 contract (see discussion in the following section). Second, even if the agency requires the owner to execute restrictive use provisions, RHS places no restrictions on the owner beyond the obligation to current tenants, and does not obligate the owner to renew the Section 8 contract for any period of time. Thus, the owner can still convert the development to market rate in a two step process by prepaying the RHS loan and then not renewing the Section 8 contract when it expires.

It may be that an owner has an incentive to continue to renew the contract because of the restrictions in place. There are two outcomes that may influence an owner's decision to opt out. If the restrictions apply to future and current tenants, any incoming tenants after a Section 8 opt out will only have to pay rent according to the terms of the Section 515 program; however, the owner will not have the benefit of any subsidies to make up the difference between that rent and the market rent it may otherwise charge new tenants. In this situation, the owner will likely want to continue to renew the contract so that it receives subsidies for all tenants' rents. However, for those restrictions that only protect tenants in the building at the time of prepayment, if the owner opts out of the Section 8 contract, most if not all of the tenants should receive vouchers upon termination of the contract. Therefore, the owner will continue to receive subsidies for them, and after turnover it will have no remaining obligation to keep incoming tenants' rents low. In any event, the existence of the Section 8 contract guarantees no long-term preservation outcome when the Section 515 mortgage is prepaid.

Another issue that may arise with regard to these restrictions is their enforcement. The owner's long-term commitment to treat current tenants as if they remained in the Section 515 program while in fact the project no longer is in the program creates interesting challenges. RHS requires the owner (and successor owners) to file annual certifications of continued compliance with restrictions. But what happens when an owner seeks to raise rents based on increased operating costs? If the project had remained in the Section 515 program, the owner would have had to submit an application to RHS for a rent increase which the agency would then have scrutinized for justification. Following prepayment and the attachment of restrictions, however, RHS practice has been to conduct only the most cursory review of rent increases. It is not hard to imagine that some years down the road, particularly with a new owner who has never participated in the Section 515 program, such a limited review may be insufficient to prevent rents creeping upward in violation of the restrictions. There is a more fundamental concern with this outcome, however. While this outcome protects current tenants, it does not preserve the long-term affordability of the project. As current tenants vacate over time, the owner is free to charge what rent the market will bear, and so over time the project transitions to market rate housing. In certain "soft" markets, the owner may find that it is unable to charge rents above the level authorized under Section 515,

and in such cases prepayment may have little impact on rents. However, in other market situations project rents can be expected to change dramatically. Even in a soft market, preservation advocates must be wary of writing off certain buildings; today's soft market may give way to a quite different situation several years down the road, but by that point the opportunity to retain the project within the Section 515 program would have disappeared.

### ***Housing Needed, Material Impact on Minority Housing Opportunities***

If minorities will be materially affected by the prepayment, the owner must offer the project for sale to a nonprofit or public agency seeking to preserve the project within the Section 515 program, or the owner must execute a new 20-year use restriction, or withdraw its prepayment application. Although the offer of sale outcome presents an opportunity to preserve project affordability, it is not without risk. If no nonprofit or public agency makes a bona fide offer to buy, the owner is free to prepay without restriction.

### **Mandatory Public Sale Process**

The time at which a mandatory public sale will occur may vary depending upon the year the loan was initiated. Loans issued prior to 1979 will trigger an immediate mandatory offer of sale by the owner. If the loan is post-1979 and still in its 20-year restrictive period, the project continues to operate as a Section 515 project for purposes of retaining affordable rent levels for the remainder of that period. This applies not only to current tenants but also to tenants who move in during the remaining restrictive period. Once the 20-year restrictive period expires, the owner must then offer the project for sale.

It should be noted that this latter scenario poses some obstacles toward long-term preservation. Since the post-1979 owner actually prepays the loan, there is no Section 515 mortgage in place when the time comes to offer the project for sale to a nonprofit or public agency. Therefore, should a public agency or nonprofit step forward after the restrictions expire, it would have to apply for Section 515 financing and would be treated as any other applicant. Furthermore, the housing must meet RHS standards. Given the financing shortages and other issues, it is uncertain if a sale would be financed by RHS at this stage. Further, prepayment of the Section 515 loan also results in the termination of RHS Rental Assistance.

In any event, the actual sale process begins with a determination of the sale price. This is necessary because if the owner sets its own price, it could set it at

a level to ensure no one could make an offer. The price the owner must offer is set at fair market value (FMV), which is determined by an appraisal process. The FMV is set based upon an RHS-initiated appraisal, an owner-initiated appraisal, and if necessary a third appraisal to reconcile any differences.

Next, the owner must market the project to nonprofit organizations and public agencies from the list maintained by RHS. RHS must assist the owner in initially notifying these organizations. The owner must advertise and offer to sell for a minimum of 180 days. The owner may suspend advertising and other sales efforts while eligibility of an interested purchaser is determined. If the purchaser is found ineligible, the owner must resume advertising for the balance of the 180 days. During the first 60 days, the owner can only accept offers from local nonprofits and public agencies, and after that, from regional and national nonprofit groups. The agency may determine that no local nonprofit or public bodies are available to purchase, so the owner can accept offers from regional or national groups earlier in the marketing process. If more than one bona fide offer to buy is submitted, local groups get preference over regional and national groups, and groups with a successful track record of developing and managing subsidized housing get preference over others.

A would-be buyer must obtain a purchase agreement from the owner based upon the previously established FMV. Although negotiating a purchase agreement should not be difficult when the price is already established, prospective buyers should be alert to the possibility that the 180 days could expire if a reluctant owner raises multiple issues in the purchase agreement in an effort to draw out negotiations past the 180 day limit. In such a situation, the proposed buyer should contact RHS. Once the purchase agreement is obtained, the buyer will then submit the purchase agreement and an application to purchase to RHS.

If a nonprofit makes an offer to buy, RHS must first determine if the organization is eligible. Although such groups need not be organized solely to provide housing nor be broadly based in the sense required by other RHS rules, the nonprofit must meet certain requirements. In particular, the nonprofit must be deemed capable of managing the project, must agree to no further transfers unless use restrictions continue, must agree to maintain the project as low-income housing for its remaining useful life, must demonstrate the financial feasibility of the purchase, and must demonstrate it is unrelated to the current owner and any other owners that have previously applied to

prepay or prepaid a Section 515 loan. If a nonprofit is determined ineligible, the group may file an administrative appeal with RHS.

Assuming the putative buyer is deemed eligible, the RHS National office will authorize the transfer and funding. RHS will provide a loan to cover the purchase at FMV and first year operating expenses. Rental Assistance (RA) must also be provided to all tenants not currently receiving it who will otherwise be rent over-burdened (required to pay more than 30 percent of their income). Depending upon the availability of appropriations to fund these expenses, the pending sale may have to be placed upon a national waiting list. In addition, the purchaser can receive a grant of up to \$20,000 to cover costs related to purchase.<sup>20</sup>

The owner is only free to prepay without restriction if (1) no bona fide offer is submitted within the 180 day sale period, or (2) an offer has been received but the offeror was unable to fulfill the terms of the offer within 24 months of the offer date and the owner was cooperative with the purchaser. Thus, a primary goal for preservation advocates is to ensure eligible buyers make timely bona fide offers, and that the sale process moves forward in a predictable and timely manner.

## Other Attrition From the Section 515 Program

In addition to applications to prepay the mortgage, projects may leave the Section 515 program when owners default on their program obligations. Unfortunately, RHS regulations permit some significant holes in the tenant safety net in some of these situations.

### Owner Payments in Response to RHS Acceleration

When RHS finds owners not following program rules, the agency engages in a series of servicing actions in an effort to bring the owner into compliance. Violation may involve anything from failing to make loan payments, provide tenant certifications or meet reporting requirements. If the owner's noncompliance persists, RHS may exercise its rights under the mortgage by accelerating the loan and declaring the remaining balance immediately due and owing. An owner is then faced with the prospect of immediately paying off the entire loan or its project goes into foreclosure. Not surprisingly, a number of owners have tendered payment of the balance on their loans, which has the effect of terminating the project's participation in the Section 515 program.

Although such a result looks very much like a prepayment of the mortgage, RHS does not consider such a payment a "prepayment" subject to the procedures and protections outlined above. The only restrictions that will attach are those remaining on loans made after December 21, 1979, otherwise tenants are given a 180 day notice that the project can be removed from the program. However, before accelerating a loan, RHS must consider the possibility that the owner is forcing an acceleration to circumvent the prepayment process. If RHS finds that this is the owner's motivation, it must consider alternatives to acceleration, such as suing for specific performance. While RHS acknowledges the risk of owners provoking the acceleration process to get around prepayment protections, there are no criteria spelled out in the regulations or agency handbooks that will guide RHS' determination regarding the owner's motivation. Further, the authors are unaware of RHS ever having taken such a course of action.

RHS and owners have in some cases avoided ELIHPA through the default and foreclosure process. Relying on an Office of General Counsel opinion, RHS has concluded that an owner's payment of the balance due on a loan is not a "prepayment" when the payment is made in response to an acceleration of the promissory note. In other words, the acceleration notice, issued in response to a monetary or non-monetary default, causes the entire loan to be due and payable and the payment by the owner, according to RHS, is therefore not a prepayment. Whether RHS is technically correct in its interpretation, its application violates the intent of ELIHPA, which was to prevent tenant displacement.

The problem is much more significant when RHS is dealing with owners of troubled projects, including those who have defaulted due to economic reasons or who have failed to maintain the property. In those cases, if RHS decides not to maintain the property in the 515 inventory, it may use the default, acceleration, and foreclosure process to dispose of the development without regard to the impact that it may have on residents. In one case, residents unsuccessfully challenged RHS' failure to impose use restrictions on a development that was being foreclosed due to an owner's default. The court, in that case, held that ELIHPA does not address foreclosures and that RHS had discretion whether or not to place restrictions on properties that are sold through the foreclosure process. Having decided not to place restrictions on the property being sold, the court concluded that RHS did not abuse its discretion and dismissed the residents' case.<sup>21</sup>

## Foreclosure

If a project is sold out of the program at a foreclosure sale, the existing restrictive-use provisions will remain unless RHS determines that they significantly affect the value of the project and its marketability. If so, the property is appraised at actual market value based upon the highest and best use of the property, and it is sold without restrictive-use provisions (unless ownership is continued by the same entity).

An owner faced with judicial foreclosure argued that the failure of the judicial foreclosure judgment to mention restrictive use provisions meant that RHS could not later attach such restrictions. The court rejected that argument, however, observing that federal regulations required such restrictions whether they were specifically mentioned in the judgment or not.<sup>22</sup>

## Inventory Property

If RHS forecloses and takes back title to a project, it will then seek to sell the project out of its inventory, and in so doing, must determine what restrictions to attach to ensure the project will serve low and moderate income tenants. This may mean continuing any use restrictions that are currently in place, or if an analysis regarding the housing need and minority impact permits, restrictions may not be required. If the agency finances the sale with a Section 515 loan, new use restrictions are imposed by virtue of the new loan.

## Using the Prepayment Process for Preservation Strategies

### Monitoring Prepayment Applications

The RHS regulations require each state office to notify interested nonprofit organizations and public agencies of prepayment requests received by that office within 30 days of receiving the request. The notice may include the name and location of the project, the number and types of units, the subsidies that are available to residents at the project and the date the owner has filed the request to prepay. Occasionally, the notice will state other information such as the owner's intentions to actually prepay the loan or merely to secure incentives. Organizations that are interested in receiving these notices must request to be placed on the "interested organization" list either with state offices, to receive notices from respective states, or the RHS Office of Rental Housing Preservation, to be placed on a national notification list. In so doing, nonprofit organizations

take the first step towards helping preserve the Section 515 stock.

Receipt of the RHS notice allows nonprofit organizations and others to monitor the prepayment process from the first stages. It enables nonprofits to inquire of RHS about the owner's intentions. And, if the nonprofit is interested in purchasing the project, it allows the organization to make RHS aware of the nonprofit's interest in buying the property.<sup>23</sup> Receiving notifications also provides nonprofits with the opportunity to directly contact property owners and engage them in discussions about possible sale of the property to a nonprofit or public entity.

Additionally, the notice enables nonprofit organizations to closely monitor the prepayment process. This can be done through periodic phone calls, letters, or more formal Freedom of Information Act requests for agency records relating to the prepayment.

Of particular importance is RHS' determination as to whether the prepayment will have a material effect on minority housing opportunities, as discussed above.<sup>24</sup> If an owner is intent on prepaying a loan, this decision will determine whether or not the owner is required to offer the project for sale to a nonprofit or public entity. Although the RHS regulations do not provide unambiguous guidance, RHS staff are expected to review certain objective data, such as census reports, market area studies, and waiting lists in order to make the determinations. Organizations that seek to influence that decision can submit additional information to the agency at any time, although it should probably be submitted within the 30 day tenant comment period because RHS will typically begin to make decisions at the end of that time. Generally, a number of advocacy organizations have found that the monitoring of the RHS prepayment process by outside organizations often heightens RHS' compliance with ELIHPA and its implementing regulations.

### Notifying Affected Residents

Within 30 days of receiving a prepayment notice, RHS must notify residents that the owner has filed a request with the agency. In addition to notifying the residents of the prepayment request, the written notice must advise the residents of their right to review information submitted with the prepayment request and submit comments to the agency within a 30-day 'comment period.

It is critical that tenant comments be made as early as possible and within the required period.<sup>25</sup> Tenant comments should address issues that will affect the

agency's decision with respect to offering the owner incentives, deciding whether the project is still needed, requiring the owner to offer the project for sale or allowing prepayment subject to use restrictions. Thus, comments should address concerns, if any, about the condition of the project, the impact of the prepayment on minority housing opportunities, the availability, or lack thereof, of alternative housing opportunities in the community, and the hardship that will be placed on residents by a prepayment.

Unfortunately, residents often do not understand the prepayment process or their right to comment. This may result in residents prematurely moving from the project or feeling anxious about the future. In these situations it may be useful to call on a local legal services or other nonprofit organization to help explain the process to residents and assist them in commenting on the prepayment request. It may also be advisable to recruit other community organizations, (i.e. public housing authorities and affordable housing owners) to comment in writing on the need for the project and their interests in keeping the property as Section 515 subsidized housing.

If, in fact, the prepayment notice is provided only for the purpose of meeting the RHS regulations (i.e. the owner is expecting to accept incentives and remain in the program, or the owner plans to sell the property to a nonprofit or public agency) it would be advisable to inform the residents by a separate notice or through a meeting.

### **Ensure Compliance With State Requirements**

After the suspension of mandatory preservation requirements for HUD-assisted housing in 1996, residents, nonprofit preservation purchasers and local communities began to advocate for local preservation policies and strategies that were independent of federal support, and those efforts applied to RHS as well as HUD-assisted housing.

In developing state and local preservation strategies, a number of states and municipalities have enacted laws requiring a notice of prepayment to the residents and local and state government and in some cases also a right of first offer or refusal to nonprofit or public agencies that seek to purchase the project.<sup>26</sup> Typically the statute requires that the notice must be given one-year prior to prepayment. While at least one court has struck down such notice requirements with respect to HUD financed developments,<sup>27</sup> the requirement should still be applicable to RHS housing because the RHS regulations require owners to prove that they will comply with applicable state prepayment laws.

Nonprofit organizations should check state and local laws, which may assist them in protecting their rights as potential purchasers and Section 515 housing preservers.

### **Linking Owners of At-Risk Projects With Nonprofits**

Nonprofit or public entities that are interested in purchasing RHS projects frequently do not know which owners may be interested in selling projects that they own. Similarly, owners may not always be aware of nonprofit or public agencies that may be interested in buying their projects. They may also misunderstand the roles of nonprofit organizations or believe that they may be disadvantaged by a sale to a nonprofit. Overcoming these barriers may be difficult and awkward for both owners and nonprofit or public agencies.

In a number of states, RD staff have made significant efforts to overcome this barrier. First, they have surveyed owners to determine if they may be interested in selling their projects. Second, they have either arranged or supported meetings of owners and buyers at which the prepayment and TPA processes are described and explained. During these meetings, owners and buyers are able to express their interests in selling or buying projects. If advocates work in a state where no such meetings have been held, they should consider asking RHS to arrange such a meeting.

In the alternative, buyers and sellers should contact the RD state Multi-Family Housing Coordinator and advise him or her of their interest. Frequently, RD staff knows that certain owners are interested in selling their projects. They also know the nonprofit or public agencies that operate housing in their state and may be interested in purchasing a project that an owner wishes to sell.

Nonprofit or public agencies may also make inquiries directly of owners. The names and addresses of all Section 515 housing projects in each state can be secured from RHS by a simple request or through a more formal Freedom of Information Act written request.

### **Litigation**

Because residents are not given independent rights to appeal prepayment approvals, the only formal recourse that residents have to enforce ELIHPA has been litigation. Owners, too, have availed themselves of the courts in order to challenge ELIHPA, quiet title through use of state legal procedures to nullify ELIHPA restrictions, and collect damages from RHS. This section provides an overview of recent litigation relating to Section 515 housing.

## Resident Protections

Residents of Section 515 housing have successfully challenged owners' and RHS' failure to comply with ELIHPA on three occasions. In each case the residents succeeded in either reversing a prepayment that had taken place or in preventing a prepayment that was about to take place.<sup>28</sup> As a result, each of these projects was either brought back under the Section 515 program or prevented from leaving the program. Results thereby protected the residents' right to continue to reside in the project and receive RHS subsidies. In each of these cases the residents sued the Secretary of Agriculture, other USDA officials, and the owners of the project, while claiming that RHS approval of a prepayment did not conform to law. The lawsuits were all filed under federal Administrative Procedures Act (APA) claims, which give federal courts the right to review agency actions that are arbitrary or capricious, or not in accordance with law.<sup>29</sup>

It is important to note that most resident cases have been filed after the prepayment occurred.<sup>30</sup> As a result of court decision or settlements, the projects were brought back into the Section 515 program.<sup>31</sup> In one of the post-acceptance cases, the property had already been transferred to a third party.<sup>32</sup> In another case the lawsuit initiated after the prepayment occurred and the residents received a rent increase and eviction notice that did not comply with the RHS requirement that evictions may only be brought with "good cause."<sup>33</sup> Another case successfully challenged an owner's attempt to increase rents after prepayments. That case was settled and resulted in the development being sold to a nonprofit agency.<sup>34</sup> While prepayment has not been a barrier to resident challenges of RHS failure to follow ELIHPA, it is clearly more advantageous to initiate a lawsuit before the prepayment occurs than after. This is particularly true when a third party may purchase the project after the prepayment and seek to assert that it is a bona fide purchaser for value, against whom the residents may not be able to bring a suit.

It is significant that the residents in some of these cases did not have to show that their displacement, as a result of the prepayment, was imminent.<sup>35</sup> It was sufficient for the residents to show that the prepayment had terminated, or was likely to result in the termination, of some rights or benefits.

Although preservation is the most desirable result, ensuring that at least the current tenants are protected from rent increases is also a significant outcome. In one

case in which RHS found that the owner could prepay without any protections, some of the residents filed a lawsuit prior to prepayment, which resulted in an Agreed Order requiring a new administrative hearing. After the new hearing, the agency overturned its previous decision and required the owner to protect the current tenants from rent increases upon prepayment.<sup>36</sup>

As noted earlier, some owners may prepay their loans if they agree to place use restrictions on the project that protect current residents from displacement. While no case has been brought to actually enforce such use restrictions, residents and advocates should be aware that the RHS use restrictions give residents an explicit right to enforce the restriction against a subsequent owner. This is a very significant right that should not be overlooked when applicable.

Resident initiated cases have validated ELIHPA and forced RHS and owners to follow the RHS regulations that are intended to protect residents and the housing. These regulations obligate the owner to submit a prepayment application to RHS,<sup>37</sup> provide adequate tenant notices, give residents the right to comment upon the owner's prepayment application<sup>38</sup> and require RHS to make an incentive offer to the owner while attempting to entice the owner to remain in the Section 515 program.<sup>39</sup> As noted earlier, if an owner accepts incentives from RHS, it agrees to new use restrictions, thereby preserving Section 515 stock for an additional 20 years.<sup>40</sup>

## Legal Challenges to Prepayment Restrictions

Although owner representatives were intimately involved in the drafting of ELIHPA, owners have never been happy with the prepayment restriction imposed by the Act and have challenged the restrictions on a variety of grounds, generally contending that neither Congress nor RHS could impose prepayment restrictions on them after they had entered the program

In one owner-filed case, owners challenged the ability of RHS to enforce ELIHPA on the grounds that the statute is unconstitutional.<sup>41</sup> The owners failed to prevail notwithstanding the fact that ELIHPA alters the loan agreements between the owners and RHS. The court found the statute constitutional in light of the fact that ELIHPA only requires the owner to sell the project at fair market value and allows the owner to prepay the loan if no offer is made to purchase the property within 180 days. While the court suggested that the owner may be entitled to money damage remedies, it concluded that ELIHPA and RHS' implementing regulations must be followed.<sup>42</sup>

In at least three cases, owners have attempted to circumvent ELIHPA by offering to prepay their RHS loans and, after RHS refusal to accept prepayment, instituting quiet title law suits.<sup>43</sup> Quiet title actions are proceedings available under state law typically used to remove any clouds on legal title to real property. In two of these cases, the federal district courts have ruled in favor of the owners.<sup>44</sup> In one of these cases, the residents tried to intervene in the case and assert their rights under ELIHPA against RHS. In that case, the residents were denied the right to intervene, a ruling affirmed on appeal by the United States Court of Appeals for the Ninth Circuit.<sup>45</sup> In one of the former cases, which involved seventeen properties, RHS was concerned about the impact of the quiet title decision on the residents.<sup>46</sup> To avoid any potential displacement of residents, the agency entered into a settlement agreement with the owners whereby the owners agreed to sell the developments to nonprofit or public agencies. Some of those sales have now been completed while others are still being negotiated as of the time of this writing.

Significantly, the RHS settlement agreement with respect to the seventeen projects, all of which were located in Idaho, also encompassed a law suit filed in Oregon by related owners of six developments.<sup>47</sup> There, the negotiations to sell the developments to nonprofit or public agencies did not go as smoothly, and the owners of two of the developments decided to prepay the loans for those developments and sell the properties to a third party. Because the prepayments terminated the RHS subsidies and forced the owners to increase the rent charged, residents of the six developments sued RHS and the owner in an effort to set aside the prepayment. The Oregon federal court, however, felt constrained by the Ninth Circuit's earlier decision, and rejected the tenants' effort to secure a preliminary injunction to enjoin further sales.<sup>48</sup> The case is still pending as this guide goes to press.

A large number of owners have opted not to attempt to nullify ELIHPA restrictions but rather to seek money damages for having to comply with them. These owners claim that they entered into the Section 515 program relying on an unfettered right to prepay and exit the program, a right which the government could not later interfere with. The leading case of this kind is *Franconia v. the United States*, a damages action filed in the United States Court of Federal Claims on behalf of 14 owners of 42 properties. In 2002, the United States Supreme Court took up the case, rejecting the government's argument that some of the owners' claims were barred by the statute of limitations.<sup>49</sup>

Following that ruling *Franconia* returned to the Court of Federal Claims. In 2004, that court issued a lengthy decision, holding that Congress violated the owner's contract rights when it imposed ELIHPA and other statutory restrictions.<sup>50</sup> In finding the U.S. liable for monetary damages, the court rejected two major arguments of the government. One was based upon the "Unmistakability Doctrine," which holds that the federal government always retains its right to modify the law as it may affect contract rights unless it gives up that right to do so in unmistakable terms. In *Franconia* the Court of Claims decided the Unmistakability Doctrine was unavailable to the government where the statutory changes specifically targeted these government contracts. The government also argued that numerous provisions of ELIHPA either benefited owners or significantly reduced any harmful effects of the restrictions, but the court sided with the owners' view that these provisions had little positive benefit and could not justify the government's interference with owners' prepayment rights.

As of this writing, the monetary award to the owners is approximately \$13 million, but there are post-trial motions pending. The U.S., of course, has the option of appealing *Franconia*. Looming on the horizon for RHS, however, are a half dozen more such lawsuits, with claims covering hundreds of Section 515 projects, pending in the Court of Claims on a track following *Franconia*. Whether the Court of Claims' quite hostile reaction to ELIHPA and the procession of further owner lawsuits awaiting trial will cause Congress or RHS to rethink federal preservation strategy is an open question.

## Transfers of Physical Assets Outside the Prepayment Process

To many owners of Section 515 housing, the method of selling a project through the prepayment process is just too uncertain and unpredictable. If a project is advertised for sale, the owner does not know who, if anyone, will make an offer to purchase the project, whether that party will have the capacity to actually close the sale, or what the sale price will be, since it is dependent upon a regulated appraisal process. Moreover, if the owner has more than one project for sale, it is possible that different parties may want to buy each project and it may be difficult, if not impossible, to structure a sale of multiple projects through the prepayment process. This is particularly arduous if the purchaser attempts to access a single financing source for all of the projects (e.g. through bond financing). As a consequence, instead of making an offer to RHS to prepay a loan and then advertising

the project for sale, an owner may want to simply negotiate a sale with a nonprofit or public agency and thereby better control the sales process.

The sale of a project that maintains the underlying RHS financing is called a transfer of physical assets (TPA) and is controlled by other RHS regulations. Unfortunately, the TPA regulations do not contemplate the types of transactions that usually are structured when one owner sells a project to another. In fact, the RHS TPA regulations have been so restrictive that they do not allow a purchasing owner to pay for any part of the sales price with income from the project. Thus, relatively few TPAs have occurred under previous RHS procedures, which were recently revised.

Fortunately, RHS has recognized the restrictive nature of its TPA regulations and the need to allow owners to sell their projects to nonprofit or public agencies. As a result, it has devised a mechanism to accomplish TPAs by relying on an exception provision that exists in RHS regulations including the TPA regulations. Under that exception, the RHS Administrator can waive various regulatory requirements when they are deemed to be in the best interest of the program and the government. Thus, owners and nonprofit agencies that want to enter into sales transactions can do so provided they request RHS to use the exception authority granted to the RHS Administrator. Closing such a transaction may take longer because the transaction needs to be reviewed by RHS national office staff and justified to the RHS Administrator (who must approve the sale through the exercise of his or her exception authority). Nevertheless, it is clearly a process that buyers and sellers should pursue because it allows them to structure deals that meet all of the parties' and tenants' needs without the constraints of RHS regulations.

RHS expects to revise its TPA regulations by the end of 2005, and it is likely that the new regulations will be less restrictive than the current regulations. If that happens, it is likely that sales can be structured through the TPA process without seeking the Administrator's exception authority. Until then, owners and buyers who want to sell and buy Section 515 projects will have to work closely with RHS to structure the deal and have it approved under the TPA process.

Finally, in September of 2004 RHS issued new guidelines designed in part to streamline the transfer process in the form of RD Administrative Notice 4010. The purpose of the AN is to use "the Agency's regulatory authorities to revitalize and preserve the existing MFH portfolio through transfers and

assumptions." A detailed discussion of this new AN can be found in the last chapter of this handbook. Although it is too soon to assess the full impact of this AN, the notice clarifies the principles which will guide agency decisions, calls for more effective processing strategies in working with third party funding sources, and declares RHS will be creative in employing an array of tools at its disposal to make preservation and revitalization deals work.

## Chapter 4 Notes

<sup>1</sup> 42 U.S.C. § 1490a(a)(1).

<sup>2</sup> RHS Finance Office, USDA, Number of Borrowers Who Paid Their Loans in Full (Report Code 852-B) (1971 and 1979).

<sup>3</sup> *Hafer v. Bergland*, No. C-1-78-693 (S.D. Ohio Nov. 13, 1978), *motion for reconsideration denied* (S.D. Ohio Nov. 13, 1980); 12 CLEARINGHOUSE REVIEW 510 (Dec. 1978) (No. 25,455).

<sup>4</sup> Subsidized projects were made subject to the 20-year use restriction, while unsubsidized projects were restricted for only 15 years.

<sup>5</sup> Projects that were unsubsidized were restricted for 15 years, those that were subsidized were restricted for 20 years.

<sup>6</sup> Pub. L. No. 96-153, § 503, 93 Stat. 1134 (1979).

<sup>7</sup> The Housing and Community Development Amendments of 1980. Pub. L. No. 96-399, § 514(a), 94 Stat. 1671 (1980).

<sup>8</sup> *Gillanders v. Smith*, No. 86-0867 (E.D. Cal. filed July 11, 1986), final judgment and order of dismissal and agreement for settlement of class action (E.D. Cal. Sept. 25, 1987) (Clearinghouse No. 41,556).

<sup>9</sup> The moratorium placed on RHS prepayments had several minor gaps which RHS and some owners invoked to allow for the prepayment of several Section 515 projects.

<sup>10</sup> 42 U.S.C.A. § 1472(c) (West 1994).

<sup>11</sup> See ¶II. E. discussing exceptions to a mandatory offer of sale requirement prior to prepayment approval).

<sup>12</sup> 42 U.S.C. § 1472(c)(1)(B).

<sup>13</sup> 42 U.S.C. § 1472(c)(1)(A).

<sup>14</sup> Preserving Rural Housing, at 17 (1992) (Final Report of the National Task Force on Rural Housing Preservation, Sponsored by the Housing Assistance Council, the California Coalition for Rural Housing Project, and the National Housing Law Project) (hereinafter *Preserving Rural Housing*).

<sup>15</sup> *Id.*; see also *Lifgren v. Yeutter*, 767 F. Supp. 1473 (D. Minn. 1991).

<sup>16</sup> See ¶II. D. discussing incentives.

<sup>17</sup> *Lifgren*.

<sup>18</sup> These regulations are codified at 7 C.F.R. Part 1965, Subpart E (1994).

<sup>19</sup> 42 U.S.C. § 1490p-1. [SB0]Final reg.

<sup>20</sup> The amount of the grant was recently increased from \$10,000 to \$20,000 in the Appropriations Bill for Rural Development and related agencies for fiscal year ending September 30, 2004. See Pub. L. 108-199, 108th Cong., 118 Stat. 22.

<sup>21</sup> *Albany Apartments Tenants' Ass'n. v. Veneman*, 2003 WL 1571576, No. 01-1976, slip op. at 14 (D. Minn. March 11, 2003) This case also challenged RHS' failure to consider its Fair Housing obligations to Affirmatively Further Fair Housing when foreclosing on a property without use restrictions. The court, using an erroneous standard, also dismissed this claim, in part because there was no showing that the foreclosure had an adverse impact on minority housing opportunities.

<sup>22</sup> *U.S. v. East Ridge Associates*, 295 F.Supp. 101 (D.Me. 2003).

<sup>23</sup> See ¶II. G, discussing mandatory offer of sale where project fails to meet exceptions.

<sup>24</sup> See ¶II. E. discussing RHS determinations.

<sup>25</sup> See ¶II. B. discussing 30-day tenant comment period upon prepayment notification.

<sup>26</sup> Jurisdictions where preservation laws exists include: RI, CT, MD, ME, MN, TX, IL, WA, CA, DC, Denver, SF, Portland, LA, Santa Cruz, Stamford. (Note that this is not an exhaustive list).

<sup>27</sup> *Forest Park II v. Hadley*, 336 F.3d 724 (8th Cir. 2003).

<sup>28</sup> *Lifgren; Meehan v. Madigan*, No. C91-1472R (D. Wash. Feb. 19, 1992); *Clark v. Yeutter*, later known as *Clark v. Schuette*, No. 85-73427 (D. Eastern Mich. filed Nov. 21, 1989).

<sup>29</sup> 5 U.S.C. § 701 *et. seq.*

<sup>30</sup> *Lifgren; Meehan; Clark; Goldammer v. Veneman* 2004 WL 2203278 (D. Or. 2004).

<sup>31</sup> *Lifgren; Meehan; Clark*.

<sup>32</sup> *Goldammer*.

<sup>33</sup> *Clark*.

<sup>34</sup> *Long v. Madigan*, No. 5-91-186 (D. Minn. Filed Dec. 30,1991).

<sup>35</sup> *Meehan*.

<sup>36</sup> *Tinney, et al. v. Veneman*, No. CV-02-C-2062-M (N.D.Al. 2002).

<sup>37</sup> *Meehan v. Madigan*, No. C91-1472R (D. Wash. Feb. 19, 1992).

<sup>38</sup> *Clark v. Yeutter*, later known as *Clark v. Schuette*, No. 85-CV-73427-DT (D. Eastern Mich. Nov. 21, 1989).

<sup>39</sup> *Lifgren v. Yeutter*, 767 F.Supp 1473 (D. Minn. 1991).

<sup>40</sup> See ¶ II. D. discussing incentives.

<sup>41</sup> *Parkridge v. Farmers Home Administration*, 13 F.3d 1192 (8th Cir. 1994).

<sup>42</sup> *Parkridge*.

<sup>43</sup> *Kimberly Associates v. United States*, No. 98-83-S-LMB (D. Idaho Filed Feb. 25, 1998) (affecting one development) reversed and remanded by 261 F.3d 864 (9th Cir 2001); *Atwood-Leisman v. USA*, No. 98-416-S-BLW (D. Idaho filed Oct. 26, 1998) (affecting 17 developments)); *DBSI v. USA*, No. CV98-1325-JE (D. Or. filed October 26, 1998). In a quiet title law suit, the owner claims that the RHS is not entitled to keep its mortgage on the property because the owner has tendered the

balance of the loan. If the owner prevails in the argument, the RHS mortgage is removed and the title to the property is quieted.

<sup>44</sup> *Kimberly*, slip op. (Dec. 12, 2002); *Atwood-Leisman*, slip op. (Nov. 18, 2002). The district courts in these cases believed that they were following the instructions of the Court of Appeals for the Ninth Circuit in an earlier appeal of a decision by one of the courts to dismiss the case. The Ninth Circuit reversed the district court decision to dismiss the case and remanded the case to the district court. *Kimberly Associates v. United States*, 261 F.3d 864 (9th Cir 2001).

<sup>45</sup> *Kimberly Associates v. United States*, 2004 WL 1663523 (9th Cir. 2004) (unreported).

<sup>46</sup> *Atwood-Leisman*.

<sup>47</sup> *DBSI v. USA*, No. CV98-1325-JE (D. Or.) (quieting title Dec. 19, 2003).

<sup>48</sup> *Goldammer v. Veneman*, 2004 WL 2203278 (D. Or. 2004).

<sup>49</sup> *Franconia Associates v. United States*, 526 U.S. 129, 122 S. Ct. 1993 (2002).

<sup>50</sup> *Franconia Associates v. United States*, 61 Fed. Cl. 718 (Fed. Cl. 2004).

## CHAPTER FIVE

## TRANSFERS OF SECTION 515 PROPERTIES AND ADMINISTRATIVE NOTICE 4010

Shereen Aboul-Saad and Adam Galowitz

**A**s part of its effort to address both the trend of increasing prepayments and the physical deterioration of the aging 515 portfolio, on September 23, 2004 RHS published Administrative Notice (AN) 4010 to encourage state offices to focus resources on preservation transactions. The Notice accompanies several similarly-motivated initiatives – the ICF Comprehensive Portfolio Assessment (“CPA”), a Fannie Mae and Freddie Mac pilot program, and the Interim Final Rule 7 CFR 3560 (“Interim Final Rule”) to govern transfers and prepayments under the 515 program. While each of these developments is functionally independent, it is clear that RD senses the growing vulnerability of its portfolio and seeks to find efficient and effective ways to re-position the portfolio for long-term viability. In this chapter, we focus on AN 4010 from a practitioner’s perspective,<sup>1</sup> but refer to each of these new developments as useful context.

Administrative Notice 4010 provides guidance in three areas aimed at using existing authorities to facilitate property transfers for preservation and revitalization, devoting resources to their preservation, and enhancing administrative processes. Briefly, the three areas are:

**1. Revitalization Principles.** The AN prioritizes use of RD resources for transactions that fall within certain parameters. Most notably, RD supports transactions that provide for rehabilitation to address immediate capital needs, not displace tenants, and cap rents at comparable market rents. RD is also concerned that the cash payment to the seller is limited to an amount that is supported by the property’s value.

**2. Effective Processing Strategies.** The AN also directs state offices to adapt their processing procedures to accommodate buyers working with third party lenders, whose processing and underwriting standards often deviate substantially from RD’s.

**3. Use of Servicing Authorities.** Finally, the AN encourages state offices to use their authorities proactively to re-amortize existing debt, provide interest rate write-downs, subordinate RD debt to new financing, and consolidate properties to provide economies of scale.

While the basic principles in the AN are not new, the AN draws needed attention to preservation of the portfolio and encourages state offices to focus precious resources on facilitating transfers.

### What AN 4010 Means for Rural Housing Practitioners

Overall, AN 4010 represents a positive development for practitioners interested in preserving rural affordable units. RD budget authority, however, remains limited relative to the challenges faced, and therefore the use of RD’s regulatory authority has a limited effect. It is therefore unclear whether the AN will facilitate a significant increase in the volume of preservation transactions. However, the AN does encourage state offices to fully utilize and apply the authorities and resources that are currently available to them to preserve rural rental housing.

The revitalization principles contained in the AN reflect both a policy commitment to the preservation of the Section 515 portfolio and priorities that are consistent with a focus on portfolio revitalization and preservation transfers. The general goals align well with achieving preservation outcomes by reflecting the legitimate need for:

- Preserving rural rental housing as a resource;
- Maintaining and requiring responsible ownership;
- Addressing the physical condition of the asset;
- Minimizing resident displacement;
- Realigning rents with local market conditions;
- Respecting property rights; and
- Providing private-sector owner incentives.

### State-Level Implementation

The AN provides some clarification to the existing transfer regulations, aims for consistency in applying waiver authority, and adds to the authority of state directors. What remains unclear, however, is how this AN will be implemented from state to state. Presumably, the more entrepreneurial state offices that have historically worked towards facilitating preservations will continue to do so and perhaps enhance their efforts. States with offices that are reluctant to innovate, lack the capacity to process a large volume of transfers, or hesitate to work with third party lenders are less likely to innovate under the authorities expressed in the AN. Nevertheless, preservation practitioners working in any state can use the AN to encourage state offices to support a proposed plan for purchasing and preserving rural rental housing.

### Implications and Limitations

The practical consequences of AN 4010 are somewhat hard to predict. For example, the AN states that RD will provide Section 521 Rental Assistance (RA) to properties being transferred through the prepayment process. While a reasonable goal, the prepayment queues are long and the demand for RA already outstrips the supply. Without expanded budget authority, RD will not be able to provide RA to all of the units that require it within a reasonable timeframe. Asking owners who have a right to prepay to wait for long intervals until RA (or other incentives) becomes available is likely to result in de-motivated owners at best and could fuel additional lawsuits that divert attention and needed resources from actual preservation.<sup>2</sup>

Further, as noted in Chapter 4, the Interim Final Rule establishes that if no incentives are provided within 15 months of the initial prepayment request, owners may market their properties to nonprofit purchasers, and if no good faith offers are received within 180 days, the owner may prepay without restriction. Although not representing RD policy, the Comprehensive Property Assessment appears to recommend in the face of this issue that instead of expending RD resources on an effort that is not likely to reduce the number of prepayment suits, RD should consider focusing more of its efforts and resources on facilitating prepayment-triggered transfers.

### Priority for Prepayment Transfers

Although the AN makes improvements in the routine transfer process, preferential treatment will still be given to transfers arising through the prepayment process in certain respects. First, AN 4010 favors

properties in the prepayment process for additional RA (Revitalization Principles 4(a) and (b)). Second, the AN also creates a disincentive for third party sales by making distinctions between the relative priorities for use of seller equity, reserves, and third party financing to fund a property's capital needs. In a prepayment transfer, the seller is not required to participate in funding capital needs by giving up all or some of the equity they may otherwise be eligible to receive. In a routine third party transfer, seller's equity is identified as a first priority source for funding property needs. If state offices respond to this guidance by further limiting or eliminating payment of seller equity,<sup>3</sup> the incentive for owners to process a transfer outside of the prepayment process (if they are eligible to prepay and have the choice) will significantly diminish.

Unfortunately, putting owner equity at risk will likely cause some owners to either cling to ownership (though they may not be the best stewards of the property) or join the long line of owners waiting to get through the prepayment process. This would undermine the goal of getting properties into the hands of those committed to long-term ownership. It would also undermine the goal of addressing properties' physical needs, as owners may wait several years to receive prepayment incentives while property conditions continue to deteriorate. It also adds to the administrative burden on state offices processing transactions. Without plans to expand and/or coordinate RD staffing, efforts that increase the volume of transactions may result in still longer delays.

In any case, practitioners may still encourage their local RD state office to prioritize preservation transfers. States wishing to preserve units while prepayment-eligible properties continue to deteriorate may be more willing to work with sponsors to this end.

### Predictability in the Transfer Process

A formidable challenge for 515 preservation transactions is the coordination, review and approval of key due diligence and underwriting items, such as capital needs assessments, appraisals, proposed operating budgets and rent increases, and transaction plans. Because RD historically provided all the financing needed for a transaction and because RD assets are typically located in markets otherwise underserved by traditional capital markets, there has in the past been perhaps less need for transparency with practitioners about how and when certain key transactional milestones will be met by the agency.

With the introduction of third party lenders in preservation efforts, a greater degree of certainty and

transparency is needed. This is particularly true when transactions are dependent on significant levels of outside capital. Lenders need to understand how the transaction will work and developers must be able to convey information to lenders in a reliable and convincing way. Developers themselves must understand the process, so that they too can assess the risks inherent in a given deal. In particular, nonprofit acquirers have limited capital for customary predevelopment costs. Because of the small size and geographic dispersion of 515 properties, predevelopment costs are expensive. This makes understanding the RD transfer process along with a sense of timing and milestones all the more critical.

Even after the initial decision to proceed has been made, practitioners continue to need periodic assurances that the transaction remains viable. Providing interim approvals to demonstrate that RD is on board with the transaction (or that kinks in the transaction plan can be worked out well ahead of closing) is equally important, especially when third party lenders require conditional commitments from RD as a condition of moving forward.

Many other housing regulators and lenders have learned that standardization is key to encouraging a meaningful volume of transactions. This is a key objective of efforts by Fannie Mae and Freddie Mac to expand their participation in 515 preservation transactions by streamlining and standardizing the underwriting process.

While the AN introduces evaluation exhibits that demonstrate the transfer process more clearly, considerable uncertainty about timing and obtainable interim approvals remains. Preservation practitioners should communicate their transaction plan to RD with special emphasis on describing the approvals and timing that third parties will expect and need and the milestones that can be shared with all parties involved.

### **Need for Additional Guidance**

The AN does not identify a process whereby the state offices or the Office of Rental Housing Preservation (ORHP) can balance or otherwise weigh the specifics of a proposed transaction against competing interests of the agency. For example, Attachment A2(a) defines as “ineligible” any applicant that is “currently in noncompliance with existing Rural Development regulations.” Consequently, some willing sellers could be excluded from pursuing transactions that would otherwise provide very real benefit to the residents, community, and agency as a result of technical

violations unrelated to their suitability as owner of RD properties. In particular, this provision will work against those owners of larger portfolios of existing RD assets and will be particularly onerous for owners of financially troubled RD assets seeking to work out or resolve issues in their portfolio but who (for a variety of legitimate reasons) can only do so serially, and not concurrently.

A provision in Attachment A2(b) provides for a waiver of the ineligible applicant provision where a workout plan to cure any noncompliance has been in place for at least six months. This time requirement does not recognize or credit the prompt curing of any noncompliance (regardless of significance or size) within an owner's existing portfolio, leaving the owner ineligible to close an otherwise reasonable transaction. Practitioners will want to set aside sufficient time in the transaction sequence (in advance of any proposed preservation transaction) to ensure that a suitable workout plan can be identified, negotiated, and executed with RD before the six month clock begins to tick.

In general, AN 4010 articulates principles that are essential for preservation of the Section 515 stock. The specifics of implementation of the individual rules associated with those principles, however, will need to be reviewed carefully to identify remaining barriers that could unnecessarily restrict the volume of potential transactions.

## **Revitalization Principles**

RD has limited resources and the AN revitalization principles directs those resources toward transactions that fill a need for affordable housing, transfer properties to eligible owners, address capital needs, cause limited displacement, have market rents as a cap, have equity supported by value, and gain ORHP approval. Several of these principles deserve careful consideration.

### **Identifying and Funding Capital Needs**

In an effort to adopt accepted industry practice, the AN recommends the use of third party capital needs assessments (CNAs). The AN also suggests that the CNA be used to determine the size and funding source for the replacement reserve account. While the June 30, 2003 proposed 7CFR 3560 rule indicated that the initial deposit to reserves and annual deposits could be set by the CNA, the Interim Final Rule states that more time is needed to determine how these levels should be set and that in

the meantime, the agency's so-called "10 percent rule" would remain in effect.<sup>4</sup>

So, practitioners should be mindful of resetting the maximum permitted, or "fully funded" balance requirements contained in the project documents. While the concept of a fully funded reserve may eventually be revised, developers will want to ensure that the fully funded amount is set at a level that corresponds to the highest anticipated account balance projected in the CNA. Otherwise, practitioners may not be able to fund the replacement reserve account from operations once the replacement reserve reaches its fully funded limit.

The AN also raises several new concerns about the protocol for assessing a property's capital improvement needs. For example, the AN requires unit by unit inspections, presumably meaning 100 percent of all units. Capital needs assessors typically inspect a sample of units. Despite the relatively small size of most Section 515 properties, requiring unit by unit inspections will take more time and make the report more expensive. Although the AN allows owners to pay the cost of the report from the operating or replacement reserve accounts, many properties likely to benefit from a transaction may be those where accounts are currently under-funded. Further, most purchasers will be reluctant to rely on a report that is commissioned by an exiting owner whose view of the appropriate level of rehab may differ from that of a buyer. Practitioners may want to commission their own CNA both to preserve their ability to discuss the assessor's recommendations in depth and in order to participate in the process of deciding when and how to phase particular project improvements.

RD is willing to make the state architect available to perform inspections in the absence of a buyer-funded third party contractor. While this is certainly helpful, the state architect does not necessarily have experience in making tradeoffs between what is financially feasible and what is desirable. As a result, there is potential for lengthy negotiation over acceptable minimum rehab scopes. RD's position has historically been heavily weighted towards focusing on improvements required by Section 504 of the Rehabilitation Act of 1973.<sup>5</sup> While Section 504 must be followed, not all deals are robust enough to support discretionary levels of improvements that may or may not be strictly required in addition to life and safety issues and any additional work a buyer may otherwise require as a minimum standard for responsible ownership.

Regardless of who pays, RD also continues to reserve the right to participate in the development of a capital needs report when rehab is substantial. However, actively participating in the development of the report makes the process of coming to agreement on a scope of work more difficult, and in many cases, is inconsistent with industry standards and commonly accepted practices for other parts of the affordable housing industry. Establishing clear standards of what must be included in a CNA or establishing protocol for selecting approved contractors should adequately address RD's concerns about the legitimacy of any assessment.

As discussed earlier in the chapter, seller equity is a priority source for funding rehab needs in non-prepayment transfers. The AN suggests seller proceeds be used prior to using third party funding sources or exiting property resources in the form of replacement reserves, even when those proceeds are available. Again, this is a major disincentive for sellers to transfer properties outside of the prepayment process. Practitioners expecting to successfully leverage third party resources or even existing property resources should be sensitive to the extent to which this priority negatively affects owners seeking to sell outside the prepayment regulations. Even if this is intended as a safeguard against purchasers who might overpay using RD resources, it is unclear why it might be necessary since sales proceeds are limited by the as-is appraised value of the property.

An important new feature of RD policy is the ability to use existing reserves to supplement rehabilitation budgets, which could alleviate some of the need for rent increases to fund transaction costs. Using reserves to fund rehab receives low priority, however, and appears as a source of last resort. Practitioners should be sure to inform RD as early in the process as possible whether they believe reserves will be needed.

### **Tenant Displacement, Rent Levels, and Debt Forgiveness**

RD intends to provide needed Rental Assistance to transfers processed under the prepayment regulation. For reasons stated earlier, practitioners should be sensitive to whether or not that additional rental assistance is readily available and, if so, how long it might take to become available for a specific transaction. The AN helpfully suggests that borrowers should contact local public housing authorities (PHAs) to check the availability of Section 8 vouchers, although it does not call attention specifically to the Project-Based Voucher program. As much as rural

PHAs might like to help, Section 8 is a very scarce resource. On the other hand, in many rural areas a statewide or regional PHA may be able to provide assistance.

The AN specifies that post-transaction rents will be capped by market rents. The Interim Final Rule adds that subsequent rent requests will continue to be budget based. So, to the extent that RA is in place on budget-based deals, rents could exceed market rents in out years. Should RD consider capping rents in the future when existing RA contracts are being renewed, it is likely that the regulations regarding debt forgiveness would need to be altered so that debt can be written down to avoid a large number of defaulted loans. Given the existing generous terms of much RD debt (i.e. 50-year, one percent loans), very large amounts of debt write-down are necessary in order to realize even relatively small improvements in the annual debt service required.

Debt forgiveness could prove a very valuable and powerful (and as of yet, largely unexplored) tool in restructuring debt and ensuring the long term viability of RD assets. Currently, debt forgiveness is employed only in instances where the amount of existing debt on a property exceeds the appraised value of the property. The CPA proposes that some hard debt be converted to soft debt for this purpose, although RD currently does not have authority to do so. Practitioners should be aware that current rules could require the remaining recast debt to be re-amortized for the lesser of the remaining useful life of the property or 30 years.<sup>6</sup> Because the term of the re-amortization could be shorter than the term of the original loan, the net impact of a modest debt write down could be to increase annual debt service.

## Effective Processing Strategies

While any successful program must accommodate the occasional exception, the importance of standardizing transfer processing in the context of RD preservation cannot be over-emphasized. In order to increase the volume of preservation transactions, the process should be predictable, standardized, and transparent. Practitioners should focus attention on these requirements, and discuss any concerns with RD prior to and while engaged with RD in a transaction.

### Coordinating with Third Party Lenders

While the AN attempts to clarify what potential buyers must submit as a part of the transfer process, it doesn't adequately address coordination of the RD transfer process

with the underwriting and processing conventions of third party lenders. Urging state offices to be mindful of third party timelines and conditions may not be enough – state offices need to be able to issue interim approvals documenting RD's position on key facets of the deal, conditions for closing, making new loans, or re-amortizing and reducing interest rates on existing loans.

Until now, buyers have found it difficult to comprehend what internal processing occurs once a transfer application has been submitted. As a result, buyers are challenged to anticipate what issues may lay ahead, when they may be resolved, or even when issues will be identified, making it difficult to keep a multi-party process moving forward. Waiting until a closing to find out what aspects of the deal have been approved can be anxiety-producing for any buyer, especially one with limited predevelopment resources.

Many third party lenders are not able to wait out a process that provides few indications as to what will actually be approved. When bank requirements conflict with RD authorities, it takes longer to close a transaction. The longer it takes to close a transaction, the harder it is for buyers to hold the parties together. Practical considerations, such as interest rate locks, fiscal year ends, and a schedule of public hearings necessitate RD's cooperation with an overall transaction schedule.

Since the AN has brought some attention to this issue, there is a good opportunity for buyers to reinforce this message by discussing concerns with their state office and establishing a plan ahead of time.

### Use of Property Assets

AN 4010 Attachment B Section 2b states that transfers should result in post-closing transaction balances in the operating account, reserve account, and tax and insurance escrow that are at least as high as they were prior to the transfer. While this has been RD's historical stance, Attachment A Section 3C (discussed earlier in this chapter) suggests that project accounts can be used to fund rehab so long as the remaining or opening balances are in compliance with the levels specified by the CNA.

This contradictory guidance should be resolved. It is perhaps reflective of RD's early efforts to adopt widely accepted underwriting and assessment measures into the transfer process and indicative that state offices must continue to use their discretion (for instance, when a property's reserve account is funded at a level that exceeds the beginning reserve balance specified in

a capital needs assessment). According to the guidance, there remains some question as to whether RD would allow use of the balance of funds to pay for rehab or other transaction costs. Allowing their use improves property conditions, protects residents from unnecessary rent increases, and facilitates transfers into the hands of eligible preservation-oriented purchasers.

### **Clarifying Uses of RD Funds and Exceptions**

One very positive development described in the AN is the adoption of a Sources and Uses matrix that allows RD to understand how borrowers plan to use their funds. This will help RD ascertain that their funds are being used for eligible costs. Without such a matrix, RD may have only a general idea of how funds are being used and may therefore determine only at a very late stage in the process (perhaps as late as closing) that certain uses are ineligible. This is a helpful step, and will help to assure buyers that their plan is clearly understood and communicated.

Attachment B Section 6 hints at the potential for productive collaboration between the State and Servicing Offices and ORHP in pursuing transactions that require exceptions or additional or new authority. Given the conflicts and limitations that remain inherent in the existing regulations, collaboration far beyond simply notifying the ORHP of such requests is necessary. In order to facilitate these transactions, the State and Servicing Offices and owners should maintain regular and substantive communication with OHRP on a variety of core issues.

### **Use of Servicing Authorities**

The AN gives authority to state directors to approve higher loan amounts and to subordinate rehab loans without having to obtain national office approval. This shortens processing time and gives state directors, whose staff has a better working knowledge of the properties, the authority to make decisions that make sense for the property, the residents, the seller, the buyer and other parties involved.

### **Loan Consolidations and Delegated Lending Authorities**

The AN confirms that state directors have the authority to approve the consolidation of loans across different properties to gain operating efficiencies. Typically, consolidating properties yields operating savings in the areas of reduced audit costs and management functions. Consolidating properties broadens the pool of units that can benefit from an underutilized RA voucher. Developers should note

that the regulations do allow for consolidations in tandem with a transfer application.

While state directors have always had the ability to re-amortize existing loans and subordinate to third parties, it appears as if some offices have been more willing to do this than others. In an environment of limited resources for affordable housing, especially affordable rural housing, these specific tools are invaluable. Practitioners should make sure that these tools are deployed on any property that can benefit from it.

### **Asset Management Fees for Nonprofit Owners**

In an effort to encourage nonprofit ownership, RD allows nonprofit owners to charge an asset management (AM) fee in lieu of the return to owner that for profit owners are eligible to receive. While the AM fee helps to offset some of the costs associated with operating regulated housing, the annual amounts are low in relation to the amount of additional reporting that is required by the regulations. The cost of running Section 515 properties is relatively high on a per unit basis due to their small size and geographic dispersion. RD should consider raising the allowable per unit asset management fees, which vary from state to state (for example, \$75 per unit in WA) but appear to be capped at \$7,500 per property.<sup>7</sup> There appear to be different interpretations as to when the AM fee can be built into budget based rents. Excluding the fee from a rent calculation could ultimately nullify the incentive for a many owners.

Allowing for payment of a developer fee from RD proceeds would be a more meaningful incentive for many nonprofit developers. Currently, the regulation does not allow payment of a developer fee from RD proceeds, but the Interim Final Rule allows nonprofit developers to fund an application fee for packaging the transfer in the amount of two percent of total development cost.

In general, developer fees reflect the amount of overhead (staff time and expenses), the trade off with other development opportunities, risk profile, and difficulty of bringing a project to fruition. As it stands now, developers who are unable to leverage third party resources (which usually allow payment of a developer fee) face an uncertain transfer process and long processing times with no prospect of getting reimbursed for the significant time and effort that must be made to successfully structure and close a transaction. Should RD consider allowing payment of a developer fee, establishing a percentage of total development cost as a cap on fee could ensure that RD

resources are being used in a reasonable and responsible way. HUD's Subsidy Layering Guidelines<sup>8</sup> and many state Low Income Housing Tax Credit allocating agencies employ similar practices.

## Conclusion

Practitioners should take advantage of the fact that the AN encourages state directors to use their authorities to facilitate preservation and revitalization transfers. Practitioners will also benefit from processing guidance contained in the AN. However, it remains up to practitioners to work with each state office to embrace the objectives articulated in the AN and put them to use. RD is moving toward underwriting standards and procedures common to other affordable housing lenders. Developers can play a critical role in helping to educate RD staff about these requirements. Since key timing issues still remain unaddressed, practitioners should be careful to preview their transaction plans and work with state offices ahead of time to map the process and discuss and establish needs and expectations throughout the process. Doing so will reinforce the need for standardization, predictability, and obtaining interim reviews and approvals in order to preserve the RD stock in collaboration with third party lenders and participants.

## Chapter 5 Notes

<sup>1</sup> Recapitalization Advisors has worked with and on behalf of Mercy Housing to acquire a portfolio of Section 515 properties in the state of Washington. The first 17 properties in the portfolio closed in September 2003; the second 13 properties closed in November 2004.

<sup>2</sup> Several suits have already been filed by owners seeking to prepay, most notable of which was *Franconia Associates v. United States*, 536 US 129 (2002). Further discussion on this case is found in Chapter 4.

<sup>3</sup> The AN does not specify limits on how much equity can be taken to fund capital needs, effectively leaving all seller equity at risk.

<sup>4</sup> Interim Final Rule 3560 does not eliminate the fully funded concept which states that the reserve account is fully funded when the reserve balance reaches 10% of the total development cost. Owners are expected to make annual reserve deposits of 1% of the TDC over 10 years.

<sup>5</sup> Section 504 of the Rehabilitation Act of 1973 prohibits discrimination against persons with disabilities in any program or activity receiving Federal financial assistance.

<sup>6</sup> Instruction 1965-B: 1965.70(d) (4) The end of the reamortization period will be the final due date of the note being reamortized, unless the term is extended with the advice and guidance of USDA's Office of General Counsel (and provided that it is permissible according to State and local statutes), and the FmHA lien position is not altered. (Any extension of the final due date will not exceed the lesser of the remaining useful life of the security property or the maximum term authorized by the respective loan program authorizations).<sup>7</sup> RD Instruction 1930-C, Exhibit B, XII A6 authorizes "borrower organizational expenses" for cooperatives and nonprofit organizations, but does not specify the amount permitted.

<sup>8</sup> Required by Section 911 of the Housing and Community Development Act of 1992. See HUD Notice H 95-4.

# APPENDIX

## COMPARISON OF OLD AND NEW REGULATIONS GOVERNING 515 PREPAYMENT PROCEDURES

TIMOTHY L. THOMPSON AND CHRISTINE R. GEOPFERT

	Old Regulations (7 C.F.R. §1965)	Interim Final Rule (7 C.F.R §3560)
<b>Owner's prepayment application</b>	The owner must submit a market analysis study, census data and waiting list with application.	These requirements have been omitted, although this information is required for the agency's findings regarding housing need and minority impact. Now the key requirements are documentation of the owner's ability to prepay the mortgage and willingness to comply with applicable state and federal laws on prepayment, including the Fair Housing Act.
	The owner must demonstrate that any applicable state laws <i>have been complied with</i> .	The owner must provide evidence it <i>will comply</i> with any applicable state laws.
<b>Tenant notifications</b>	Within 30 days of complete prepayment application, RHS must notify tenants, explain the prepayment process and the likely effect of prepayment, and provide a 30 day comment period.	Within 30 days of complete prepayment application, RHS must notify tenants of the date and place where tenants may meet with the agency to discuss the prepayment, advise them of the right to review information submitted by the owner, provide a 30 day comment period, and advise that the owner may set up its own tenant meeting. The owner may send its own notice of prepayment and meet with tenants, which RHS and other housing providers may attend. RHS will also send notices to tenants as the prepayment process proceeds.
<b>Other notifications</b>	The agency is to notify other agencies of a prepayment request. These agencies include nonprofits; local, state and federal agencies; and public organizations that have expressed an interest in purchasing a project and provide housing assistance to low income people. Organizations interested in being notified must contact the state office to be placed on the interest list.	The agency will notify nonprofits and public bodies involved in providing affordable housing or financial assistance to tenants of the receipt of a prepayment request. There is no formal process for getting on the list of interested parties, but the agency must maintain a list according to agency handbooks. <i>Further analysis is needed regarding statutory requirements for the range of nonprofits getting notice</i>
	The Agency makes all initial notifications, unless other applicable laws require the owner to provide a separate notification of its intent to prepay to certain entities.	The owner must notify public entities involved in providing affordable housing or financial assistance to tenants in the project of the prepayment request. The notice must include a statement specifying how long financial assistance will be provided to tenants after prepayment. The prepayment application must include a certification that these notifications have been made.

	<b>Old Regulations (7 C.F.R. §1965)</b>	<b>Interim Final Rule (7 C.F.R §3560)</b>
<b>Incentives to Owner</b>	If an owner accepts incentives in return for remaining in the program, the incentive request is placed on a waiting list until it is funded or owner requests to be taken off.	If owner accepts incentives, it is placed on a wait list for funding; however, if it goes unfunded for 15 months, the owner may sell the project to a nonprofit or public body, withdraw its prepayment request, obtain a third party equity loan, or stay on the list; if it withdraws its request, it may resubmit an updated one. The agency believes more owners may accept incentives if they know they will not have to wait indefinitely for them.
<b>Housing Need Analysis (to determine if prepayment should trigger restrictions protecting current tenants)</b>	RHS must determine if the housing is still needed in the “market area,” defined as the community in which the project is located and any outlying areas, excluding any other established communities.	RHS must determine if housing is still needed <i>in the local community</i> , which is the standard outlined in the agency handbook. However, the regulations indicate that the analysis is based on the “market area,” which is redefined more broadly to include outlying areas affected by the prepayment, such as areas that have properties that effectively compete with the subject property.
<b>Minority Impact Analysis (to determine if the owner will be required to offer the project for sale to nonprofits)</b>	RHS must determine if housing opportunities for minorities will be materially affected by the prepayment. Additional factors for consideration are outlined in a separate RD Instruction.	RHS must determine if housing opportunities for minorities in the project, on the wait list, and in the market area will be “disproportionately adversely affected” by the prepayment. Additional factors are outlined in an agency handbook. <i>Further analysis is needed regarding standards for the decision, including the notion of “disproportionate effect.”</i>
<b>Mandatory Offer of Sale</b>	The owner must market the project for 180 days, with the first 60 days exclusively to local nonprofits and public agencies.	The agency may determine that there are no local nonprofits or public agencies, whereby the owner can accept offers from regional or national groups earlier in the marketing process.
<b>Nonprofits</b>	Local nonprofits must have a broad-based board reflecting various interests in the community or trade area. They must also include as a primary purpose developing or managing low income housing or community development projects.	Nonprofits are redefined as private entities organized under state or local laws that have no part of net earnings inuring to the benefit of any member, founder, contributor or individual, and that are approved by the Secretary and considered to be financially responsible. This broader definition will allow more nonprofits to purchase projects without having to obtain waivers.
<b>If no purchase offer is made</b>	The owner may prepay without restrictions if no bona fide offer is submitted within the 180 day sale period or the agency has been unable to fund the buyer’s offer for a period equal to 15 months because of a lack of funding.	The owner may prepay without restrictions if no bona fide offer is submitted within the 180 day period or an offer has been received but the offeror was unable to fulfill the terms of the offer within 24 months of the offer date and the owner was cooperative with the purchaser.

	Old Regulations (7 C.F.R. §1965)	Interim Final Rule (7 C.F.R §3560)
<b>LOPE Letters</b> (allowing displaced tenants priority at other Section 515 projects)	If tenants are threatened with displacement, the agency will issue the letters of priority entitlement (LOPE) that give them priority to move into other Section 515 projects. Tenants must request the LOPE letter and have 60 days to apply to other Section 515 projects to receive priority.	Tenants have up to one year to request a LOPE letter following the prepayment. It is not clear how long it can be used to apply at other Section 515 projects.
<b>Acceleration (RD makes entire loan due in response to owner default)</b>	If an owner pays in response to a notice of acceleration, the tenants are issued LOPE letters and rents cannot be raised for 180 days following prepayment.	If a loan is accelerated, any remaining restrictions on post-79 projects will attach; otherwise, tenants are given a 180-day notice that the project can be removed from the program.
	If an owner of a post-79 project pays in response to an acceleration, any remaining restrictions will attach. If an owner of a pre-79 project pays in response to an acceleration, RHS will only impose restrictions if the owner applied to prepay within the preceding year.	Before accelerating any loan, RHS must consider the possibility that the owner is forcing an acceleration to circumvent the prepayment process. If RHS finds this is the owner's motivation, it must consider alternatives to acceleration, such as suing for specific performance or assessing monetary penalties. <i>It is unclear how this provision can be implemented in cases where evidence of owner bad faith is lacking. A proposed voucher program to protect tenants may help here.</i>
<b>Foreclosures</b>	At the foreclosure sale, RHS will attach any remaining restrictions on a post-79 project. No restrictions attach on pre-79 projects unless the owner has applied to prepay within the preceding year.	If any restrictions remain for a post-1979 project, RHS will attach those at the sale unless RHS determines they will significantly affect the value of the project and its marketability. If so, the project is appraised at market value based upon the highest and best use of the property and it is sold without restrictions unless ownership is continued by the same entity. No restrictions attach for pre-1979 projects. <i>Further analysis is needed to determine whether this approach will result in the loss of projects from the program.</i>

## RURAL PRESERVATION GLOSSARY

**Affordable Housing Program (AHP):**

A program of the Federal Home Loan Bank system, AHP provides subsidized cash advances to member institutions, to permit them to make below-market loans for eligible housing activities.

**Administrative Notice (AN) No. 4010:**

Issued by RHS on September 23, 2004, AN 4010 provides guidance on preserving housing using improved procedures for property transfers. See Chapter 5.

**Bargain Sale:**

A tax deferral mechanism involving a sale of the property to a charitable organization for an amount that is less than its appraised fair market value. The seller takes a charitable contribution deduction for the difference between the fair market value and the reduced sales price. The deduction may be used to offset the tax liability resulting from the sale.

**Bridge Financing or Bridge Loan:**

Short-term mortgage financing between the end of one loan or financing instrument and the beginning of another.

**Capital Account:**

The owner's original cash investment in the property plus cumulative profits and tax losses over the life of the investment. Properties that experienced accelerated depreciation and interest deductions with limited or negligible cash flow eventually will have a negative capital account. Taxes will be owed on the negative capital account even if no cash proceeds are realized from the sale (see Exit Tax).

**Capital Needs Assessment (CNA):**

An assessment of the physical condition and required repairs and upgrades of a property. Also known as a physical needs assessment.

**Community Development Block Grant (CDBG):**

Annual grants administered by HUD on a formula

basis to cities and other units of government for community development activities. The CDBG program is authorized by Title I of the Housing and Community Development Act of 1974.

**Community Development Financial Institutions Fund (CDFI Fund):**

A federal agency in the U.S. Department of Treasury that certifies Community Development Financial Institutions (CDFIs), administers grants, and also administers the New Markets Tax Credits program.

**Community Reinvestment Act (CRA):**

Requires periodic evaluations of insured depository institutions and their efforts in helping meet the credit needs of its entire community.

**Delegated Underwriting and Servicing Program (DUS):**

Fannie Mae's program under which participating lenders are authorized to underwrite, close and sell loans to Fannie Mae.

**Emergency Low Income Housing Preservation Act (ELIHPA):**

Title II of the Housing and Community Development Act of 1987 statute, which authorized the original federal preservation program for both multifamily properties with HUD-subsidized mortgages (Subtitle B) and Section 515 properties (Subtitle C).

**Enhanced Vouchers:**

Tenant-based Section 8 assistance from HUD provided to eligible residents when owners prepay their HUD-subsidized mortgages or opt out of HUD project-based Section 8 contracts. Rents are set at market comparable levels, instead of the regular voucher payment standard, as long as the tenant elects to remain in the building.

**Exit Tax:**

Taxes paid on the recapture of depreciation and other deductions, experienced upon sale of a

property. In some affordable housing transactions, sellers may face a significant exit tax even when they do not receive net cash at sale.

**Fair Market Rent (FMR):**

HUD-determined benchmark rent level, used to establish regional payment standards for the Section 8 program.

**Fannie Mae (Federal National Mortgage Association, or FNMA):**

A government sponsored enterprise providing financial products and services, including purchase of mortgages from originators in order to facilitate new mortgage lending.

**Farmers Home Administration (FmHA):**

former name of the Rural Housing Service. See RHS.

**Freddie Mac (Federal Home Loan Mortgage Corporation, or FHLMC):**

A government sponsored enterprise providing financial products and services, including purchase of mortgages from originators in order to facilitate new mortgage lending.

**Government Accountability Office (GAO):**

Formerly known as the General Accounting Office, a Congressional agency that monitors the programs and expenditures of the federal government.

**HOME Investment Partnerships Program:**

The HOME program, administered by HUD's Office of Community Planning and Development, provides formula grants to states and localities (See Participating Jurisdictions) to fund a wide range of activities that build, buy, and/or rehabilitate affordable housing for rent or homeownership or provide direct rental assistance to low-income people. The HOME program is authorized by Title II of the 1990 Cranston-Gonzalez National Affordable Housing Act.

**Interim Final Rule 7 CFR Part 3560:**

Published in the Federal Register on November 26, 2004 (Vol. 69, No. 227, p. 69032), this regulation

consolidates and streamlines several previously separate RHS multifamily housing regulations. The Interim Final Rule significantly reduced the length and complexity of the regulations and is supplemented by new multifamily housing handbooks on loan origination (HB-1-3560), asset management (HB-2-3560), and project servicing (HB-3-3560). The Interim Rule took effect on February 24, 2005 (See Chapter 1).

**Letters of Priority Entitlement (LOPE):**

A letter issued to tenants displaced by rent increases as a result of prepayment, natural disaster or uninhabitable situation that allows them priority placement on the waiting list of USDA-assisted rental housing, for 120 days from the date of the LOPE.

**Low Income Housing Preservation and Resident Homeownership Act (LIHPRHA):**

1990 statute authorizing the "permanent" federal preservation program, active 1990-1996. The LIHPRHA program is authorized by Title VI of the 1990 Cranston-Gonzalez National Affordable Housing Act, as amended.

**Limited Partnership (LP):**

A partnership in which some of the partners have a limited liability to the firm's creditors.

**Low Income:**

Between 50 and 80 percent of area median income, as defined by HUD.

**Low Income Housing Tax Credits (LIHTC):**

Tax Credits are allocated to states on a per-capita basis and allocated by the states to affordable rental housing development and rehabilitation projects. Tax Credits are authorized pursuant to Section 42 of the Internal Revenue Code.

**Millennial Housing Commission:**

Established by an Act of Congress in December 2000, the Commission developed recommendations that highlight the importance of housing and recommended possible legislative and regulatory initiatives. The Commission issued its final report on May 30, 2002.

**Office of Rural Housing Preservation (ORHP):**

Processes applications to prepay RHS multifamily housing loans and preserve housing as affordable low- and very low-income housing.

**Participating Jurisdiction (PJ):** A HUD-recognized entity that is an eligible recipient of HOME funding.

**Phantom Income:**

Income taxable to a property owner in an amount greater than the cash flow distributions actually received. Phantom income creates an incentive for owners to refinance or sell.

**Project-Based Section 8:**

Administered by HUD's Office of Multifamily Housing, Section 8 Project-Based Assistance takes the form of a contract between HUD and building owners, who agree to provide housing to eligible tenants in exchange for long-term tenant rental subsidies. Tenants pay 30% of adjusted household income. Assistance may be provided to some or all of the units in a project occupied by eligible tenants and is attached to the unit and stays with the housing after the tenant leaves.

**Purchase Money Note:**

Obligation to pay the seller a portion of the purchase price on a deferred basis, either over time or at a future date. The Purchase Money Note may be secured by a mortgage or, more typically for subsidized properties, by a pledge of the partnership interests.

**Real Estate Investment Trust (REIT):**

A business trust or corporation that combines the capital of many investors to acquire or finance real estate, which may include assisted housing. Cash flow generated by the properties is distributed to investors in the form of stock dividends. The REIT can also provide an attractive tax deferral mechanism by enabling investors to exchange their partnership shares for interests in the REIT, a non-taxable transfer.

**Rental Assistance (RA):**

also known as Section 521 of the Housing Act of

1949, provides a direct subsidy for tenant in Section 515- or 514/516- financed rental housing.

**Right of First Refusal:**

Right to match the terms and conditions of a third-party offer to purchase the property within a specified time period. Holder must be notified of the third party offer and may be required to close by a designated date.

**Rural Business Cooperative Service:**

Builds businesses in rural areas, including cooperatives.

**Rural Development (RD):**

Part of the U.S. Department of Agriculture, RD administers grant and loan programs to promote and support housing and essential community facilities development in rural communities.

**Rural Housing Service (RHS):**

Part of the Department of Agriculture's Rural Development division, RHS is responsible for administering a number of rural housing programs.

**Section 8 Vouchers:**

Administered by HUD's Office of Public and Indian Housing and local housing authorities, portable vouchers are allocated to individual households and provide a rental subsidy, limiting the tenant contribution to 30 - 40% of the household's adjusted income.

**Section 8 Project-Based Contracts:**

Administered by HUD's Office of Multifamily Housing, Section 8 Project-Based Assistance takes the form of a contract between HUD and building owners, who agree to provide housing to eligible tenants in exchange for long-term tenant rental subsidies. Project-Based Assistance limits tenant contributions to 30% of the household's adjusted income. Assistance may be provided to some or all of the units in a project occupied by eligible tenants and is attached to the unit and stays with the housing after the tenant leaves.

**Section 8 Project-Based Vouchers:**

Administered by HUD's Office of Public and Indian Housing and local housing authorities, the Section 8 Project-Based Voucher program allows local housing authorities to contract with property owners to ensure that Section 8 voucher holders will occupy up to 25% of a building's units. When assisted tenants move and take their vouchers with them, new voucher holders replace them.

**Section 514 Loans and Section 516 Grants:**

Authorized by Sections 514 and 516 of the Housing Act of 1949. May be used to buy, build, improve or repair housing for farm laborers.

**Section 515 Rural Rental Housing Program:**

Authorized by Section 515 of the Housing Act of 1949. Provides funds for loans made by RHS to nonprofit, for profit, cooperatives and public entities for the construction of rental or cooperative housing in rural areas for families, elderly persons, persons with disabilities or for congregate living facilities.

**Section 533 Housing Preservation Grant Program (HPG):**

Authorized by Section 533 of the Housing Act of 1949. Grant funds are available from RHS to promote preservation of Section 515 properties.

**Section 538 Rental Housing Loan Guarantees:**

Authorized by Section 538 of the Housing Act of 1949. Enables RHS to guarantee loans made by private lenders for the development of affordable rural rental housing. This program serves a higher income population than that served by the Section 515 program.

**Tax-Exempt Multifamily Housing Bonds:**

For certain qualified multifamily housing projects, Section 142 of the Internal Revenue Code authorizes tax-exempt Exempt Facility Bonds that provide access to Low Income Housing Tax Credits, and Section 145 authorizes so-called 501(c)(3) bonds for nonprofit owners.

**Tenant-Based Section 8:**

Administered by HUD's Office of Public and Indian Housing through local housing authorities, portable

vouchers are allocated to individual households and provide a rental subsidy, limiting the tenant contribution to 30 - 40% of the household's adjusted income. The subsidy is awarded to tenants and stays with tenants when they leave the property.

**Transfer of Physical Assets (TPA):**

A procedure in which a property is transferred to a new owner, subject to pre-existing RHS financing and RHS approval.

**Umbrella Partnership Real Estate Investment Trust (UPREIT):**

A limited partnership in which the General Partner is a Real Estate Investment Trust, and which has the ability to exchange partnership interests as an alternative to a cash transaction, resulting in deferral of tax consequences.

**Very-Low Income:**

Defined by HUD as households below 50 percent of area median income.

## ABOUT THE AUTHORS

**Shereen Aboul-Saad** specializes in transaction support for existing affordable housing acquisitions at Recapitalization Advisors, Inc., a firm that provides affordable housing transactional consulting expertise in acquisitions, dispositions, valuations, and renewed affordability. Most recently, Shereen worked on the acquisition of a 30-property portfolio of Section 515 properties in the state of Washington. Previously, Shereen worked as a Project Manager for McCormack Baron & Associates of St. Louis, a national for-profit developer of affordable housing specializing in LIHTC and HOPE VI transactions.

**Gideon Anders** is the Executive Director of the National Housing Law Project (NHLP), a national and California legal and housing advocacy center working to preserve and expand the supply of affordable housing and to establish and enlarge the housing rights of low-income persons and households. As a staff attorney at NHLP, he specialized in the housing programs of the Rural Housing Service. Mr. Anders has authored a number of housing-related publications, is admitted to practice law in California, and serves on the boards of the Housing Assistance Council, National Rural Housing Coalition, California Coalition for Rural Housing Foundation, and St. Mary's Elderly Housing.

**Adam Galowitz** is a Vice President at Recapitalization Advisors, Inc. where he specializes in Preservation Acquisitions. Mr. Galowitz has been active in institutional asset management, investment banking, workouts, and dispositions and the design and implementation of strategic solutions to recapitalize and preserve multifamily affordable housing. Before joining Recap, Mr. Galowitz spent nine years with Lend Lease Real Estate Investments, Inc., one of the nation's premier LIHTC syndicators. Previously, Mr. Galowitz was with Old Boston Restorations, a developer/owner of market-rate residential, HUD-subsidized, and commercial property in Boston's South End.

**Christine R. Goepfert** started with the Housing Preservation Project as a law clerk in 1999. After passing the Bar in 2000, she remained with HPP as an attorney and has been an invaluable addition to the staff. Ms. Goepfert graduated with a B.A. in Criminal Justice from Metropolitan State University and received her law degree from the University of Minnesota Law School. Christine also served internships with the Minneapolis City Attorney's Office as a victim liaison, and as a project researcher with the Battered Women's Justice Project.

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**Timothy L. Thompson** has worked for various legal services programs and public interest law firms for more than 25 years, specializing in tenants' rights, government housing programs and class actions. In addition to litigating, Mr. Thompson has worked extensively lobbying at the state and local level for changes in policy and law, has advised numerous community organizations on various legal issues, and has also lectured and prepared materials for continuing legal education seminars covering tenants' rights, civil rights, government housing programs, and Federal court litigation. Mr. Thompson is employed at the Housing Preservation Project, as well as serving as the Director of Litigation for the Mid-Minnesota Legal Assistance.



LISC established its Affordable Housing Preservation Initiative in 2001 to strengthen efforts toward preservation and promote preservation-oriented policy. Since then, LISC has helped nonprofit community development corporations (CDCs) acquire and preserve housing developments, build partnerships with housing authorities and other organizations, and advocate for government policies that can reduce the loss of affordable homes and apartments. Local LISC offices help identify properties at risk, raise awareness of the potential impact on the surrounding community, and maintain long-standing partnerships with CDCs, other nonprofit and for-profit developers, banks, foundations, and state and local governments. The national housing preservation staff specializes in assessing preservation opportunities, advising on project strategy, and developing innovative financing. Other resources include National Equity Fund, Inc. (NEF), a LISC subsidiary, which mobilizes private equity investments fueled by Low Income Housing Tax Credits; the Community Development Trust (CDT), launched by LISC as the nation's first mission-driven real estate investment trust to preserve affordable housing by providing a secondary market for small affordable housing loans and making direct equity investments; and LISC's Housing Authority Resource Center (HARC), which builds affordable housing partnerships with local housing authorities. Visit [www.lisc.org/preservation](http://www.lisc.org/preservation) for more information about LISC's Affordable Housing Preservation Initiative.

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