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# The Fallout from Federal Low-Income Housing Preservation Programs: A Case Study in Estimating Damages

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## *Abstract*

In 1987, Congress passed the Emergency Low-Income Housing Preservation Act (ELIHPA) to prevent owners of low-income housing projects from converting their properties to market rents as allowed under the owners' original government-insured mortgage contracts. Three years later, ELIHPA was replaced by the Low-Income Housing Preservation and Resident Homeownership Act (LIHPRHA), which imposed permanent restrictions on property owners' rights to prepay their mortgages. The compensation to owners under ELIHPA and LIHPRHA did not cover their losses during the prepayment freeze and led to a series of lawsuits.

This article presents the methodology for evaluating owners' losses that was accepted by the U.S. Court of Federal Claims. If the court's decision is ultimately sustained on appeal, American taxpayers may face a damage bill on the order of $500 million or more. The real long-term damage, however, lies in how the private sector will react to future attempts by the government to produce low-income housing.

**Keywords:** Low-income housing; Preservation; Federal

## Introduction

During the 1950s and 1960s, Congress enacted legislation to encourage private developers to build multifamily housing for low- and moderate-income families. Congress authorized the Federal Housing Administration (FHA) and later the U.S. Department of Housing and Urban Development (HUD) to provide mortgage insurance for low-interest mortgages to private developers. The insurance programs, primarily FHA 221(d)(3) and 236, required the owners to abide by HUD-imposed "affordability restrictions" on the income levels of tenants, the rents that could be charged, and the rates of return that owners could receive.

The programs under which the properties were built locked the owners into a return of 6 percent of their original equity in the project. Over the 20-year term of the mortgages, as property values increased, the value of the owner's equity also increased so that the restricted return of 6 percent on *original* equity was typically far

below what the owner's current cash flow would be on an unrestricted basis.

The original contracts gave owners the right to pay off the mortgages after 20 years and convert their apartments to market rental rates, thereby ending the restrictions to rent to low-income tenants. By the late 1980s, Congress became concerned that a large number of owners might take advantage of the prepayment clauses within a short period of time, thus dramatically reducing the supply of low-income housing throughout the country. As a result, Congress passed two pieces of legislation to counter the threat of massive prepayments. The first, the Emergency Low-Income Housing Preservation Act (ELIHPA or Title II), effectively placed a two-year moratorium on prepayments in order to give Congress time to find a permanent solution. The second bill, the Low-Income Housing Preservation and Residential Homeownership Act (LIHPRHA or Title VI), passed in 1990, was intended to provide incentives to owners to maintain the affordability restrictions on their properties (*Cienega Gardens v. United States*, 1997, 6).

ELIHPA's stated purposes were the following:

1. To preserve and retain to the maximum extent practicable as housing affordable to low-income families or persons those privately owned dwelling units that were produced for such purpose with federal assistance

2. To minimize the involuntary displacement of tenants currently residing in such housing

3. To continue the partnership among all levels of government and the private sector in the production and operation of housing that is affordable to low-income Americans (U.S. Public Law 100–242. 100th Congress, 1st Session, February 5, 1988, 1,878)

In 1990, Congress replaced ELIHPA with LIHPRHA, which placed permanent restrictions on property owners' rights to prepay HUD-endorsed mortgages. As a result, property owners who were prevented from paying off their mortgages suffered significant losses. This article presents a methodology for evaluating those losses.[1] The article describes why and how the owners of such properties were damaged and provides an illustration of the damage computation for one property. The entire story, starting with Congress's enactment of ELIHPA, illustrates how *not* to deal with the nation's low-income housing stock.

[1] The methodology and damage analysis were developed by the author when he appeared as an expert witness in the case *Cienega Gardens v. United States.*

## Background and literature review

David Listokin (1991) presents an excellent brief history of low-income housing during the 1960s and 1970s. Construction of low-income housing grew dramatically in the 1960s. The 1961 Housing Act, under Section 221(d)(3), provided for below-market interest rate (BMIR) mortgages of 3-percent loans to limited dividend and nonprofit sponsors of rental housing. This housing was targeted for households with incomes below the area median but above the level required for public housing. In the Housing Act of 1968, a new subsidy, Section 236, offered BMIR loans with interest rates as low as 1 percent for privately developed rental housing. Listokin (1991, 164) concludes that “the inadequacies of these subsidies (in the 1965 Housing Act and Brooke Amendment of 1969) in an era of rapid inflation, coupled with loose administration by HUD that encouraged chicanery, led to a mounting number of troubled projects by the late 1960s and early 1970s.”

Carla Pedone (1991) describes the magnitude of the mortgage prepayment and default problem on federally assisted low-income rental units and presents preliminary estimates of the potential scope of the problem in terms of the possible incidence and timing of defaults and the costs of preventing them. The number of projects and units subject to prepayment is shown in table 1.

*Table 1.* **Number of Projects and Units Subject to Prepayment**

| Program Type | Number of Projects | Number of Units |
|---|---|---|
| Section 236 | 2,372 | 266,754 |
| Section 221(d)(3) MR (Market rate) | 349 | 23,545 |
| Section 221(d)(3) BMIR | 522 | 72,255 |
| Total | 3,243 | 362,554 |

*Source:* Pedone (1991, 262).

When Congress passed ELIHPA, it recognized that owners would need to be compensated in some way for the losses they would incur by not being able to convert their projects to market rents. To address this problem, ELIHPA provided financial compensation, primarily through increased rent subsidies, to allow property owners to earn a fair return on the market value of their properties while they continued to face HUD restrictions. The mechanism for determining Title II compensation involved a process whereby the owner submitted an independent appraisal of the property. HUD would re-

view and, in most cases, adjust the market value and rent figures contained in the appraisal. The owner and HUD then would negotiate and ultimately agree on rent levels for the property. These rents became the basis for a "plan of action" (POA) and, subsequently, a "use agreement" that served as the final agreement. The processing and reprocessing of the POA took from two to four years to complete. Because of the complexity of the POA, many owners, especially those with a small number of properties, did not even attempt to start the process, let alone complete it. HUD delayed the payment of financial compensation to the property owner until the use agreement was executed.

Although Congress passed ELIHPA in 1990, it was several years before assistance was actually provided under the act. Furthermore, the process established to claim benefits under Title II and Title VI was very cumbersome and added significantly to the damages incurred by owners of property caught in the freeze on conversion.

Smith (1990) presents a methodology for valuing the conversion of rent-restricted apartments to market rents. He states that owners have three choices: (1) sell the property and receive the preservation equity in cash; (2) continue to hold the property and receive a fair annual return on the entire preservation equity; or (3) take out a portion of the preservation equity through an equity-takeout secondary financing and receive a fair annual return on the remainder. Smith proposes a simple model that takes into account the new market rents and the anticipated operating expenses under market operating conditions. The resulting net operating income (NOI) is capitalized at a market capitalization rate to produce the fair market value after conversion. The preservation value is calculated by subtracting the economic fix-up costs and transition costs. The preservation equity then is computed by subtracting the current mortgage balance from the preservation value. HUD adopted this method for computing preservation equity as part of the process for compensating owners subject to continued HUD restrictions. Smith's methodology is important for understanding what HUD did, but it does not answer the question about the extent of damages to property owners whose right to convert was taken away by ELIHPA and LIHPRHA.

Property owners were justifiably frustrated by their predicament and loss of income. Many owners were trapped: Much of their life savings was tied up in properties where they could not raise rents, and they could not sell the properties because there were no buyers. Since ELIHPA was passed, several owners have unsuccessfully sued the government for damages resulting from the loss of their conversion rights. The first owner to prevail was the Los Angeles–based firm of Goldrich and Kest (G&K) in *Cienega Gardens v. United*

*States* (33 Fed. Cl. 196, 1995) (Cienega I) and *Cienega Gardens v. United States* (37 Fed. Cl. 79, 1996) (Cienega II). Cienega II added 21 more properties to the lawsuit.

This article discusses the determination of damages. The damage phase of the trial (*Cienega Gardens v. United States,* 38 Fed. Cl. 64, 1997) (Cienega III) focused on four "model" properties out of the 42 G&K-owned properties named in the lawsuit. In the opinion on Cienega II that was issued on April 29, 1997, the U.S. Court of Federal Claims accepted the plaintiff's model with minor exceptions and awarded G&K $3,061,107 in damages on the four model properties.

The government appealed the decision to the U.S. Court of Appeals for the Federal Circuit, which ruled on December 7, 1998 (*Cienega Gardens et al. v. United States* (Fed. Cl. 97-5126, -5134) that there was no privity of contract between HUD and the owners (G&K), and therefore the government was not liable for damages. This latest ruling does not end the owners' claim, which will be pursued through additional appeals. Whatever the outcome, the methodology presented here for estimating damages is applicable to any subsidized housing where owners' property rights are taken for a defined period. This model, if sustained on appeal, will be used to calculate damages on the rest of the properties.[2] It likely also will be used as a basis for computing damages to other owners of properties caught in the ELIHPA freeze on conversion.

## Damage model

This section presents the damage analysis for one of the four sample properties in the case: Pico Plaza Apartments, a 43-unit project in Los Angeles. Because the prepayment date on the original contract, December 28, 1993, was after LIHPRHA was passed, it was processed under Title VI.

It is always dangerous to infer too much from a single case study. Pico Plaza Apartments was considerably smaller than the average project owned by G&K and was in the worst neighborhood of the four sample projects. It was one of the two properties selected by the government. (G&K selected the other two.) Pico Plaza's damages were a fraction of those of the other properties, which were larger and located in better neighborhoods with higher market rents.

[2] The government's appeal of the court decision does not focus on the damage model, but rather on whether or not privity of contract existed between the government and the plaintiff.

In addition to size and location, the other most important factor influencing the amount of damages is the length of the damage period. The later the prepayment date, the shorter the period and the lower the damages. Because the primary purpose of this article is to present the methodology for determining damages, the Pico Plaza case study provides a good illustration.

The total damages due to the owners of Pico Plaza are $186,986 (see table 2.) These damages consist of two main parts. The first part is the “operating cash flows under market conditions”: $165,658. This is the amount that G&K would have received if it had been able to convert to market conditions on the prepayment date. (The computations are discussed below.) The second part is the “losses incurred under HUD restrictions”: $21,328. It is the amount that G&K actually received (or lost, as in the Pico Plaza case) under HUD restrictions. The present value of the difference—$186,986—is the measure of damages.

Under Claims Court rules, no interest is allowed on claims against the government. Even though it is unarguably proper to compute the present value in determining damages, the court looks only at the sum of the nominal damages for the years in question. The calculations used for table 2 and other tables in this article assume a 10-percent present value discount rate. A second set of tables using a zero-discount rate was presented to the court.

The model is deliberately designed to be conservative. It deals strictly with the damage period (defined by the dates, beginning with the time that properties could have been prepaid and ending with the date that the right to prepay was restored, with minor adjustments as described below). The methodology avoids determining

*Table 2.* **Summary Contract Damage Analysis, Pico Plaza Apartments**

| | Present Value as of October 31, 1996 |
|---|---|
| Operating cash flows under market conditions [Schedule A] | $165,658 |
| Losses incurred under HUD restrictions [Schedule B] | 21,328 |
| Lost income contract damage | $186,986 |

*Note:* The damages have been calculated assuming the mortgage was prepaid and the regulatory agreement was terminated on May 31, 1996, two months after the legislation reestablishing prepayment rights was enacted. However, this did not occur. Therefore, damages continue to accrue on a daily basis and will be recalculated once the earliest prepayment date is known.

capitalization rates, which are the most subjective and contentious part of any appraisal. (A minor change in capitalization rates, say a few tenths of a percentage point, has a major impact on value.[3]) The model focuses strictly on income—revenues less expenses—that the owners would have received if they had been allowed to go to market conditions, versus what they actually received. A less conservative approach could have estimated the market value of the properties with and without HUD restrictions, but this would have required making more subjective assumptions such as capitalization rates. Indeed, an important part of the model's credibility is the elimination of subjectivity wherever possible, even though this means that the owners may have left some money "on the table."

A list of the full set of schedules appears in table 3. Table 4 provides a description of the property. The table includes key dates: the inception of the damage period, the prepayment date (December 28, 1993), and the expected termination date when prepayment is assumed to occur (May 31, 1996), plus other key assumptions for building replacement cost and market rent.

The market rent figure is the most important number in the analysis because it has the largest impact on damages, affecting every unit every year. For properties processed under Title II, a market rent was agreed to by both G&K and the government as part of the POA process, which culminated in the signing of the use agreement. For properties processed under Title VI, there was no agreed-upon rent, but two appraisals were done, one by each side. To avoid making a subjective judgment about the appropriate market rent, the "agreed-upon rent" was used where it was available (if the use agreements were signed). Where it was not available, the average of the market rent found in the two appraisals was used. The agreed-upon rents under the use agreement provided an estimate of market rent that had been accepted by the government. Using this number (where it was available) was attractive because it eliminated the need to estimate market rent. The estimate used here is unbiased and should be accurate, on average, for the full collection of properties in the lawsuit.[4]

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[3] Capitalization rates are used in the following formula to determine value *(V)*: $V = \text{NOI}/k$, where NOI = net operating income and $k$ = capitalization rate. For example, if NOI = \$100,000 and $k$ = 10 percent, then $V$ = \$1,000,000. If $k$ = 9.5 percent, then $V$ = \$1,052,631, an increase of \$52,631.

[4] The owners argued that they got fed up with the back-and-forth process in negotiating the use agreements and therefore agreed to a lower rent than they felt was

*Table 3.* **List of Schedules**

| |
|---|
| Summary—Contract Damage Analysis [table 2] |
| Description—Key Dates and Property Data [table 4] |
| Schedule A—Operating Cash Flow under Market Conditions (1993 to 1996) [table 5] |
| Schedule A(1)—New Financing Costs, at Prepayment Date |
| Schedule B—Benefits (Losses) Received under HUD Restrictions [table 6] |
| Schedule B(1)—Operating Cash Flows, HUD-Restricted Rents (1993 to 1996) [table 7] |
| The following schedules are too lengthy to be printed here, but copies are available from the author: |
| Schedule B(2)—Lost Income Following Termination Date |
| Schedule B(3)—Increase (Decrease) in Value of Reserve Accounts Between Prepayment Date and Termination Date |
| Schedule B(4)—Savings from Lower Mortgage Balance |
| Schedule B(5)—Savings from Deferred Cost of Converting to Market [B(5)a minus B(5)b] |
| Schedule B(5)a—Cost of Converting to Market at Prepayment Date |
| Schedule B(5)b—Cost of Converting to Market after Termination Date |
| Schedule B(6)—Savings from HUD Earthquake Loan Program (HELP) |
| Schedule B(7)—Cost of Processing Plan of Action |
| Backup Calculation [Notes 37B and 39B, Schedules B(5)a and B(5)b]—Maximum Rents under Los Angeles Rent Control for Nonsubsidized Tenants |

Table 5 (Schedule A) computes the cash flow after debt service under the condition that the property was converted to market rents at the prepayment date.[5] The owners of HUD-restricted properties should have been allowed to prepay their HUD-endorsed mortgages and convert their properties to conventional market properties on the 20th anniversary of the original contract. This date marks the beginning of the "damage period." Both Title II and Title VI allowed the owners to raise the rents to market rates and eventually to enjoy the benefits of the increased NOI after certain hurdles were met. Under both Title II and Title VI, this occurred upon signing of the use agreement. However, Congress did not fund Title VI, so

accurate. The use agreement had to be finalized before they could raise rents or receive any compensation under the preservation equity loans.

[5] Beginning and ending dates for the damage period were rounded to the nearest end of month.

*Table 4.* **Description, Key Dates, and Property Data, Pico Plaza Apartments**

| Description | | | |
|---|---|---|---|
| Project address: | 1226 and 1237 S. Arapahoe Street, Los Angeles, CA | | |
| Project number: | Project No. 122-44533-LDP | | |
| Complex type: | Family | | |
| Number of units: | 43 | | |
| **Key Dates** | **Actual Date** | **Date Used** | |
| Prepayment date[a] (original contract) | 12/28/93 | 12/28/93 | |
| Plan of action date[b] | none | none | |
| Title for processing plan of action | | Title VI | |
| Expected termination date[c] | | 5/31/96 | |
| End of existing Section 8 contract | | n/a | |
| Fiscal year end | | December 31 | |
| Valuation date for damages | | 10/31/96 | |
| **Appraisal Data** | **HUD Appraisal[d]** | **Owner's Appraisal[e]** | **Value Used** |
| Name of appraiser | Taylor Dark | Marvin E. Lopata & Associates | |
| Date of appraisal | 8/25/95 | 6/15/95 | |
| Market value[f] | $1,150,000 | $1,500,000 | $1,325,000 |
| Extension preservation value | $799,000 | $1,380,000 | $1,089,500 |
| Building replacement cost[g] | | | $1,433,824 |

*Table 4.* **Description, Key Dates, and Property Data, Pico Plaza Apartments** *(continued)*

| Unit Type | Number of Units | Rentable Living Area (in Square Feet) | Unit Rent per Month | Number of Units | Rentable Living Area (in Square Feet) | Unit Rent per Month | Average of Two Appraisals |
|---|---|---|---|---|---|---|---|
| Efficiency | 2 | 442 | $340.00 | 2 | 442 | $425.00 | $382.50 |
| Efficiency | 3 | 494 | $340.00 | 3 | 494 | $430.00 | $385.00 |
| 1 bedroom, 1 bath | 27 | 676 | $520.00 | 27 | 676 | $550.00 | $535.00 |
| 1 bedroom, 1 bath | 5 | 713 | $520.00 | 5 | 713 | $560.00 | $540.00 |
| 2 bedroom, 1 bath | 3 | 884 | $630.00 | 3 | 884 | $670.00 | $650.00 |
| 2 bedroom, 1 bath | 3 | 936 | $630.00 | 3 | 936 | $680.00 | $655.00 |
| Total/Average | 43 | 689 | $514.42 | 43 | 689 | $554.42 | $534.42 [to Schedule A] |

[a]Twenty years after first mortgage.
[b]No plan of action in place.
[c]The damages have been calculated assuming the mortgage was prepaid and the regulatory agreement was terminated on May 31, 1996, two months after the legislation reestablishing prepayment rights was enacted. However, this did not occur. Therefore, damages continue to accrue on a daily basis and will be recalculated once the earliest prepayment date is known.
[d]Taylor Dark Appraisal.
[e]Marvin E. Lopata & Associates Appraisal.
[f]Average of two appraisals; form 9607 not finalized.
[g]Replacement cost not provided in appraisals. Estimate here based on Marshall & Swift Residential Cost Handbook.

*Table 5.* **Schedule A: Operating Cash Flow under Market Conditions (1993 to 1996), Pico Plaza Apartments**

| Annual Adjustment Factors | | Three Days Ending 12/31/93 | Year Ending 12/31/94 | Year Ending 12/31/95 | Five Months Ending 5/31/96 |
|---|---|---|---|---|---|
| Rate of increase for market rents[a] | | | 0.00% | 0.00% | 3.00% |
| Expense adjustment factor[b] | | | | | 3.00% |
| Project vacancy rate[c] | | 6.50% | 6.90% | 6.87% | 6.50% |
| Average market rents (description) | | $534.42 | $534.42 | $534.42 | $550.45 |
| Revenues | | | | | |
| Gross potential rental income | | $2,298 | $275,761 | $275,760 | $118,347 |
| Other revenue[d] | | 26 | 3,208 | 4,998 | 2,083 |
| Interest income on operations[e] | | 4 | 389 | 428 | 191 |
| Vacancy (vacancy rate × GPI) | | (149) | (19,027) | (18,945) | (7,693) |
| Credit loss[f] | | (11) | (1,284) | (1,284) | (553) |
| Gross income | | 2,168 | 259,046 | 260,957 | 112,375 |
| Expenses | | | | | |
| Administrative | Source | | | | |
| Management fee[g] | IREM | 102 | 13,112 | 13,196 | 5,660 |
| Other administrative | | 77 | 6,974 | 7,019 | 3,011 |
| Subtotal administration[h] | IREM | 179 | 20,086 | 20,215 | 8,671 |
| Operating | | | | | |
| Utilities[i] | Actual | 410 | 55,122 | 54,405 | 23,349 |
| Other operating[j] | IREM | 74 | 6,416 | 6,457 | 2,770 |
| Subtotal operating | | 484 | 61,538 | 60,862 | 26,119 |
| Subtotal maintenance[k] | IREM | 186 | 22,039 | 22,180 | 9,514 |
| Taxes and insurance[l] | | | | | |
| Taxes | Actual | 93 | 11,585 | 11,160 | 4,790 |
| Insurance | Actual | 86 | 10,946 | 7,774 | 3,336 |
| Subtotal taxes and insurance | Actual | 179 | 22,531 | 18,934 | 8,126 |
| Subtotal amenities/other payments[m] | IREM | 105 | 14,785 | 14,880 | 6,383 |
| Total expenses | | 1,133 | 140,979 | 137,071 | 58,812 |

*Table 5.* **Schedule A: Operating Cash Flow under Market Conditions (1993 to 1996), Pico Plaza Apartments** *(continued)*

| Annual Adjustment Factors | Three Days Ending 12/31/93 | Year Ending 12/31/94 | Year Ending 12/31/95 | Five Months Ending 5/31/96 |
|---|---|---|---|---|
| Net operating income (Gross income minus total expenses) | | | | |
| Net operating income | 1,035 | 118,068 | 123,886 | 53,563 |
| Debt service [Schedule A (1)] | (424) | (52,538) | (52,538) | (21,891) |
| Deposit to replacement reserve[n] | (72) | (8,603) | (8,603) | (3,585) |
| Cash flow after debt service | $540 | $56,926 | $62,745 | $28,087 |
| Present value as of 10/31/96 Present value at 10 percent | $707 | $67,795 | $67,931 | $29,225 |
| Total present value [to Summary] | | | | $165,658 |

[a]Assumption of a 0 percent rent increase for 1994 and 1995.
[b]No expense adjustment factor used for 1994 and 1995 because financial statements are available. IREM ratios for 1994 (the last year available) were applied to later years. For 1996, a constant 3 percent increase was assumed, except where expenses are calculated as a percent of gross potential income.
[c]Based on Real Facts Market Survey, city of Los Angeles.
[d]Actual laundry and parking revenue from annual financial statements.
[e]Interest calculated based on average deposit of 1.5 months' cash flow, earning 5.38 percent.
[f]0.50 percent of potential rental income, less vacancy. See summary of credit loss at conventional apartment properties managed by G&K Management Co., Inc.
[g]Institute for Real Estate Management (IREM) median percentage for garden apartments in the Los Angeles region, applied to gross potential rental income plus other income.
[h]IREM median percentage for garden apartments in the Los Angeles region, applied to gross potential rental income plus other income.
[i]Actual utility expenses from yearly financial statements.
[j]IREM median percentage for garden apartments in the Los Angeles region (building services plus other operating), applied to gross potential rental income plus other income.
[k]IREM median percentage for garden apartments in the Los Angeles region, applied to gross potential rental income plus other income.
[l]Actual taxes and insurance expenses from yearly financial statements.
[m]IREM median percentage for garden apartments in the Los Angeles region (recreational amenities plus other payroll).
[n]0.60 percent of building replacement cost of $1,433,824.

very few Title VI properties—and none of G&K's—completed the POA and use agreement process.[6]

The other key date in modeling the damages is the *termination date* of the damages. For reasons of conservatism, the damage period is assumed to end when the rents on all units are allowed to go to market rates. For Title II, this occurs on the "use agreement date," the date each plaintiff began receiving Title II compensation. Because Title VI was not funded, the damage period was assumed to end on the date when the owners would be allowed to prepay their HUD-endorsed mortgages. The damage period also included an additional 60 days, which the owners were required to wait before raising rents, even though they had retired the mortgages. Furthermore, if the property had a Section 8 contract, the damage period was extended to the end of the contract, at which time the owners were allowed to raise the rents to market rates. It is appropriate to include the lost rent attributable to the Section 8 contracts because the owners would not have extended the contracts if they could have paid off the mortgages on the contract prepayment date. Under the existing mortgage, however, the owners still were obligated to have low-income tenants. They therefore needed the Section 8 contracts in order to obtain any rent subsidy.[7]

The primary reason for not including damages after the properties were allowed to go to market rents was the desirability of avoiding speculative damages. Standard valuation models include a sales assumption that depends on the capitalization rate used to compute the sales price. Even if market rents were the same for both the restricted and unrestricted cases, the operating expenses arguably would be higher in the case in which occupancy rates per unit were higher (more children). One also might argue that the capitalization rate should be higher (sales price lower) in the restricted case because of government restrictions on future rent increases under the use agreement. Nevertheless, the nature of future damages and future cap rates were sufficiently speculative that it was preferable to assume they were a wash, and, therefore, to cut off the damage analysis at the earliest date on which the units could be converted to market rents.

The format for table 5 is a standard computation of NOI minus debt service and deposit to replacement reserve. Market vacancy rates

[6] Title VI properties are those whose dates of prepayment occurred after LIHPRHA was passed and which were eligible to be processed by HUD according to the rules under Title VI.

[7] While most of the new Section 8 contracts were one-year contracts, some properties had the remaining terms of five-year contracts. These were required by HUD in order for the use agreement to be signed.

are based on local market data from the Apartment Owners Association, RealFacts, and conventional apartments managed by G&K in the vicinity of the subject property. A credit loss factor based on G&K's experience with conventional apartments was applied to gross rents. Market-rate expenses are based on industry averages published by the Institute for Real Estate Management (IREM), except for utilities, taxes, and insurance, which are actual expenses taken from the financial statements for each property.

An important damage methodology is to use readily available data that are unbiased and avoid subjective judgments in selecting and interpreting them. While using IREM operating expense data results in some loss of property specificity, the availability and full market coverage of these data make them attractive for use in the model. Individual properties may show expenses that are higher or lower than the IREM data, but differences should average out for all properties in the lawsuit.

A key assumption is the amount of the mortgage. For conservatism, the existing mortgage is assumed to be rolled over to a market-rate mortgage. This assumption was one of the important factors in the court's decision. The rollover amount was assumed to be the same as before, except for refinancing points of 1.5 percent, which were added to the amount borrowed. The expert for the defense assumed a larger mortgage based on 75 percent of the estimated market value. The resulting mortgage generated higher debt service and lower cash flow. However, this expert omitted any benefit from the return on the extra cash that would flow to the owners by refinancing the existing mortgage for a higher amount. Presumably, the owners would pull cash out of the deal only if they could reinvest it at a higher rate than they were paying.[8]

Table 6 (Schedule B) summarizes the operating cash flows and additional benefits (or losses) that the plaintiffs received under the HUD-restricted program. Table 7 (Schedule B(1)) shows the operating cash flow that the plaintiffs actually received. Under the terms of the original mortgage, the plaintiffs were entitled to receive cash flow from operations ("a limited dividend") of up to 6 percent of the original equity in a property. Whether or not this amount actually was paid depended on the cash flows needed as reserves for repairs and replacements. In the case of Pico Plaza, no cash was distributed. The "cash available for distribution at the prepayment date" was actually negative (−$29,241), which means that Pico Plaza had overdrawn its cash account by $29,241 (expenses exceeded income

[8] G&K's anticipated returns on equity were well above current mortgage rates, but because this return would be speculative, we made the more conservative assumption that net cash from refinancing was zero.

*Table 6.* **Schedule B: Benefits (Losses) Received under HUD Restrictions, Pico Plaza Apartments**

| | Present Value as of October 31, 1996 |
|---|---|
| Operating cash flows, HUD-restricted rents (1993–1996) [Schedule B(1)] | $ 15,077 |
| Lost income following termination date [Schedule B(2)] | (10,092) |
| Increase (decrease) in value of reserve accounts [Schedule B(3)] | (42,740) |
| Savings from lower mortgage balance [Schedule B(4)] | 32,526 |
| Savings from deferred cost of converting to market rents [Schedule B(5)] | 10,844 |
| Savings from HUD Earthquake Loan Program (HELP) [Schedule B(6)] | 179 |
| Cost of processing plan of action [Schedule B(7)] | (27,122) |
| Benefits (Losses) under HUD Restrictions [to Summary] | (21,328) |

by this amount, which was covered by G&K). During the damage period, the cash position improved by $14,490, going from −$29,241 to −$14,751. Therefore, table 7 shows that Pico Plaza generated net cash benefits of $14,490.[9]

The other B schedules represent adjustments to the main computation of damages: what the plaintiffs would have received if they could have exercised their prepayment option at the prepayment date versus what they actually received. The first three adjustments relate to (1) lost income following the termination date, primarily due to the 60-day waiting period after prepayment before they could raise rents, and additional lost rent through the end of the existing Section 8 contracts (B(2)); (2) changes in reserve account balances over the damage period (B(3)); and (3) changes in the mortgage balance resulting from the different amortization rates associated with different interest rates. (The mortgage amounts were the same except for the addition of points in the market-rate scenario (B(4)).)

[9] The income under the HUD-restricted case becomes $15,077 if one assumes that interest is computed from the termination date (May 31, 1996, when G&K could first pay off the HUD-endorsed mortgage) to the effective damage date of October 31, 1996.

*Table 7.* **Schedule B(1): Operating Cash Flows, HUD-Restricted Rents (1993 to 1996), Pico Plaza Apartments**

Prepayment date: 12/28/93
Termination date for analysis: 5/31/96

| Cash Flows from Operations | At Prepayment Date 12/28/93 | Year Ending 12/31/94 | Year Ending 12/31/95 | Five Months Ending 5/31/96 |
|---|---|---|---|---|
| Limited dividend allowed[a] | $4,661 | | | |
| Limited dividend paid[b] | | $0 | $0 | $0 |
| Cash available for distribution at prepayment date[c] | ($29,241) | | | |
| Beginning balance, prior years | | (29,241) | (29,241) | (29,241) |
| Limited dividend paid—applied to prior years | | 0 | 0 | 0 |
| Ending balance, prior years | | (29,241) | (29,241) | |
| Cash available at termination date[d] | | | | (14,751) |
| Less: ending balance, prior years | | | | 29,241 |
| Total cash flow through 5/31/96 | | 0 | 0 | 14,490 |
| Present value as of 10/31/96[e] at 10 percent | | $0 | $0 | $15,077 |
| Total present value of cash flow as of 10/31/96 (to Schedule B) | | | | $15,077 |

[a]Pico Plaza Apartments financial statements.
[b]Pico Plaza Apartments financial statements, surplus cash calculation.
[c]The amount available for distribution during the next fiscal year.
[d]Surplus cash as of nearest financial statement.
[e]Assumes payment received four months following earned date. 1996 cash flow discounted to 10/31/96.

The fourth adjustment, Schedule B(5), computes the savings to the plaintiffs by deferring the conversion of their properties to market conditions. In a world in which the time value of money exists (unlike the world of the U.S. Court of Federal Claims), money not spent for several years represents a real savings to the property owner. The amount saved is equal to the interest the owner would earn on the conversion costs that are deferred. However, in a world with no time value of money, these savings are immaterial, and may in fact be negative if conversion costs go up during the damage period as a result of inflation.[10] In addition to capital expenditures, the costs of converting to market conditions include the rent loss due to turnover, the rent loss resulting from the Los Angeles City Rent Stabilization Ordinance (LARSO),[11] and leasing costs.

The fifth adjustment, Schedule B(6), reflects the benefits received by the plaintiffs because they were able to borrow money more cheaply under the HUD Earthquake Loan Program (HELP), which is available to owners of HUD-restricted properties. (This amount is small on most properties because the owners could have borrowed the money from the Small Business Administration at 4 percent rather than from HELP at 1 percent.) The final adjustment, Schedule B(7), shows the additional losses that the plaintiffs incurred because they were required to process and reprocess the POAs under ELIHPA and LIHPRHA legislation. For Pico Plaza, these costs came to $27,122. Of all the costs claimed in the damage model, this was the only one that Judge Wilkes C. Robinson omitted, stating that POA processing costs were "unforeseen at the time of contract formation and remote, and as such, are not awardable as consequential damages" (*Cienega Gardens v. United States* 1997, 36).

## The court's opinion and restoration of repayment rights

The issue before the court was the precise measure of damages to which the plaintiffs were entitled. The court previously had held in

[10] A reviewer commented that it was "unhelpful" to criticize the U.S. Court of Federal Claims for not considering the time value of money. The fact that the court does not is important because it leads to distortions in damage calculations. The fourth adjustment in Schedule B(5) leads to a perverse computation; one that should benefit the government because the owners saved money by deferring certain property improvements, but instead benefits the owners because of inflation.

[11] The government argued that the city's rent control ordinance should limit the rents that owners could charge when the properties were converted to market rents. LIHPRHA stated that the properties were not subject to rent control. The plaintiffs argued that vacancy decontrol let owners raise rents to market levels unconstrained by rent control. Subsequent rent increases *then* would be subject to the city's rent control. The judge ruled that since the city's rent control ordinance was enacted after the owners entered into the contracts with HUD, rent control did not affect the rents upon conversion.

its March 25, 1995, opinion on liability, *Cienega Gardens v. United States,* 33 Fed. Cl. 196 (1995), that (1) the plaintiffs established privity of contract between themselves and the government; (2) HUD was authorized to enter into enforceable contracts with the plaintiffs; and (3) the defendant breached its contracts with the plaintiffs.

Judge Robinson's opinion summarizes the contentions of the plaintiffs as follows: The plaintiffs argued that they were entitled to damages of $3,420,864 on the four model properties (of 42 entitled to damages) selected for the court case. They further argued that LARSO does not reduce their damages. In addition, they argued that their damage award should not be reduced as a result of HUD's forced extension of their Section 8 rent subsidization contracts, or be offset by their acceptance of post-POA relief pursuant to HELP (*Cienega Gardens* 1997, 10).

The court states that the "purpose of an award for damages is to 'place the non-breaching party in as good a position as it would have been if the contract had been completely performed and without charging the breaching party with harms that he had no sufficient reason to foresee when the contract was made'" (12).

The opinion discusses the main assumptions in the damage model, including rent levels, vacancy rates, operating expenses, Section 8 Housing Assistance Program (HAP) contracts, HELP, and LARSO.[12]

The court concluded, "Plaintiffs' damages model is comprehensive, reliable, and based on objective verifiable HUD and industry data. In contrast, defendant's economic model is subjective and plagued by admitted errors, material omissions, and incorrect assumptions. Whereas plaintiffs' damages model can easily be applied to the remaining litigation, defendant's model would almost certainly require individualized judgment calls and mire the court and the parties in 38 additional, costly evidentiary and valuation hearings for the non-model plaintiffs in this phase of the case. Accordingly, after careful consideration of the arguments . . . the court adopts plaintiffs' damages model with the limited exceptions discussed *supra,* Section V.C., and concludes that plaintiffs are entitled to damages in the amount of $3,061,107 for the four model properties" (36).[13]

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[12] The court dealt with LARSO by concluding that LARSO "inhibits plaintiff's ability to prepay their existing mortgage balances and to convert their properties to conventional" (30).

[13] The only part of the plaintiffs' claims that the court denied was variable and fixed legal/appraisal costs associated with processing the POAs under ELIHPA and LIHPRHA (33).

On March 28, 1996, President Clinton signed into law the Housing Opportunity Program Extension Act of 1996 (the Extension Act), which specifically permits owners to exercise their contractual right to prepay their mortgages or cancel FHA mortgage insurance. "Owners of eligible low income housing can now elect to: continue LIHPRHA processing to extend the low income affordability restrictions through a sale or a refinancing; (2) do nothing and have existing subsidies continue unchanged; or (3) prepay the mortgage or mortgages, thus terminating the use restrictions imposed by the project regulatory agreement" (Hessel and Sturman 1996, 316). Hessel and Sturman state that the properties most likely to prepay are those that are in good physical condition, require few physical upgrades, are located in markets with low vacancy rates, and have minimal project-based Section 8 assistance.

Congress funded LIHPRHA in fiscal year (FY) 1996, but not in FY 1997 or thereafter. Prepayment thus became the only mechanism for owners to realize the value in their properties.

## MAHRA

The Multifamily Assisted Housing Restructuring and Affordability Act (MAHRA) passed by Congress in October 1997 raises some of the same issues found in ELIHPA. MAHRA addresses the problem of what to do with properties that have above-market rents. MAHRA offers owners of eligible properties the opportunity to restructure their mortgages in a way that allows rents to be consistent with local markets. As noted by Smith (1999), MAHRA eliminates the budget-based formulae for setting above-market rents subsidized by Section 8. Budget-based rents are administratively demanding and often create an adversarial situation between owners and HUD. They also create perverse incentives for owners, since profligacy in operating expenses is rewarded with higher rents. Whenever rents are determined by nonmarket forces, distortions develop over time. Smith estimates that approximately 400,000 of the 900,000 units in the Section 8 inventory have above-market rents.[14]

A number of properties are likely to leave the assisted housing stock as owners exercise their prepayment rights. These properties represent the cream of the housing stock because they are the most

[14] Smith catalogues the reasons that many projects have above-market rents, which primarily result from budget-based rent setting, adjustments that create further inaccuracies over time, and government legislation in 1987 (Section 142(d)) that precluded HUD from lowering rents to correspond with decreases in market rents.

valuable. The properties that remain in the assisted housing stock are, by definition, those for which prepayment was not economically desirable.

The main difference between MAHRA and ELIHPA and LIHPRHA is that MAHRA is voluntary while ELIHPA and LIHPRHA were mandatory. Because ELIHPA violated the Fifth Amendment's takings clause,[15] LIHPRHA was intended to give owners full value. As described in this article, the resulting procedures proved to be very costly and time consuming for all concerned, and led to many lawsuits like the one described here.

Smith points out that the cumbersome process and resulting litigation under LIHPRHA "provided strong impetus to make sure that mark-to-market would never expose the government to takings claims" (Smith 1999, footnote 19). Properties with above-market rents that are not economically feasible without subsidies are MAHRA's primary focus. The main issue affecting program cost is what happens when a property's first mortgage is written down to a level that is supportable by market rents. A "soft second" mortgage is created for the amount of the write-down. The write-downs will cost more in FHA insurance claims, but the soft second mortgages—payable from at least 75 percent of future cash flow—will provide a mechanism for the government's recovery of some of its losses from the initial write downs. The size of the soft second mortgage's claim on future cash flow may prove to be an obstacle to the program's success. If owners have too little incentive to participate in MAHRA because their share of future cash flows is too small, they will be more likely to allow their properties to go into default.

The area in which MAHRA most resembles ELIHPA and LIHPRHA is its complexity. A principal weakness of ELIHPA/LIHPRHA was the time it took to process all of the properties. The workload proved to be too much for HUD. Many resubmissions were required, in fact, because earlier submissions became out of date because of HUD's processing problems. If the recapitalization process under MAHRA becomes bogged down and owners become frustrated trying to satisfy HUD's requirements, MAHRA too may become the subject of litigation.[16]

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[15] "nor shall private property be taken for public purpose without just compensation."

[16] Damages should be much lower than those resulting from ELIHPA because of the above-market rents. However, if the owners have equity built up in the projects resulting from restrictions on annual dividends (such as 6 percent on original equity), it is conceivable that processing problems could lead to sizable damages.

## Implications for housing policy

The long-term fallout from ELIHPA and LIHPRHA is difficult to predict. The arbitrary abrogation of important prepayment rights by Congress sends a signal to housing producers that even contractual rights with the government are subject to change, and that subsequent compensatory mechanisms may be unworkable. This raises the risks associated with government housing programs. Elementary economics tells us that when risks go up, so do the returns required by producers. One would expect housing providers to be more circumspect in the future and to factor into their cost structure the new risk that key contractual provisions such as mortgage prepayment rights might be abrogated.

Another sobering fallout from ELIHPA and LIHPRHA is that many traditional low-income housing developers either have gone out of business or have become very wary about building more low-income housing. Training a new cadre of housing producers is costly and inefficient. To be sure, there seems to be no dearth of developers willing to build housing under the only current housing production program, the Low-Income Housing Tax Credit (LIHTC). Every new government housing program places participants on a new learning curve—one that often requires them to hire expensive consultants to help them understand and meet the requirements. Successful programs tend to be those that have a long enough life span for all of the participants to learn how to use the programs efficiently.

LIHTC illustrates the benefits of longer-term programs. Whereas underwriters were purchasing tax credits for as little as 39 cents per dollar of tax credit in 1992, today the credits often command prices around 80 cents, evidence of the markets' improved understanding of how tax credits work and the risks they carry. Much of the improvement is the result of participants moving up the learning curve and investors becoming more comfortable with the risks associated with tax credits.[17]

ELIHPA and LIHPRHA both represented attempts by Congress to fix inherent inequities in existing subsidized housing programs. One of the most important lessons of ELIHPA and LIHPRHA is the need to structure a program that is less cumbersome. The more a program requires the extensive involvement of high-priced attorneys, accountants, and investment bankers for an owner to participate, the costlier it is to administer, both initially and down the road, when contracts or loans must be extended or modified.

[17] Some of the early difficulties that increased the costs of LIHTC are described in Peiser, Baer, and Fairman (1993).

ELIHPA and LIHPRHA make abundantly clear how shortsightedness in setting housing policy can be costly. Some might argue that the legislation bought low-income tenants a seven-year delay in raising their rents to market levels. If so, the programs imposed that cost on landlords who were continuing to maintain the low-income housing stock. The ensuing litigation points up the problems of placing a cost that should be borne by society as a whole onto a single subgroup.

## Conclusion

Congress's passage of ELIHPA and LIHPRHA adds a sad chapter to the convoluted history of low-income housing in the United States. Although the acts were motivated by the worthwhile objective of preserving low-income housing, Congress's abrogation of the owners' contractual right to prepay the HUD-endorsed mortgages will affect future low-income housing. If Judge Robinson's opinion is sustained on appeal, American taxpayers may face a damage bill on the order of $500 million or more if all the eligible properties caught by the ELIHPA freeze on prepayment file actions similar to *Cienega Gardens.*[18] The only thing they will have to show for the damage bill is a delay in the timing of raising rents on the affected properties.

The real long-term damage lies in how the private sector will react to future attempts by the government to produce low-income housing. If Congress is willing to void contractual rights on which citizens have relied to make investment decisions, then investors are likely to increase their return requirements to account for the additional risk associated with the possible loss of valuable rights. This will raise the cost of many government programs.

Congress should never have passed ELIHPA. It set a terrible precedent by unilaterally canceling a key contractual provision of the original programs, and established an unwieldy mechanism for compensating owners that discouraged many smaller owners from even attempting to receive compensation because the process was so complicated. The entire exercise represents an enormous amount of wasted time, energy, and money. A far better solution would have

[18] A crude calculation of total damages ranges from $350 to $560 million, assuming that a quarter of the affected projects (750) receive damages of $500,000 to $750,000 per property. The *Cienega* damages averaged $765,000 per property. A reviewer commented that this estimate was exaggerated because California property values are comparatively high and only about 350 properties actually have prepaid their mortgages.

provided incentives to owners to voluntarily participate in a program that renewed the below-market rents while enabling them to pull out the equity built up in their projects. Those owners who wanted to convert their properties to market rents should have been allowed to do so as provided by the original agreement. Congress should have anticipated the impending reduction in low-income housing stock long before 1987 and taken steps to address the issue with more thoughtful, nonemergency legislation.

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