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September 14, 2010

VIA ELECTRONIC MAIL AND HAND-DELIVERY

Ms. Carol Galante
Deputy Assistant Secretary
Office of Multifamily Housing
U.S. Department of Housing and Urban Development
451 Seventh Street, S.W., Room 6110
Washington, D.C. 20410

Re: Section 8 Mark-to-Market ("M2M") Surplus Cash Audit Issues

Dear Ms. Galante:

On behalf of the National Leased Housing Association ("NLHA"), the National Affordable Housing Management Association ("NAHMA") and several M2M owners, we are writing to follow-up on your recent discussion with Steve Niles relating to the Surplus Cash audits ("Audits") that have been conducted on behalf of HUD's Office of Affordable Housing Preservation ("OAHP"), with respect to a significant number of M2M projects. We are particularly concerned about certain positions taken by OAHP in connection with the Audits that were spelled out in a letter from Linda Field to Denise Muha, NLHA's Executive Director, dated August 6, 2010 ("Field Letter"). As discussed below, we believe that OAHP's positions are contrary to (1) the applicable statutes, M2M regulations and HUD Handbook provisions, (2) the terms of the restructuring documents executed in connection with the M2M program ("M2M Documents"); and (3) sound and prudent management practices that have been supported by HUD for many years.

The specific issues of concern are as follows:

- OAHP is wrongly requiring M2M project owners to use the project's reserve for replacement account ("Replacement Reserve") to pay for all major repairs and replacements rather than allowing owners to fund some of these expenses from the project's operating account ("Operating Account"). And OAHP is wrongly requiring such project owners to forfeit their Incentive Performance Fees ("IPFs") and Capital Recovery Payments ("CRPs") if they do not refund the cost of any repairs and replacements that were paid for from the project's Operating Account instead of the Replacement Reserve.

- OAHP is wrongly requiring M2M project owners to forfeit their IPFs if an annual payment on the project's Mortgage Restructuring Note ("MR Note") is delayed for even a brief period beyond the "Payment Date" specified in the MR Note.

I. OAHP Cannot Require Owners To Pay For All Major Repairs and Replacements From The Replacement Reserve

HUD has never before had a policy, much less a requirement, that project owners use the Replacement Reserve to pay for all major repairs and replacements. In fact, to the contrary, HUD's Asset Management Handbook 4350.1 REV-1 has long instructed project owners that capital needs may be funded from operating cash flow, as well as other sources, because the Replacement Reserve "will not always be adequate to meet the future capital needs of a project nor is it expected to do so."[1] The HUD Handbook further explains that the Replacement Reserve is intended "to help defray the costs of replacing a project's capital items"[2] and is not intended "to provide for a complete, dollar for dollar, capability of replacing all building structural components and equipment as these wear out but rather to provide a readily available source of capital that will help defray these costs."[3] HUD has instructed project owners to conserve their Replacement Reserve funds so that they will be available for future anticipated and unanticipated project needs. "Judicious use of the [Replacement Reserve] is expected to extend the physical life" of their projects.[4] HUD will not approve expenditures from the Replacement Reserve that cause it to fall below a minimum threshold [$1,000 per unit or a multiple of the monthly deposit] so that adequate funds are available for "an emergency or unforeseen contingency."[5]

The provisions cited above are just a few examples of the fact that HUD has encouraged owners to pay for some major repairs and replacements from the Operating Account, while also directing the owners to pay for "minor" repairs from the Operating Account. Furthermore, HUD itself has recognized that "[t]here has always been some confusion regarding what items are normally considered [minor] repairs, and therefore not eligible for Reserve for Replacement. This is quite often a judgment call."[6] In sum, HUD's policy with respect to use of the Replacement Reserve has been that "[e]ach situation is unique and some flexibility is allowed and necessary to handle situations in a responsible manner."[7]

Now, however, OAHP and its contractors have sought to impose a whole new set of rules relating to use of a project's Replacement Reserve – and they have provided no guidance as to how these new rules are to be reconciled with HUD's long-standing rules and policies governing the Replacement Reserve. Specifically, OAHP and its contractors have cited numerous M2M project owners for using a project's Operating Account, instead of the Replacement Reserve, to pay for some major repair and replacement items. The Field Letter asserts that "the first source of funds for [capital] needs or repairs must be the [Replacement Reserve]." (emphasis added). The items cited as objectionable include not only those which HUD traditionally contemplated as eligible for Replacement Reserve funding but those, such as routine carpet replacement, which

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[1] Asset Management Handbook, Section 4-30.
[2] Id. at Section 4-1 (emphasis added).
[3] Id. at Section 4-8 (emphasis added).
[4] Id. at Section 4-5A (emphasis added).
[5] Id. at Section 4-11; see also HUD Region VIII Reserve for Replacement Guidelines (January 2009).
[6] HUD Region VIII Reserve for Replacement Guidelines (January 2009).
[7] Id.

HUD "traditionally contemplated as ineligible" for Replacement Reserve funding[8] and items that do not clearly fit into either the "eligible" or the "ineligible" category.

OAHP has no legal basis for completely changing HUD's longstanding practices and requiring a M2M project owner to use a project's Replacement Reserve to pay for all major repairs and replacements, and to forfeit the IPF and the CRP if the owner instead uses the Operating Account to fund a portion of such repairs and replacements. Moreover, OAHP's insistence on imposing such a requirement is bad policy. It serves no legitimate interest of HUD and is often contrary to the best interests of a project and its tenants – and to HUD's interest in preserving the property's condition and avoiding a default on the mortgage loans.

A. Mandating Use of the Replacement Reserve To Pay For All Major Repairs and Replacements Is Not Sound Policy

HUD's longstanding policy of encouraging or requiring owners to pay for some major repairs and replacements out of operating funds is sound. Otherwise, some owners might be tempted to over-utilize the Replacement Reserve in order to maximize Surplus Cash available for distribution to the owner. This runs the risk of depleting the project's Replacement Reserve to the point that it is unable to fund future necessary repairs and replacements, particularly ones that are unanticipated. This risk is especially acute in older projects, such as all of the M2M projects. Another reason why a robust Replacement Reserve is desirable stems from HUD's recurrent delays in making Section 8 HAP payments to owners, often because of appropriations delays. HUD on multiple occasions has authorized owners to tap the Replacement Reserve to cover project expenses during periods when HAP payments are delayed. Yet some OAHP officials evidently believe that M2M restructuring transactions alter this set of incentives and risks so that HUD's established policy regarding use of the Replacement Reserve should be completely reversed. This is incorrect.

Under the Multifamily Assisted Housing Reform and Affordability Act of 1997 ("MAHRA"), M2M restructurings provide for Surplus Cash to be used (1) to retire the MR Note, and (2) for distribution to the project owner. Typically, project owners are permitted to keep 25% of the available Surplus Cash, and 75% is used to reduce the balance of the MR Note.[9] If an owner uses the Operating Account to pay for repair and replacement items then (1) the Surplus Cash available for distribution to the owner is thereby reduced, (2) the owner reduces the rate at which its debt under the MR Note is being retired, and (3) the funds in the Replacement Reserve are conserved for the property's future repair and replacement needs. Given that the owner ends up with less cash in its pockets, and more debt on its property, we submit that there is no financial advantage to the owner in taking this approach. Rather, owners do so as a matter of prudent and responsible property management.

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[8] Asset Management Handbook at Sections 4-9.B and 4-11.D
[9] MAHRA Section 517(a)(3).

Some OAHP officials have suggested that project owners seek to "hoard" the Replacement Reserve because a well-funded Reserve allows the owner to receive a higher purchase price upon a sale of the project. We do not dispute that a potential purchaser will look favorably on a project that has a substantial Replacement Reserve – and may be reluctant to purchase a project with an underfunded Replacement Reserve. But, to the extent that operating funds, rather than the Replacement Reserve, have been used to pay for repairs and replacements, the purchaser must pay-off (or assume) a larger MR Note. This will reduce correspondingly the portion of the purchase price received by the seller/owner.

Nor is there any convincing empirical evidence of significant "hoarding" by project owners. Both NLHA and NAHMA have contacted various project owners and management agents in an effort to determine whether the M2M projects are hoarding their Replacement Reserves and thereby reducing payments on the MR Notes. Their findings, thus far, are that the majority of the projects have met or exceeded the payments on their MR Notes projected as part of the M2M restructuring.

In sum, owners of M2M projects have no different set of incentives with respect to the use of the Replacement Reserve than owners of other HUD-regulated projects, nor does HUD face a different set of risks with respect to the use of the Replacement Reserve in such projects. The maintenance of a well-funded Replacement Reserve, over which HUD exercises control, is always in the best interest of the project, its residents and HUD. And owners who are willing to fund repairs and replacements out of operating funds – thereby diminishing the Surplus Cash they can reap – are responsible stewards whose actions should be encouraged, not punished, by HUD.

B. There Is No Legal Basis For Mandating Use of the Replacement Reserve To Pay For All Major Repairs and Replacements

OAHP's mandate that the Replacement Reserve must be used to pay for all major repairs and replacements apparently was first articulated in a November 19, 2007 "Accounting Letter" supposedly addressed to all M2M owners. Evidently OAHP began generating such Accounting Letters in 2004 and all of them now have been posted on HUD's website, although we have been unable to confirm when they were first posted. Both NLHA and NAHMA, two of the largest multifamily industry trade associations (each of which regularly tracks HUD issuances), both advise us that they were not aware of the existence of the Accounting Letters until earlier this year. And the name partner of one of the largest accounting firms in the country handling HUD-regulated projects advised NLHA just last week that he was unaware of the Letters.

The November 19, 2007 Accounting Letter consisted of ten pages of questions and answers relating to M2M and DEMO program issues. Questions 17 and 18 dealt with use of the Replacement Reserve. The answer to Question 17 asserted that it was not acceptable for an owner of a M2M property to absorb repair and replacement expenses from operations. The explanation was that:

> The M2M statute and regulations, and the property-specific M2M underwriting, to which the owner agreed, include a clear intent that the R4R be utilized to meet ongoing major repair and replacement needs. M2M restructurings examine the adequacy of the R4R, typically fund a significant additional deposit at closing, and typically provide for a significantly increased deposit after closing, so that 100% of anticipated 20-year needs can be funded from the R4R. Failure to promptly request R4R reimbursement understates surplus cash, which in turn understates the required payments due to HUD.

And the answer to Question 18 asserted that, "[i]n general, reimbursement from the R4R should be sought for all expenditures for items included in the PCA [Physical Condition Assessment], so long as such reimbursements would not lead to a R4R balance below the 'floor' established in the M2M underwriting."

OAHP's position is devoid of legal support. There is no statute, HUD regulation or M2M Document that requires owners to use exclusively Replacement Reserve funds to pay for all major repairs and replacements. And, as discussed above, HUD's longstanding policy and practice is to the contrary. Significantly, OAHP did not articulate its position until November 2007, some ten years after the passage of MAHRA and seven years after the issuance of the final HUD regulations implementing MAHRA. In seeking to justify OAHP's novel and belated position, the Field Letter cites (1) MAHRA Sections 514(e)(3), 514(e)(5) and 517(a)(3); (2) the HUD regulations at 24 C.F.R. Sections 401.450 to 401.453; and (3) the M2M rider to the regulatory agreement. But none of these provisions provide any support for OAHP's position. OAHP cannot create a new regulation under the guise of interpreting existing statutes or regulations. See Christensen v. Harris County, 529 U.S. 576, 588 (2000).

i. Cited MAHRA Provisions

The three sections of MAHRA cited in the Field Letter provide as follows: (1) Section 514(e)(3) discusses the components of the mortgage restructuring and rental assistance sufficiency plan, and requires the owner to "evaluate the rehabilitation needs of the project, in accordance with [HUD regulations]"; (2) Section 514(e)(5) indicates that the owner is required to "take such actions as may be necessary to rehabilitate, maintain adequate reserves, and to maintain the project in decent, safe and sanitary condition, based on [the HQS] established by HUD"; and (3) Section 517(a)(3) addresses the disposition of "excess project income remaining after payment of all reasonable and necessary operating expenses (including deposits in a reserve for replacement), debt service on the first mortgage and any other expenditures approved by the Secretary."

None of these provisions imposes any requirement on M2M project owners to fund all major repairs and replacements from the Replacement Reserve – or to use the Replacement Reserve "first." To the contrary, Section 517(a)(3) equates deposits to the Replacement Reserve with other operating expenses and Section 514(e)(5) requires the owner to take action to maintain adequate reserves. These provisions support the owner's use of operating funds to pay

for some repair and replacement items because the effect is to maintain the Replacement Reserve at a higher level that is more likely to be adequate for future needs.

ii. Cited M2M Regulations

As for the HUD regulations cited in the Field Letter: (1) Section 401.450 discusses the procedures for the project owner to evaluate the physical condition of its property and requires the owner to identify "the estimated" monthly deposits to the Replacement Reserve for the next 20 years; (2) Section 401.451 discusses the need for the "participating administrative entity" ("PAE") to make an independent evaluation of the physical condition of the project; (3) Section 401.452 addresses the need for the restructuring plan to provide for a level of rehabilitation that restores the property to the standard required by HUD; and (4) Section 401.453 indicates that the restructuring plan must provide for reserves "for capital replacement sufficient to ensure the property's long-term structural integrity" (emphasis added).

None of these regulations indicates that the project owner must pay for all replacement and repair items from the Replacement Reserve. In the first place, the Replacement Reserve is used to fund many items, such as appliances, flooring, cabinets, and drapes, that have nothing to do with the structural integrity of the property. Second, and more basically, the regulations provide for a Replacement Reserve funded based on "estimates" of project needs for the 20-year period after the restructuring. Similar estimates are made in connection with other FHA-insured loans for rehabilitating or refinancing an existing project. There is no suggestion in the regulations that the MAHRA estimate becomes a straightjacket that constrains all spending on the upkeep of the property during the next 20 years. Indeed, when the MAHRA regulations were proposed by HUD, one commenter expressed concern that owners might be incentivized to neglect upkeep of the project in order to reduce expenses and boost distributable Surplus Cash. HUD's response was not that the Replacement Reserve would pay for all necessary project upkeep but, rather, that the project must meet management and physical condition standards as a condition for distributing the owner's portion of net cash flow.[10] Clearly, HUD did not contemplate that all the upkeep of a project would be covered by the Replacement Reserve.

Even OAHP acknowledges that operating funds must sometimes be used to pay for repair and replacement items -- whenever payment out of the Replacement Reserve would result in a balance below the floor established in the M2M underwriting. This underscores the arbitrary and unsupported nature of OAHP's position. Nothing in the regulations mandates that the Replacement Reserve must be used to pay for all major repairs and replacements but only up until the point when the "floor" established in the restructuring is reached. OAHP's position is an edict of its own creation, announced without going through the requisite rule-making process.

[10] 65 Fed. Reg. 15451, 15468 (March 22, 2000).

iii. Regulatory Agreement Rider

The Field Letter also asserts that the "M2M rider to the regulatory agreement" "states that all structural and mechanical needs are to be addressed through the [Replacement Reserve]." (emphasis added). This is simply not so. While the Rider indicates that the project owner should maintain a Replacement Reserve "to cover the cost of major replacements," it never indicates that "all" such needs must be satisfied from the Replacement Reserve – or that the Replacement Reserve must be used first.

C. OAHP Is Enforcing Its Unlawful Position Regarding Use of the Replacement Reserve In An Arbitrary and Unlawful Manner

Earlier this year, MBI, one of OAHP's contractors, sent a letter to a project owner indicating that an expense incurred and paid back in 2007 from the project's Operating Account (in this case, a carpet replacement) should have instead been paid from the Replacement Reserve. MBI said that the owner must "repay [the disallowed amount] immediately from entity funds and submit a request for reimbursement from the Replacement Reserve" or else "the project will be deemed to have not satisfied the preconditions for payment of CRP and IPF for FYE 2009 and any subsequent years thereafter ..." (emphasis added).

This directive is arbitrary and unlawful for several reasons. First, as discussed above, there is no legal requirement that all major repair and replacement items must be paid out of the Replacement Reserve (leaving aside the issue that carpet replacement is usually deemed ineligible for funding from the Replacement Reserve).

Second, MBI's challenge to this expenditure and its proposed remedial action come far too late – 3 years after the expense was incurred. MBI's "remedy" would invalidate the project's financial statements for the year in issue and for successive years as well. Moreover, it would require the owner to repay the disallowed amount with entity funds under circumstances where the owner may well be unable to obtain reimbursement from the Replacement Reserve. HUD normally expects an owner to request such reimbursement within one year after an expenditure is incurred.[11] Given that it is now 2010, the owner cannot satisfy this deadline and it is probable that any request for reimbursement would be denied as untimely by many HUD field offices.

Third, MBI's threat to forfeit the owner's IPF and CRP for fiscal year 2009 and every year thereafter is not only extortionate, but without legal support. There is no statutory provision or regulation that authorizes such a forfeiture. OAHP relies upon the Regulatory Agreement Rider, which requires that owners receiving IPFs and CRPs have made all required payments on the MR Note and not be in default under any of the key governing documents such as the Regulatory Agreement. But the Rider cannot be construed to authorize forfeiture of an owner's IPF and CRP because the owner paid for a repair or replacement out of operating funds rather than the

[11] Asset Management Handbook Section 4-15E; HUD Region VIII Reserve for Replacement Guidelines (January 2009).

Replacement Reserve. The owner's use of the operating funds does not constitute a breach of contract by the owner. The net effect is to reduce the payoff of the MR Note by 75 cents for each dollar spent from operating funds while simultaneously increasing the Replacement Reserve – which is controlled by HUD and serves as security for both mortgages – by one dollar. In short, HUD does not suffer any loss; it comes out ahead. See Restatement (Second) of Contracts § 241 (1981).

II. OAHP Cannot Forfeit An Owner's IPF Based Upon A Delay In Paying the MR Note

OAHP has, in numerous instances, required owners to forfeit their IPFs simply because MR Note payments were made a few days or weeks past the "Payment Date." OAHP asserts that this constitutes a default under the MAHRA Restructuring Loan and disqualifies the owner from receiving the IPF pursuant to the terms of the Regulatory Agreement Rider, Section 7b. This issue is particularly disturbing (and galling) to owners given that, on many occasions, HUD has made Section 8 HAP payments to these owners that were three, four, five or more months late! Indeed, sometimes HUD's delay in making HAP payments has prevented owners from paying the MR Note when due.

Leaving aside the inequity of OAHP's position, it is legally insupportable. HUD's form MR Note indicates that payments are due on each "Payment Date," which is "ten (10) days after the date that the project's annual financial statements are due to HUD." See Section A(2)(b). The Note further provides that "[i]n the event that any payment or part of any payment due under this Mortgage Restructuring Note becomes delinquent for more than fifteen (15) days, there shall be due ... a late charge in an amount equal to two percent (2%) of the Payment Amount so delinquent." See Section G. The Note does not provide that a late payment constitutes a default. In fact, neither the MR Note, the Regulatory Agreement Rider, nor any of the other M2M Documents defines the term "default." And "performance dates are by their nature accessory rather than central aspects of most contracts." Sahadi v. Continental Illinois National Bank, 706 F.2d 193, 198 (7th Cir. 1983).

Moreover, even if failure to pay the MR Note can become a default, it would require HUD to go through the steps necessary to declare a default. The HUD form Regulatory Agreement clearly indicates that HUD will provide 30 days' prior written notice of any violation thereunder by registered or certified mail.[12] Based upon the information provided to us, the requisite notices were not provided by HUD to many (and perhaps all) of the owners alleged to be in default on their MR Note payments. In fact, in many instances, the first (and only) notices received by the owners were letters from MBI that were sent several years after the MR Note payments had been made. Further, while the HUD form Regulatory Agreement indicates that HUD can "declare a default" after the permitted notice has been provided and the 30 day cure period has expired,"[13] even then, a default can be cured by making the overdue payment (and any

[12] HUD Regulatory Agreement for Insured Multifamily Housing Projects, HUD-92465, Section 14.
[13] Likewise HUD regulations, in the context of insured loans, have long recognized a "30 days grace period." See 24 C.F.R. Section 207.256.

applicable late charge). Both the HUD form Mortgage and the Regulatory Agreement Rider provide that the owner is permitted 30 days to cure any default before any acceleration on the MR Note will occur.

The Regulatory Agreement Rider provides that the IPF is payable if "there are no outstanding sums due" and "there is no default under the Regulatory Agreement" (emphasis added). There is no language in either the MR Note or the Regulatory Agreement Rider which provides that a late payment or any other default, if cured, is deemed to be a continuing default. Neither HUD nor its contractors can unilaterally revise the terms of HUD's own contracts after such contracts have been executed.

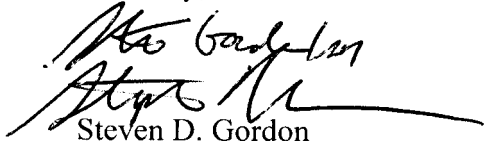
In fact, some owners believed that the Regulatory Agreement Rider requires them to wait at least 60 days after the Payment Date before making payment in order to see if HUD has any objection to the payment of the IPF and the related Surplus Cash calculation, which also determines the amount of the MR Note payment. The Rider provides that "HUD will be deemed to have concluded that the [IPF can be paid] ... if HUD has failed, within 60 days after HUD's receipt of the Owner's annual financial statement, to object to the payment of the ... [IPF]."

Because all of the relevant documents were drafted by HUD – the MR Note, the Regulatory Agreement Rider, and the other M2M Documents -- any ambiguities in them will be resolved in favor of the owners. See United States v. Schlesinger, 88 F.Supp.2d 431, 441-42 (D. Md. 2000). Moreover, in construing contracts, "ordinarily there is some period of time ... [in which] a party may cure his failure [to perform]." Restatement (Second) of Contracts § 242 cmt. a (1981). A delay of 30-60 days in making a mortgage payment will not be deemed a material breach under the circumstances here. Id. § 241. And a court will not impose a disproportionate forfeiture, such as loss of the IPF, simply because the owner was tardy in making payment. Id. § 229.

III. Conclusion

Thank you in advance for your serious consideration of this matter. We hope that it can be resolved amicably and constructively, rather than through resort to litigation. If you have any questions or need any additional information, please do not hesitate to contact either of us.

Sincerely,



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