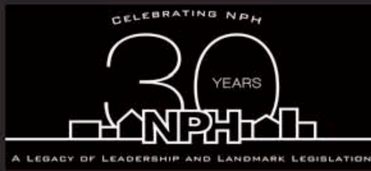

Local Government Working Group

May 27, 2009
1:00 – 3:00 PM
NPH
369 Pine Street, Suite 310

This is an in person meeting.

Agenda	**Time**
1. Welcome & Introductions (Kara Douglas and Jeff Levin)	1:00-1:15
2. Subordination Agreements between banks and local jurisdictions	1:15-2:15
3. Invited Speakers: Polly Marshall from Goldfarb & Lipman LLP Jim Mather from Union Bank	
4. Other current local government issues: PMIB Update Effect of CA budget on local governments	2:15-3:00
5. Adjournment	3:00

Please RSVP to Megan Kirkeby, megan@nonprofithousing.org. Snacks will be provided.

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SUBORDINATION AGREEMENTS

NPH LOCAL GOVERNMENT WORKING GROUP

May 27, 2009

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Should Local Governments Subordinate Their Multifamily Affordability Restrictions to Private Lender Financing?

1. **The Issue**: Local governments, including cities, counties, and redevelopment agencies, impose affordability restrictions on rental housing projects either because they are providing financing that requires these restrictions or they are implementing land use approvals that require the restrictions. If a private bank provides a loan for the project, the private bank usually requires subordination of the affordability restrictions. If a recorded affordability restriction is subordinated to a bank's deed of trust, and the project goes into default and the bank forecloses, the subordinated restriction will be "wiped out" – it will be removed from title to the project and will not bind the new owner of the project. The project may become market rate housing.

2. **How do local governments impose affordability restrictions?** Local governments typically impose affordability restrictions on a rental project either through a regulatory agreement or through a declaration of restrictions. These agreements or declarations are recorded against the property and are intended to run with the land and bind subsequent owners of the property for the stated term of the agreement.

The restrictions usually include:

- occupancy requirements - limiting units to occupancy by households at certain income levels and to households with certain qualifications (seniors, disabled, homeless, etc.)

- rent requirements – limiting rents to certain levels deemed affordable to occupying households.

- eviction requirements – prohibiting termination of tenancies for reasons that are not "just cause".
- use and maintenance requirements – restricting the project to residential use and requiring a certain level of maintenance with oversight by the public agency.

- leasing requirements – governing how the project is leased, the form of rental agreements, security deposits, etc.

- requirements to accept Section 8 tenants.

- non-discrimination clauses.

3. **Why do local governments impose affordability restrictions?** There are several general reasons a local government will require the recordation of affordability restrictions against a multifamily rental project:

- **Financing Requirements** – If the local government is providing financing for the project, the statutes and regulations that govern the funds being used require the imposition of recorded affordability restrictions. Funding sources that typically require recorded restrictions include:

    - Redevelopment housing funds (20% set-aside funds).
    - Local housing trust funds.
    - HOME funds.
    - HOPWA funds.
    - Supportive Housing Program (SHP) funds used for acquisition or development.
    - Tax-exempt multifamily housing revenue bonds.

- **Land Use Requirements** – Sometimes the local governments impose the restrictions because land use approvals or entitlements require that a certain number of the units in the project be affordable, and state law, local ordinances, or local planning approvals require the recordation of affordability restrictions against the project. Examples of affordability restrictions required by land use regulations:

- Density Bonuses – If a density bonus is granted to a project, state law requires a recorded affordability restriction.
- Inclusionary Housing Ordinances – Local inclusionary housing ordinances require a certain percentage of units in each project be affordable at certain.
- Planned Unit Developments, Specific Plans – Local policy may require certain percentage of affordable units.

- **Lawsuits** – Sometimes a local government is sued for failure to comply with state law requirements (for example, redevelopment affordable housing production requirements). A court order, stipulated judgment or settlement agreement may require the imposition of affordability restrictions on specified rental projects.

4. What does it mean for the local government to subordinate these restrictions to a private lender? Subordination is a legal process by which an encumbrance on title to property is made junior in priority to another encumbrance on title. For example, if a city's regulatory agreement is subordinated to a bank's deed of trust, the city's regulatory agreement will be a junior encumbrance, subordinate to the senior bank deed of trust.

5. How does subordination occur? Later-recorded documents are generally subordinate to earlier recorded documents. In affordable housing transactions, subordination is effected by the parties signing a subordination agreement where they agree to the order of priority between the parties' documents. The subordination agreement will also set forth any special agreements between the parties regarding notice to each other of defaults by the borrower and rights each party may have to cure borrower defaults and prevent a foreclosure.

6. What happens to a junior encumbrance when the senior deed of trust is foreclosed? A private lender will provide an acquisition loan, construction loan, or permanent loan to the project owner, and will secure the loan with a deed of trust. The deed of trust allows the lender to foreclose against the project in the event of a default that is not cured by the owner. Foreclosure is a legal process by which the lender can force the project to be put up for sale and the lender can either buy the project

itself or get its loan paid back with sales proceeds from a third party purchase. When foreclosure occurs, the purchaser in foreclosure takes title to the project subject to all the title restrictions that are prior or senior to the foreclosed deed of trust. All the title restrictions that were subordinate or junior to the foreclosed deed of trust are "wiped out" – they are removed from title and no longer control or restrict the project.

7. Does state law give junior lienholders any special rights to prevent foreclosure? Yes, the Civil Code requires that a junior lender receive a copy of a senior lender notice of default and that a junior lender has the right to cure a borrower default within 90 days to prevent foreclosure. It is unclear if these rights extend to a beneficiary of affordability restrictions who is not also a holder of a junior deed of trust.

8. What are the implications for the local government if a bank foreclosure occurs and the local government's affordability restrictions are wiped-out? If the local government's affordability restrictions are removed (and there are no remaining affordability restrictions from another source that were senior to the bank deed of trust) the project will be unrestricted and may become 100% market rate.

Consequences include:

- Existing low income tenants may be forced out of the project by an inability to pay increased market rate rent.
- Existing low income tenants may be evicted because all eviction controls in the regulatory agreement will also be terminated.
- Increased homelessness.
- Decreased stock of affordable housing in the community.
- If local agency also provided funding for the project the deed of trust securing the local government investment is likely also wiped out, and the local government loses ability to obtain repayment of loan.
- Bad press, heartbreak stories, political repercussions.

- Local government loses "credit" for units under various state laws.

- If restriction was a land use requirement, the project will be out of compliance with its entitlement requirements. If the project was meeting inclusionary requirements for a larger development, the larger development will be out of compliance with its entitlement requirements.

9. Do all financing and land use programs permit subordination of affordability restrictions? Most financing programs permit subordination, most land use programs do not.

- Redevelopment law permits subordination of affordability covenants to private lender deeds of trust only if certain findings are made and redevelopment agency is provided special rights to prevent a foreclosure (see attached excerpt from Community Redevelopment Law).

- HOME program permits subordination, but if affordability restrictions are wiped-out in foreclosure, the local government must repay HUD the HOME funds put in the project (even if local government, through foreclosure, has lost ability to require repayment of the funds by the project owner).

- Density bonus state law does not authorize subordination and many jurisdictions refuse to subordinate density bonus affordability restrictions on multifamily projects. Many banks go along with this because the density bonus restrictions affect only a small percentage of units in the project, and also because of uncertainty on the validity of land use approvals if the affordability conditions of approval are not complied with.

- While some local inclusionary housing ordinances prohibit subordination of inclusionary restrictions, most are silent on this authority in recognition of the need for flexibility in inclusionary implementation. If inclusionary restrictions affect only a small percentage of units (10-15 percent), most cities will not agree to subordinate and most banks will not require subordination. If the inclusionary restrictions affect more units (perhaps because one affordable project is meeting the inclusionary requirements of several market rate projects), the banks will usually require subordination and the local government, will resist subordination because

so many affordable units are at stake. This situation can be very problematic.

9. <u>If a local government has to agree to subordination, what should be included in the subordination agreement?</u> Unfortunately, this is usually a case-by-case negotiation with each bank and a repeated negotiation for each project. Typical provisions include:

- Mutual notice of borrower default.

- Mutual right to cure borrower default, sometimes with extended time periods, to prevent foreclosure.

- Right for public agency or its designee to take title to project, cure default, and assume loan.

- Watch out for onerous provisions, like cure periods that are too short for staff to go to elected board to obtain authority to spend money, suspension of all public agency remedies while bank deed of trust is in effect, suspension of regulatory requirements if bank files notice of default, etc.

List of attachments:

1. Excerpts from Community Redevelopment Law, setting forth requirements for subordination of affordability restrictions (Health and Safety Code Section 33334.14(a)).

2. HOMEFires – June, 2003 – HUD publication regarding repayment of HOME subsidy to HUD if affordability restrictions are wiped-out in foreclosure.

Health & Safety Code Section 33334.14(a)

33334.14. (a) The covenants or restrictions imposed by the agency pursuant to subdivision (e) of Section 33334.3 may be subordinated under any of the following alternatives:

(1). To a lien, encumbrance, or regulatory agreement under a federal or state program when a federal or state agency is providing financing, refinancing, or other assistance to the housing units or parcels, if the federal or state agency refuses to consent to the seniority of the agency's covenant or restriction on the basis that it is required to maintain its lien, encumbrance, or regulatory agreement or restrictions due to statutory or regulatory requirements, adopted or approved policies, or other guidelines pertaining to the financing, refinancing, or other assistance of the housing units or parcels.

(2) To a lien, encumbrance, or regulatory agreement of a lender other than the agency or from a bond issuance providing financing, refinancing, or other assistance of owner-occupied units or parcels where the agency makes a finding that an economically feasible alternative method of financing, refinancing, or assisting the units or parcels on substantially comparable terms and conditions, but without subordination, is not reasonably available.

(3) To an existing lien, encumbrance, or regulatory agreement of a lender other than the agency or from a bond issuance providing financing, refinancing, or other assistance of rental units, where the agency's funds are utilized for rehabilitation of the rental units.

(4) To a lien, encumbrance, or regulatory agreement of a lender other than the agency or from a bond issuance providing financing, refinancing, or other assistance of rental units or parcels where the agency makes a finding that an economically feasible alternative method of financing, refinancing, or assisting the units or parcels on substantially comparable terms and conditions, but without subordination, is not reasonably available, and where the agency obtains written commitments reasonably designed to protect the agency's investment in the event of default, including, but limited to, such as any of the following:

(A) A right of the agency to cure a default on the loan.

(B) A right of the agency to negotiate with the lender after notice of default from the lender.

(C) An agreement that if prior to foreclosure of the loan, the agency takes title to the property and cures the default on the loan, the lender will not exercise any right it may have to accelerate the loan by reason of the transfer of title to the agency.

(D) A right of the agency to purchase property from the owner at any time after a default on the loan.

This page is located on the U.S. Department of Housing and Urban Development's Homes and Communities Web site at
http://www.hud.gov/offices/cpd/affordablehousing/library/homefires/volumes/vol5no2.cfm.

HOMEfires - Vol. 5 No. 2, June, 2003

Q: Does the termination of the *affordability restrictions* on a HOME-assisted project due to foreclosure or transfer in lieu of foreclosure relieve the Participating Jurisdiction (PJ) of the requirement to repay the HOME investment in projects in which the *affordability requirements* are not met for the full affordability period?

A: No. Notwithstanding the termination of *affordability restrictions* on a HOME project conveyed to a lender due to foreclosure or transfer in lieu of foreclosure, the PJ must repay the HOME account because the project has not met the *affordability requirements* for the full affordability period. Consequently, if a HOME-assisted rental project or homebuyer project with a resale agreement no longer meets applicable affordability requirements, the PJ must repay the HOME investment.

- Revised explanation of HUD's waiver policy

Affordability Requirements

The HOME Rule imposes affordability requirements for rental and homebuyer housing that must be met for an established affordability period. In the case of foreclosure or transfer in lieu of foreclosure, the HOME Rule allows the lender to take the property without the affordability restrictions. This permits primary lenders to maximize the amount of investment recouped in the event of a default, and thereby encourages private lenders to participate in the HOME program. The affordability restrictions must be revived according to the original terms if, during the original affordability period, the owner of record before foreclosure or transfer of the deed in lieu of foreclosure, or any entity that includes the former owner or those with whom the former owner has or had family or business ties, obtains an ownership interest in the project or property.

The PJ must repay the HOME account if the HOME-assisted housing fails to meet the affordability requirements for the full affordability period without regard to the term of any loan or mortgage or the transfer of ownership, even in the event of foreclosure, transfer in lieu of foreclosure or assignment to HUD.

Preserving Affordability

To preserve affordability, PJs should negotiate as part of the original financing agreement, purchase options, rights of first refusal or other preemptive rights to purchase the housing before foreclosure or transfer in lieu of foreclosure. PJs should regularly review the management and financial condition of projects so that they can intervene before projects reach the point of default. If a project goes into default, the PJ must work with the project owner and primary lenders to maintain the project as affordable housing for the remaining affordability period or the PJ must repay the HOME account.

Repayment of HOME Investment

When the affordability requirements are not met for the full affordability period, Section 219(b) of the HOME statute and § 92.503(b)(1) of the HOME Rule require the PJ to repay HOME funds invested in the housing to the HOME Investment Trust Fund. The PJ is responsible for repaying the funds, whether or not it is able to recover any portion of the HOME investment from the owner, project developer, state recipient, subrecipient or CHDO.

HUD may waive the repayment requirement for good cause when the PJ can demonstrate that it made good faith efforts to salvage the project and preserve it for affordable housing, or where foreclosure was due to some extreme circumstance, such as a building being destroyed by fire and the insurance proceeds are insufficient to repay the HOME funds. This waiver authority has been used infrequently.

If the HOME funds were provided as an amortizing loan, the amount of the repayment is the outstanding principal balance of the loan. If the HOME funds were provided as a grant, the amount of the repayment is the full grant amount. For deferred loans provided to rental housing and homeownership housing under a resale agreement undergoing foreclosure, the pro rata reduction of the HOME loan over time under the terms of the loan agreement with the owner does not reduce the amount of HOME funds that must be repaid by the PJ to the HOME account. Homebuyer projects under recapture provisions are treated differently when the noncompliance is due to foreclosure.

Rental Housing

Section 92.252(e) of the HOME Rule provides that the affordability restrictions may terminate upon foreclosure or transfer in lieu of foreclosure. However, this does not terminate the long-term affordability requirements. The affordability requirements would be met if the new owner agrees to enter into a written agreement subjecting the project to the HOME affordability requirements for the remainder of the affordability period.

Homebuyer Housing with a Resale Agreement

Section 92.254(a)(5)(i)(A) of the HOME Rule provides that the affordability restrictions for homebuyer housing subject to a resale agreement may terminate upon foreclosure, transfer in lieu of foreclosure or assignment of an FHA insured mortgage to HUD. However, this does not terminate the long-term affordability requirements. The affordability requirements would be met if the housing is sold to another HOME-eligible low-income family and the new homebuyer agrees to enter into a resale agreement for the remaining affordability period. Homebuyer housing with a resale agreement that is presumed to meet the affordability requirements pursuant to § 92.254(a)(5)(i)(B) continues to meet the affordability requirements even after a foreclosure.

If the PJ provides additional HOME funds to the new homebuyer or invests additional HOME funds in a property, the original affordability period is terminated and a new affordability period starts. The length of the new affordability period is determined by the amount of HOME funds invested.

Homebuyer Housing with a Recapture Agreement

Homebuyer housing with a recapture agreement is not subject to the affordability requirements after the PJ has recaptured the HOME funds in accordance with its written agreement. If the ownership of the housing is conveyed pursuant to a foreclosure sale, the family may or may not have a recapture obligation, depending upon the option the PJ has chosen in accordance with §92.254(a)(5)(ii)(A). Unlike rental housing and homeownership housing under resale restrictions, the amount of HOME funds required to be repaid in the event of foreclosure is the amount that would be subject to recapture under the terms of the written agreement with the homebuyer. If the recapture agreement provides for shared net proceeds, the amount subject to recapture is based on the amount of net proceeds (if any) from the foreclosure sale. If the recapture agreement requires the entire amount of the HOME investment from the homebuyer or an amount reduced prorata based on the time the homebuyer has owned and occupied the housing measured against the affordability period, the amount required by the agreement is the amount that must be recaptured by the PJ for the HOME program. If the PJ is unable to recapture the funds from the family, the PJ must repay the HOME account in the amount due pursuant to the recapture agreement. [Please note that in the case of noncompliance other than foreclosure (e.g., homebuyer is no longer using the property as a principal residence), the amount the PJ must repay is the entire HOME investment rather than the amount due under the written agreement.] Regardless of the terms of its written agreements, it is important that the PJ establish mechanisms that ensure that it will be notified of pending foreclosures so that it can attempt to recoup some or all of the HOME subsidy.

PJs concerned about the possibility of repaying funds in case of foreclosure may wish to consider adopting recapture provisions that base the recapture amount on the net proceeds available from the sale rather the entire amount of the HOME investment. If the written agreement bases the recapture amount on net proceeds and there are no net proceeds from the foreclosure, repayment is not required and HOME requirements are considered to be satisfied. **A PJ that was unaware that its homebuyer program design obligated it, in the event of foreclosure, to repay funds in excess of what would be available through the foreclosure and has changed the design to base recapture amounts on net proceeds may want to pursue a waiver of the repayment requirement at § 92.503(b)(1) for homebuyers assisted under its original program design. HUD may grant a waiver on a program basis that, in the event or foreclosure involving homebuyers assisted under its previous program design, would limit the PJ's repayment obligation to the amount that it is able to obtain through the foreclosure.**

You may obtain additional information about the HOME program from the HOME program web page.

Content updated August 26, 2003

U.S. Department of Housing and Urban Development
451 7th Street, S.W., Washington, DC 20410
Telephone: (202) 708-1112 Find the address of a HUD office near you

Subordination of Secondary Municipal Financing - A lender's Perspective

Jim Francis
Housing California
April 24, 2007

Background:

- Q: ***Why would a lender make a loan with restrictions on the potential revenue (source of repayment) in the unfortunate event she must forclose on the property?***
  - Why would a lender foreclose?
    1. "Controllable" Reasons
       1. Bankruptcy of sponsor
       2. Mismanagement – Operating expenses or marketing or both
    2. "Uncontrollable" Reasons
       1. Operating expense increases (ex. Insurance/utility allowance)
       2. Market declines – high vacancy or rent declines

Why are lenders opposed to unsubordinated municipal financing?

- **Basically: It Ties the hands of future owners to fix unforeseen problems:**
  - Risk of slum creation:
    - Q: What will a developer do when his "back's against the wall" because his costs higher and he can't raise the rents?
    - A: Defer the maintenance – examples - Hud public housing
  - Dramatically raises refinance risk at the end of 15 years.
    - Traditionally offset by amortization/ good replacement reserves and cap-ex budgets. Not so in this case.
    - Much smaller pool of potential lenders – Fannie Freddie – No way. No matter what, will raise borrowing and legal costs to the transaction.
  - Damages potential back-end with investors
  - Makes the transactions less attractive to equity, current and future.

Why lenders will sometimes consider unsubordinated restrictions:

- Despite all the above:
- We have been willing to accept it on certain occasions, but keep in mind:
  - Not all markets are equal:
    - Area Median Incomes fluctuate dramatically
    - Demand conditions & demographics are very different form market to market & w/in submarkets
    - Product Type – SR vs. Family vs. special needs
  - Not all developers have equal resources
    - Guarantees/ investors play in to the equation
  - How much Skin do the players have in the game?
    - Ex. City has $10 or $20mm, I view them a lot differently than with $1MM
    - Low Perm Debt/Cost makes lenders a bit more comfortable
  - If we can parlay into higher pricing
    - A lot less competition for these types of deals.
  - How do the restrictions compare to:
    - Max TCAC rents
    - Market rents

Conclusions

- LIHTC Program has been widely acknowledged as the best affordable housing program ever. Why?
  - Not accidental: Alignment of interests and a good mix of risk between:
    - Fed Govt., Municipal lenders, developers, investors and lenders resulting in positive community impact.
  - Good quality product for the most part – Not over-leveraged
  - Some Flexibility built in to the structure
- My question: Why do municipal lenders want to jeopardize the success of this program by introducing new risk elements?