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## Navigating Recent Challenges in the Regulation of Affordable Housing by the Office of Multifamily Housing, U.S. Department of Housing and Urban Development

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**NAVIGATING RECENT CHALLENGES IN THE REGULATION OF  
AFFORDABLE HOUSING BY THE OFFICE OF MULTIFAMILY  
HOUSING, U.S. DEPARTMENT OF HOUSING AND URBAN  
DEVELOPMENT**

LISA A. TUNICK\*

The United States Department of Housing and Urban Development (hereinafter “HUD”) is a unique federal agency tasked with sometimes conflicting responsibilities. HUD operates as a broad regulatory body, overseeing housing programs and federal housing rights; it also functions at a very micro level, providing retail services to owners, operators and residents of individual properties. As such, HUD is a party to numerous contracts that are subject to one body of law. At the other end of the spectrum, HUD promulgates rules governing regulatory policy. In addition, even the courts that adjudicate these disputes are different. Thus, at times, it can be difficult to tell in what capacity HUD is functioning. Discerning whether HUD actions have contractual or regulatory impacts (or both) can be quite complex. To further complicate matters, HUD is subject to a difficult environment, as it faces pressure from Congress, the Office of Management and Budget (hereinafter “OMB”), shifting political priorities, staff shortages, and a lack of experience and expertise associated with staffing issues.

This article focuses on the current regulatory environment posed by the HUD Office of Multifamily Housing (hereinafter “MFH”), charged with the oversight and regulatory compliance of nearly 17,000 properties<sup>1</sup> providing multifamily<sup>2</sup> housing for households with income levels that range from

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\* The author is a Principal with the law firm of Hessel and Aluise, P.C. An overview of this article was presented at the joint conference of the American Bar Association Commission on Homelessness and Poverty and the St. Louis University School of Law, “Creating Healthy Communities: Ending Homelessness Symposium,” hosted by the Saint Louis University Public Law Review. The views expressed in this article are not necessarily those of Hessel and Aluise, P.C.

1. See HUD Website, available at <http://www.hud.gov/offices/hsg/mfh/exp/mfhdiscl.cfm#instruct> (follow “Database as of 01/08/2007” hyperlink and download instructions) (last visited Jan. 20, 2007).

2. HUD multifamily housing is generally defined as properties with five or more residential units. 24 C.F.R. § 200.215(f)(1) (2006).

extremely low-income to moderate-income.<sup>3</sup> This article also discusses some of the challenges of operating within this environment. While owners and management agents are the most directly affected by these issues, there is an inevitable effect on the residents they house, as proprietors struggle to provide good quality housing with diminishing resources amid shifting policies.

## I. INTRODUCTION

As the cost of housing continues to grow relative to income, especially at the lower ranges of the affordability spectrum, the demand for reasonably priced housing persists in outstripping the available supply.<sup>4</sup> Stagnating wages in relation to rising housing and utility costs continue to put low-income families at a distinct disadvantage, and elderly households on fixed incomes particularly are at risk.<sup>5</sup> These factors are further complicated by the steady decline in the stock of available housing that is affordable to low-income renters.<sup>6</sup>

Rental stock losses are concentrated at the lower end of the cost range as many of the older, more distressed properties have left the inventory but have not been replaced.<sup>7</sup> Rising operating costs, a trend towards prepayment of FHA-insured mortgages and the opportunity to put properties to a more profitable use, triggered a number of “opt outs” of HUD programs<sup>8</sup> and

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3. Extremely low-income families are defined as families whose annual income is less than 30% of area median income (AMI), and low income families' annual income does not exceed 80% of AMI. U.S. Housing Act of 1937 § 3, 42 U.S.C. § 1437a (2006); 24 C.F.R. § 5.603 (2006). The definitions for very-low income (generally less than 50% of AMI) and moderate income (generally less than 95% of AMI) families are not as clearly defined, and vary depending upon the type of housing assistance program. *See, e.g.*, Sections 221(d)(3) and (d)(5) of the National Housing Act (12 U.S.C. § 17151(d)(3) and (d)(5) (2006)) governing Below Market Interest Rate (BMIR) mortgages affordable to residents earning no more than 95% of AMI, and Section 236 of the National Housing Act (12 U.S.C. § 1715z-1 (2006)), where eligibility is limited to low-income families, as well as HUD tabulations of various income standards, FY 2002, HUD Income Limits Briefing Material, *available at* <http://www.huduser.org/DATASETS/il/fmr02/briefing02.pdf> (last visited Jan. 20, 2007).

4. Joint Center for Housing Studies of Harvard University, *The State of the Nation's Housing 2006*, 1 (2006).

5. Joint Center for Housing Studies of Harvard University, *America's Rental Housing: Homes for a Diverse Nation*, 3 (2006) [hereinafter JCHS Rental Housing Study].

6. DANILO PELLETIERE, THE RENTAL HOUSING AFFORDABILITY GAP: COMPARISON OF 2001 AND 2003 AMERICAN HOUSING SURVEYS, NATIONAL LOW INCOME HOUSING COALITION 5-6 (2006).

7. JCHS Rental Housing Study, *supra* note 5, at 22.

8. The HUD programs focused upon in this article are those that receive project-based assistance, including mortgages insured by the Federal Housing Administration (FHA) and rental assistance issued pursuant to Section 8 of the U.S. Housing Act of 1937 (42 U.S.C. § 1437f (2006)) that is specifically tied to a particular property (project-based Section 8 and project-based vouchers), but does not include Section 8 tenant-based vouchers that are portable and, for the

contributed to additional losses in affordable stock.<sup>9</sup> With a large number of HUD-insured properties nearing the end of their forty-year mortgage terms, as many as 1,800 subsidized properties (comprising nearly 200,000 units) could be lost over the next ten years.<sup>10</sup>

There are a number of reasons for these shifts, most notably the movement away from pro-development policies, as evidenced in the Presidential budget priorities and the appropriations passed by Congress.<sup>11</sup> Presently, the Internal Revenue Service's 1986 Low-Income Housing Tax Credit (hereinafter "LIHTC") program is the primary proactive federal program (albeit, a form of indirect assistance), which is adding a significant quantity of affordable rental housing units to the supply of multifamily housing.<sup>12</sup>

As a result, the emphasis, by default, must fall to attempting to maintain and preserve the existing supply of affordable housing. This has always been a challenging endeavor but is even more so given the ever shrinking federal budgets that are allocated for housing needs.<sup>13</sup> This leads to increasing pressures to preserve the quality of the existing portfolio at the least expense to the government. The unintended consequence of these actions is the creation of a difficult regulatory environment, which tends to drive up the cost of doing business with HUD. As the costs rise,<sup>14</sup> the number of affordable properties falls, as project owners increasingly opt out of HUD programs.

HUD staff are hard pressed to cope with these difficulties. Since at least 1995, HUD has been under pressure to outsource many functions to the private sector, only to realize minimal cost and time savings. As a result, a private bureaucracy made up of contract administrators, inspectors, and other third

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most part, may be moved from property to property, and are subject to different regulatory requirements.

9. JCHS Rental Housing Study, *supra* note 5, at 21.

10. *Id.*

11. There are only a limited number of active federal multifamily housing production programs: HOPE VI, a 1990's program intended to revitalize public housing and deconcentrate poverty; HUD's Section 202 and 811 programs, focusing on housing for the elderly and disabled; certain Rural Development programs of the Department of Agriculture; and military housing. *See* United States Housing Act of 1937, 42 U.S.C. § 1437v (2006); The Housing Act of 1959, 12 U.S.C. § 1701q (2006); The National Housing Affordable Housing Act of 1990, 42 U.S.C. § 8013 (2006).

12. Andre Shashaty, *Tax Credits at 20: A Tale of Survival*, in AFFORDABLE HOUSING FINANCE: TAX CREDIT 20TH ANNIVERSARY SUPPLEMENT 6, 12 (2006); OFFICE OF POLICY DEVELOPMENT AND RESEARCH, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, UPDATING THE LOW-INCOME HOUSING TAX CREDIT (LIHTC) DATABASE: PROJECTS PLACED IN SERVICE THROUGH 2003 2 (2006), available at <http://www.huduser.org/Datasets/lihtc/report9503.pdf> (last visited Jan. 20, 2007).

13. CUSHING N. DOLBEARE ET AL., CHANGING PRIORITIES: THE FEDERAL BUDGET AND HOUSING ASSISTANCE 1976-2005, NATIONAL LOW INCOME HOUSING COALITION 4-6 (2004).

14. Both direct (out of pocket expenses) and indirect (the time factors and paper work associated with HUD program participation) costs are rising.

parties, has sprung up. This essentially created another layer between HUD, the regulator, and the owners and property managers. Furthermore, the pressures of assisting the Gulf Coast in rebounding from the effects of Hurricanes Katrina and Rita have placed additional strain on the HUD workforce, which was already stretched to its limit before the 2005 storms.

The net effect of this convergence of issues has been the creation of a challenging regulatory environment for those who are regulated by MFH. Some of the problems that housing providers must grapple with include lowering income targets and implementing other new requirements without opportunity for notice and comment, ambiguous regulatory language, restrictive interpretations of HUD regulations, and directives issued outside of formal rulemaking channels. Many of these actions would appear to violate the Administrative Procedures Act (APA), which requires openness in the rulemaking process.<sup>15</sup>

## II. REGULATORY PRACTICES THAT DEPART FROM THE SAFEGUARDS OF THE ADMINISTRATIVE PROCEDURES ACT

The APA requires that government agencies adopt a two-stage notice and comment publication process when implementing new regulations.<sup>16</sup> The first publication of the proposed or interim rule in the Federal Register is intended to inform the general public of a proposed new policy and invites comments on the regulations.<sup>17</sup> Following receipt of any comments, the government agency is required to respond to these comments and may alter the proposed rule to eliminate any inconsistencies.<sup>18</sup> In some cases, proposed rules may be withdrawn following receipt and consideration of the public comments.<sup>19</sup>

After consideration of and response to the public comments received, the regulation is re-issued along with commentary discussing the public comments submitted and the agency's interpretation and treatment of the comments.<sup>20</sup> Issuance of the agency's responses to the public comments and re-issuance of the regulation is considered to be the final rule, which generally goes into effect thirty days following publication in the Federal Register.<sup>21</sup> In no event is the regulation supposed to be changed substantively at the final rulemaking stage.

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15. *See* 5 U.S.C. §§ 553(b)-(c) (2006).

16. *Id.*

17. *Id.*

18. *Id.* at § 553(c).

19. *Id.*

20. *Id.*

21. 5 U.S.C. § 553(d).

A. *Significant Changes Implemented at Final Rule Stage Without Adequate Provision for Public Comment*

HUD may have violated the above requirements of the APA when it published the final rule for the Project Based Section 8 Voucher program on October 13, 2005.<sup>22</sup> The Project Based Section 8 Voucher (hereinafter “PBV”) program was first authorized under Section 545 of the Quality Housing and Work Responsibility Act of 1998 and merged the Section 8 certificate and voucher programs into a single initiative.<sup>23</sup> Because of the need to rely on a number of subsidies to fund development,<sup>24</sup> a change in one program may increase reliance on other funding sources. This is the case with the changes to the PBV program.

The final PBV rule departed significantly from the proposed rule, as well as established policy, which permitted Section 8 contract rents to equal market rates. The final rule, however, which was issued without benefit of notice and comment, applied a new ‘lesser of’ test to the rents, and, thus, limited the contract rents on LIHTC projects to the lower of 110% of HUD fair market rents (FMRs) or the LIHTC rents.<sup>25</sup> In high cost markets and/or where FMRs exceed LIHTC rents, the new restrictions essentially eliminate the ability to leverage Section 8 funds in order to enhance financing, which undermines many properties’ financial feasibility.

In addition to the apparent departure from standard rulemaking, the previously unannounced policy shift caused a huge disruption in the industry as it was unclear whether the final rule affected all projects currently in the financing pipeline or only those that were yet to be submitted. After some discussion, HUD ruled that only prospective deals were affected, but this does not address the irregularities in the rulemaking process itself.<sup>26</sup> During the 109th Congress, there was legislation pending to reverse the PBV policy implemented at final rulemaking stage without notice or comment.<sup>27</sup> It is expected that this initiative will be revisited during the next Session.

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22. Project-Based Voucher Program, 70 Fed. Reg. 59,892 (Oct. 13, 2005) (to be codified at 24 C.F.R. pt. 983).

23. See 42 U.S.C. § 1437, *et seq.* (2006).

24. See generally *The Best of 2005-2006*, AFFORDABLE HOUSING FINANCE (2006) (featuring thirty-two properties contending for the 2nd Annual Reader’s Choice Award for the Nation’s Best Affordable Housing Development.) On average, a minimum of five funding sources tend to be leveraged to provide the financing necessary for these developments. *Id.*

25. Project-Based Voucher Program, 70 Fed. Reg. at 59,896. The only exception to the new ‘lesser of’ rent policy is for properties located within Qualified Census Tracts. *Id.*

26. *Id.*

27. The Section 8 Voucher Reform Act of 2006, H.R. 5443, 109th Cong. (2006) (received Committee approval on June 14, 2006); S. Res. 3535, 109th Cong. (2006).

*B. Occasionally HUD Will Modify Its Procedures and Regulations, but Typically the Changes Come Too Late or Do Not Go Far Enough to Correct Problematic Policies*

Another example of adopting policies that depart significantly from established procedures is the August 2004 publication of the Revised Multifamily Accelerated Processing (MAP) closing documents.<sup>28</sup> HUD desires to bring these documents up-to-date and to enhance tools for fighting fraud.<sup>29</sup> However, far reaching changes were proposed to the documents, including an attempt to impose personal liability on both the borrower and the principals involved in an FHA-insured project.<sup>30</sup> Publication of the proposed documents unleashed a groundswell of industry protest primarily because HUD already possesses significant enforcement tools intended to address fraud and failures to abide by the regulatory requirements.<sup>31</sup>

Recently, HUD published a notice responding in part to the concerns raised by the commentators and announced a meeting to update stakeholders on the status of the document revision process.<sup>32</sup> In the notice, HUD justified its attempt to proceed to the final document stage with only limited public comment on the basis that “informal” comments had been solicited and received on a HUD website in 2000.<sup>33</sup> However, such publication does not comport with the requirements of the APA. It appears that some concessions to the public comments have been made, such as elimination of the proposed recourse provisions in the loan documents, and sufficient time will be allotted for the industry to adopt the new documents.<sup>34</sup> Nevertheless, HUD has indicated that it intends to continue to produce final closing documents without any further notice or comment.<sup>35</sup>

The above is a good example of HUD’s dual role as both a party to contracts and a regulator. The MAP issue raises additional questions about how published contracts might limit HUD’s ability to be flexible as conditions change and require modification. No doubt, the MAP document revisions will remain a closely watched issue for some time to come.

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28. HUD Multifamily Rental Projects and Health Care Facilities: Regulatory Revisions, 69 Fed. Reg. 46,210 (Aug. 2, 2004) (to be codified at 24 C.F.R. pts. 200, 207, 232) (proposed Aug. 2, 2004).

29. *Id.*

30. *Id.*

31. See 24 C.F.R. §§ 24.600, 24.700 (2006) (governing debarment and suspension activities).

32. HUD Multifamily Rental Project and Health Care Facility Closing Documents; Status on Finalizing Closing Documents and Announcement of Meeting, 71 Fed. Reg. 51,842 (Aug. 31, 2006).

33. 71 Fed. Reg. at 51,843.

34. *Id.*

35. *Id.*

In another action, HUD recently modified the methodology used to calculate FMRs. Effective for the Fiscal Year 2006 FMRs, HUD instituted limited safeguards to protect against substantial changes in rent levels from year to year.<sup>36</sup> This modification followed two years of strenuous objections to the integration of new Census Bureau county definitions without allowance for the distortions in rents wrought by the geographic area changes.<sup>37</sup> However, in the Section 8 Moderate Rehabilitation program, program rents are set by statute to the lowest of comparable market rents, the FMRs, or current rents adjusted by an Operating Cost Adjustment Factor (hereinafter "OCAF").<sup>38</sup> Because FMRs have been very low in many areas for a number of years, in many cases, the program rents have already been reset to levels too low to support project operations. As a result, many properties are on the brink of failure as they struggle to meet debt service payments and operating costs with significantly lower rents. This is particularly evident in the Section 8 Moderate Rehabilitation program, where many properties have opted out of the program with many more expected to follow. Absent a statutory change permitting retroactive adjustments, the recent correction to the Fiscal Year 2006 FMRs will not benefit these properties.

### III. POLICY CHANGES THAT FALL OUTSIDE OF THE FORMAL RULEMAKING PROCESS

Discerning all of the various requirements imposed upon program participants is a daunting task, particularly given MFH's reliance on the issuance of notices and handbooks and even emails, in some cases, that elaborate upon the regulations. In some instances, the new guidance departs from or goes beyond the published regulations. These issues play out in a variety of ways.

#### A. *Real Estate Assessment Center Physical Inspections and the Challenging Appeals Process*

The Real Estate Assessment Center (hereinafter "REAC") is charged with assessing the physical condition and financial fitness of more than 20,000

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36. Proposed Fair Market Rents for Fiscal Year 2006 for Housing Choice Voucher, Moderate Rehabilitation Single Room Occupancy and Certain Other HUD Programs, 70 Fed. Reg. 32,402, 32,402-03 (Jun. 2, 2005) (Proposed Rule implemented as Final Rule at 70 Fed. Reg. 57654 (Oct. 3, 2005)).

37. Fair Market Rents for the Housing Choice Voucher Program and Moderate Rehabilitation Single Room Occupancy Program Fiscal Year 2005, 69 Fed. Reg. 59,004, 59,008-09 (Oct. 1, 2004); Final Fair Market Rents for the Housing Choice Voucher Program and Moderate Rehabilitation Single Room Occupancy Program for Fiscal Year 2006, 70 Fed. Reg. 47,654, 57,656-58 (Oct. 3, 2005).

38. Multifamily Assisted Housing Reform and Affordability Act of 1997, 42 U.S.C. § 1437f (2000) [hereinafter MAHRA].



multifamily projects.<sup>39</sup> The regulations pertaining to the physical condition requirements are general in nature; therefore, REAC has promulgated a number of directives that set forth the relevant requirements.<sup>40</sup> Because of the nature of the evaluative process and the fact that every REAC deficiency definition must be programmed into the REAC software, modifying the definitions is a difficult task. In fact, following a Congressional mandate to evaluate the REAC system for accuracy and eliminate inconsistencies between inspections,<sup>41</sup> REAC published proposed changes to forty-seven deficiency definitions in March of 2004,<sup>42</sup> but these changes have yet to be implemented.

Keeping abreast of the physical requirements and having the requisite knowledge of the inspection process to determine if an inspector is following the inspection protocol can be difficult. Unfortunately, from time to time, inspectors fail to exercise discretion in the citation of physical condition deficiencies, and in some rare instances, appear deliberately to manipulate the inspection process in order to penalize a property. This is the human element that REAC has taken great pains to guard against by attempting to create an objective framework. However, with nearly 700 possible citations that could be noted during a given physical inspection,<sup>43</sup> it is virtually impossible to remove all subjectivity from the inspection process.

Recognizing that things can and do go wrong with how an inspection is conducted, REAC instituted an appeals process.<sup>44</sup> The regulations squarely

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39. See U.S. Department of Housing and Urban Development, Real Estate Assessment Center—Physical Inspection, *available at* <http://www.hud.gov/offices/reac/products/prodpass.cfm> (last visited Jan. 20, 2007); U.S. Department of Housing and Urban Development, Real Estate Assessment Center—Financial Assessment of Multifamily Housing, *available at* <http://www.hud.gov/offices/reac/products/prodmf.cfm> (last visited Jan. 20, 2007).

40. Perhaps the most commonly known REAC directive is the Dictionary of Deficiency Definitions (“REAC Dictionary”), which sets forth nearly 250 possible deficiencies, most of which may be cited in any of three levels of severity. U.S. Department of Housing and Urban Development, Real Estate Assessment Center—Physical Inspection Library, *available at* [http://www.hud.gov/offices/reac/library/lib\\_phyi.cfm#HANDBOOKS](http://www.hud.gov/offices/reac/library/lib_phyi.cfm#HANDBOOKS) (last visited Jan. 20, 2007) [hereinafter REAC Dictionary of Deficiency Definitions]. This works out to approximately 700 possible citations that may be noted during an average REAC inspection. *Id.* Changes to the REAC Dictionary were originally issued as Inspector Notices, and as these grew in number, REAC issued the REAC Compilation Bulletin, which includes nearly ninety clarifications to the REAC Dictionary, some of which have many subparts. *Id.* In addition, REAC continues to issue periodic Inspector Notices that focus on particular issues requiring additional clarification or changes in inspection policy. *Id.* For further information on the REAC Dictionary of Deficiency Definitions see *id.*

41. H.R. REP. NO. 106-988, at 69 (2000) (Conf. Rep.).

42. Public Housing Assessment System, Physical Condition Inspection Proposed Changes to the Dictionary of Deficiency Definitions, 69 Fed. Reg. 12,474 (Mar. 16, 2004).

43. See REAC Dictionary of Deficiency Definitions, *supra* note 40.

44. There are two types of REAC appeals. Technical Reviews may be requested to challenge instances where inspector error is at issue, and requests for a Database Adjustment may

place the burden of providing “objective and verifiable proof” that an error has occurred on the owner or management agent;<sup>45</sup> however, REAC has only loosely defined what constitutes such proof.<sup>46</sup> In general, we understand that third party documentation from an independent source should satisfy this standard, but we have seen REAC reject such evidence on what appear to be arbitrary bases. In such cases, property owners’ appeals are denied fair consideration. Given that HUD has a policy of instituting foreclosure proceedings and/or abating Section 8 payments following receipt of two consecutive failing REAC scores, the lack of an adequate appeals process raises serious due process concerns.

*B. Real Estate Assessment Center Financial Assessments and the Secrecy Surrounding Some of the Evaluative Criteria*

The other main role that REAC performs for MFH is assessing the financial soundness of multifamily housing developments and their ownership structures.<sup>47</sup> In order to apprise project owners of their reporting obligations and outline the financial data subject to evaluation, REAC has issued a comprehensive industry user guide.<sup>48</sup>

It appears that during 2004, HUD adopted a new financial evaluation tool known as a “performance designation,” and properties may be rated as “green” for “financially healthy,” “yellow” for “potentially troubled,” or “red” for “troubled.”<sup>49</sup> Interestingly and disturbingly, HUD is unwilling to clarify how these designations are determined. The FASSUB Industry User Guide specifically states that “the overall performance ratings are an internal asset management tool used to identify potential financial performance weaknesses. [HUD Project Managers] *are not authorized to release* performance ratings (i.e. red, yellow, or green) outside HUD.”<sup>50</sup>

By shrouding the criteria used to arrive at a property’s performance designation, HUD deprives project owners of information necessary to avoid running afoul of compliance requirements.<sup>51</sup> This raises additional concerns,

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be made for those instances that are outside of the control of the owner, such as zoning requirements. 24 C.F.R. § 200.857(d)-(e) (2006).

45. 24 C.F.R. § 200.857(d)(2) (2006).

46. *Id.*

47. See Industry User Guide for Financial Assessment Subsystem- Multifamily Housing (“FASSUB”), version 6.0, issued June 22, 2004, available at [http://www.hud.gov/offices/reac/products/PDFs/finl\\_memo\\_2004\\_1a.pdf](http://www.hud.gov/offices/reac/products/PDFs/finl_memo_2004_1a.pdf) (last visited Jan. 20, 2007).

48. *Id.*

49. *Id.* at 10.

50. *Id.* at 10-11 (emphasis in original).

51. On April 25, 2005, I filed a Freedom of Information Act (FOIA) request for clarification of the criteria used to develop the FASSUB performance indicators. The limited information that HUD supplied on June 13, 2005 indicated that REAC is evaluating various cost and expense ratios in reaching these performance designations; however, HUD did not disclose how these

because compliance deficiencies may result in a “flag,” which may affect an owner’s ability to participate in HUD programs. Thus, the secretive performance designations also raise due process concerns.

*C. Significant Policy Departures from Published Regulations*

Since at least 2000, HUD has sought to implement a system capable of electronically processing requests by “principals”<sup>52</sup> to participate in multifamily housing programs.<sup>53</sup> Up until recently, all requests to participate in HUD programs were documented on paper Form HUD-2530<sup>54</sup> and filed with the local field office. The 2530 forms were reviewed by hand - a time-consuming process that involved checking participants’ names and social security numbers against internal and external databases to determine if the proposed participant may pose a risk to the Department’s programs. Because of the non-integrated nature of the review process, significant delays occurred and threatened to hold up closings or corporate restructuring activities.

The computer system that replaced paper 2530 processing, and is intended to share information about participants across the entire Federal government, is known as the Active Partners Performance System, or “APPS.” On June 18, 2003, HUD published proposed regulations describing the scope of APPS and notified interested parties that the Department intended to roll out the system swiftly.<sup>55</sup> Following a number of programming glitches and nearly two years later, HUD issued final APPS regulations on April 13, 2005.<sup>56</sup>

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ratios relate to the indicators themselves. I appealed HUD’s partially responsive reply on June 23, 2005, and was informed by the Deputy General Counsel on January 11, 2006 that additional responsive documentation existed that should have been shared with me. Presently, my FOIA request remains open, as I have yet to receive the additional information promised.

52. A principal is defined as “an individual, joint venture, partnership, corporation, trust, nonprofit association, or any other public or private entity proposing to participate . . . in a project as a sponsor, Turnkey Developer, management agent, nursing home administrator or operator, packager or consultant . . .” 24 C.F.R. § 200.215 (e) (2006). The term also includes affiliates of a principal. *Id.* In a partnership, the general partner and any limited partner with a 25% or greater interest in the partnership are considered to be principals. *Id.* In a corporation, all executive officers, directors, and any stockholders with a 10% or greater interest in the corporation are considered to be principals. *Id.*

53. The programs subject to the clearance requirements include projects with mortgages insured under the National Housing Act, projects financed pursuant to Section 202 of the Housing Act of 1959, sales of projects by the Secretary, and projects where 20% or more of the units receive certain subsidies, including interest reduction payments under Section 236 of the National Housing Act, Rent Supplement payments under Section 101 of the Housing and Urban Development Act of 1965, Housing Assistance Payments under Section 8 of the United States Housing Act of 1937. 24 C.F.R. § 200.213 (2006).

54. Such processing is referred to colloquially as “2530 clearance” or simply “2530.”

55. *See* 68 Fed. Reg. 36,752 (Jun. 18, 2003).

56. Revised Guidelines for Previous Participation Certification, 70 Fed. Reg. 19,660 (Apr. 13, 2005) (codified at 24 C.F.R. pt. 200).

In order to give participants time to register with the APPS system and input the organizational structure of participating entities (the “baseline”), the effective date for adoption of electronic submission and processing was delayed for six months until October 11, 2005.<sup>57</sup> Due to challenges that participants experienced in registering with the system and inputting their baseline data, HUD extended this deadline a number of times. During this period, HUD continued to make changes and improvements to the software as it was readied for implementation. Finally, on July 1, 2006, the electronic APPS system was fully implemented, and paper filings of 2530 applications were no longer accepted.<sup>58</sup>

However, one of the software changes implemented in August 2005 not only contradicts the current regulations but also runs contrary to standard and traditional business practices. Without notice, APPS failed to recognize entities without a natural person in an organization.<sup>59</sup> Thus, for example, a limited liability company whose sole member is a corporation would be unable to enter data into the APPS system because it lacks an individual necessary to satisfy HUD’s requirements.<sup>60</sup>

As of August 2005, APPS required the identification of a “Key Principal” for those entities that lack a natural person in each organizational tier. Since APPS was intended to drill down through the ownership structure and identify and evaluate all principals, arguably there should be no need to identify a “Key Principal” at every level. HUD has not formally defined “Key Principal,” which leaves open for interpretation questions of what obligations the designees have and what risks or liabilities they may face for serving in this capacity. Furthermore, the creation of the “Key Principal” requirement essentially forces all who sign and certify as to the submission’s accuracy to falsely certify, because not all organizations contain a natural person. In short, it appears that HUD exceeded its authority in requiring the designation of a “Key Principal” who must be a natural person.

The multifamily industry strongly objected to the new requirement particularly because organizations that had been accepted into APPS prior to

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57. 70 Fed. Reg. at 19,662.

58. Memorandum from Brian D. Montgomery, Assistant Secretary of Housing - Federal Housing Commissioner, U.S. Department of Housing and Urban Development (Apr. 31, 2006), available at <http://www.hud.gov/utilities/intercept.cfm?offices/hsg/mfh/apps/e-filingext.pdf> (last visited Jan. 20, 2007).

59. See Active Partners Performance System Industry User’s Guide, 12-2, 13-6 (2006), available at <http://www.hud.gov/offices/hsg/mfh/apps/wappsqrq.pdf> (last visited Jan. 20, 2007).

60. In order to satisfy this requirement, a corporate entity must identify a “Key Principal.” This is confusing for a number of reasons. First, HUD has not formally defined this term, but it is suspected that this is HUD’s way of asking for a contact person for the corporate entity. Second, the term “Key Principal” means something completely different in the Fannie Mae context, and very likely would confuse a participant who is regulated by both bodies.

the August 2005 software change were later rejected for failing to include a “Key Principal.” Requests for clarification of the need for the new requirement were not adequately addressed, although we understand that proposed regulations are under development.

*D. Undercutting 2530 Approvals with the “Business Reasons” Rationale*

Embedded in the participation review regulations is a brief provision that cautions that obtaining 2530 approval to participate in HUD programs “does not obligate the Department to approve the principal’s applications or contracts for program participation.”<sup>61</sup> On occasion, we have become aware of a participant that has received approval to participate in a HUD program but whose application to manage a property, for example, has been denied for “other business reasons.” All too frequently, the “other business reasons” for the denial are not adequately explained to the participant.

In essence, these actions amount to a denial of 2530 participation and may amount to a deprivation of the due process rights of the participant. Furthermore, the amorphous “other business reasons” rationale is likely void for vagueness. In the end, these decisions are difficult to challenge. Participants, who may have waged a hard-fought battle to obtain 2530 clearance in the first place, may lack the resources to challenge program level denials based on “business reasons.” In addition, those who may have the resources to fight such a determination frequently refrain from pursuing legal remedies for fear of retaliation. HUD should cease in allowing such end runs around 2530 clearance to take place.

*E. When Implementing Policy, There Is a Heavy-Reliance on Handbooks and Notices, Which Are Rarely Subject to Public Comment and Do Not Carry the Force of Law*

It is common knowledge that getting a regulation through a federal agency’s internal clearance process, as well as that of OMB, takes significant time and effort. As a result, it is not unusual to experience a significant lag between the time a law is passed and implemented via regulation. In addition, there are limits to the amount of detail that can be contained in regulations; thus, it becomes necessary to have other means of promulgating programmatic guidance. MFH makes frequent use of Handbooks and Notices to elaborate upon policy points. Although the use of Handbooks and Notices is not conceptually controversial, concerns arise if there tends to be an over-reliance on their use in place of issuing or modifying outdated regulations, or if the guidance issued departs significantly from standard practices or published regulations. In addition, we are aware of situations where policy guidance is

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61. 24 C.F.R. § 200.233 (2006).

promulgated via internal HUD memorandum or email and is thus unavailable to the public.

HUD's Handbooks are rarely subject to public comment prior to issuance. Even if public comments are solicited, there are far fewer formalities in the consideration of those comments than are part of formal rulemaking. Nevertheless, HUD has a tendency to treat these pronouncements as if they have the force of law.

For example, before it takes over a property via foreclosure, HUD makes a practice of formally evaluating the property. This review includes a thorough analysis of the property's physical needs and environmental conditions.<sup>62</sup> HUD commissions a comprehensive physical inspection prior to foreclosure, despite that it lacks both legal title and the right to access the property.<sup>63</sup> As part of this process, the expense of the comprehensive inspection, which typically costs \$20,000 to \$25,000, is charged back to the project owner as "advances for foreclosure expenses."<sup>64</sup> However, a review of relevant case law suggests that the physical inspection is not a proper pre-foreclosure activity and is not one that is chargeable to the project owner.<sup>65</sup> HUD's sole rationale for this practice is Housing Handbook 4315.1. Although these inconsistencies have been brought to MFH's attention, the issue remains unresolved.

Similarly, the Management Agent Handbook<sup>66</sup> includes somewhat conflicting provisions about what constitutes eligible front-line (on-site) project expenses that may be paid from project operations and what costs must be borne by the management agent and covered by the agent's fee. For example, project owners are permitted to maintain HUD-approved centralized accounting functions, and all such costs pertaining to the operation of these

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62. HOUSING AND URBAN DEVELOPMENT HOUSING HANDBOOK, 4315.1 REV-2 CHG-2 Chapter 2 § 2-2 (Jul. 1992), available at <http://www.hudclips.org/cgi/index.cgi> (last visited Jan. 20, 2007) [hereinafter HUD Handbook].

63. *Id.*

64. This line item, if applicable, is reflected on FHA pay-off statements or FHA loan mortgage statements as a fee that must be paid to bring the mortgage current, or else is passed along as part of the foreclosure process.

65. *ComFed Savings Bank v. Newtown Commons Plaza Assoc.*, 719 F. Supp. 367, 374, 377-78 (E.D. Pa. 1989) (attorney fees and advertising expenses are recoverable); *U.S. v. Bedford Assoc.*, 548 F. Supp. 748, 753 (S.D.N.Y. 1982) (out of pocket expenses related to mortgage foreclosure are not recoverable); *Robinson v. Parkhurst*, 289 F. Supp. 528, 529 (W.D. Mo. 1968).

66. HUD HANDBOOK, 4381.5 REV-2, Chapter 6 §§ 6.38, 6.39 (Dec. 1994), available at <http://www.hudclips.org/cgi/index.cgi> (follow hyperlink "Search or Browse All HUD Handbooks and Guidebooks;" then follow "Search;" search "Enter word or phrase" for "Front-line costs;" then follow hyperlink "Chapter 6: Program Monitoring") (last visited Jan. 20, 2007) (Figure 6-2 provides certain examples of fees that are alternately paid from the project account or the management agent fee).

services are payable from the project account.<sup>67</sup> However, the guidance goes on to suggest that certain overhead expenses, including phone calls with home-office staff, are disallowed.<sup>68</sup> Clearer guidance about what constitutes an appropriate project expense would be desirable.

On November 28, 2005, one of the Multifamily Hub (hereinafter “Hub”) offices waded into this area and opined on the appropriateness of charging certain marketing activities, centralized bookkeeping, training, travel and telephone expenses to a property’s operating account.<sup>69</sup> The Hub Memo applied a new test to whether such expenses are appropriate. This test created a “necessary and reasonable” standard, which it inferred existed pursuant to the HUD Regulatory Agreement.<sup>70</sup> However, this guidance ignores the fact that not all properties are necessarily governed by a HUD Regulatory Agreement. For example, a property that receives only Section 8 assistance is not governed by a HUD Regulatory Agreement but instead must follow the provisions of the Section 8 Housing Assistance Payments Contract, which has different standards.

In addition, the Hub’s position does not recognize the benefits of certain project-related activities. For example, with respect to training, the Hub suggests that on-site or locally based training is preferable to national sessions; however, there appears to be no allowance for the quality or the content of such training.<sup>71</sup> Distance from the project site should not be the primary determinate of a training program’s appropriateness as a project expense. Similarly, the Hub Memo ignores the many cost savings associated with operating a centralized accounting system and undercuts such operations by forbidding agents to charge the cost of communications with the home office back to the properties.<sup>72</sup>

#### IV. THE IMPACT ON AFFORDABLE HOUSING PROVIDERS AND RESIDENTS; A HOPE FOR MORE OPENNESS AND TRUST

As a result of these policy issues, a number of properties are unable to be preserved, and the residents are given vouchers, which many find difficult to utilize, leading to an uncertain future for themselves and their families. We have also witnessed a significant slow down in the processing time of transactions.

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67. *Id.*

68. *Id.*

69. Memorandum from Ferdinand R. Juluke, Jr., Director, Jacksonville Multifamily Hub on Appropriate Use of Project Funds in HUD Subsidized Housing (Nov. 28, 2005).

70. *Id.*

71. *Id.* at 2-3.

72. *Id.* at 2.

Some providers chose to abandon HUD programs entirely due to frustration with the complexities or costs of complying with what some deem to be an unnecessarily hostile regulatory environment. This can have a deleterious effect on residents as increasing numbers of owners elect to opt out of HUD programs. These concerns are reflected in a recent United States Government Accountability Office (GAO) report examining Project-Based Rental Assistance during the period from 2001 to 2005 which concluded that outdated HUD policies and sometimes confusing procedures have induced a number of housing providers to opt out of the program rather than continue to cope with “HUD fatigue.”<sup>73</sup> There is a growing and encouraging trend, however, to peel back the veil from how federal agencies oversee program participants and to engage in greater regulatory and policy transparency.

On November 23, 2005, OMB published the Good Guidance Practices Preamble.<sup>74</sup> This publication invited public comments on the problems caused by regulatory guidance creep – situations where broad legislative and regulatory pronouncements are elaborated upon by ever-growing agency guidance which is frequently issued without notice or comment.<sup>75</sup> The OMB Good Guidance Practices acknowledge that such guidance, frequently issued in a vacuum and outside of traditional procedural safeguards, has a negative effect on those who hope to operate within its constructs.<sup>76</sup> OMB solidified these principles upon issuance of the Final Bulletin on this subject on January 18, 2007.<sup>77</sup>

OMB set forth various arguments and proposals, and now requirements, for increasing opportunities for procedural review of proposed agency guidance, including opening up policy decisions to greater notice and comment.<sup>78</sup> Exceptions would be made for those situations where it is infeasible or inappropriate to seek public comment prior to implementation of guidance necessary to protect the public health, safety or environment or if

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73. U.S. GOV'T ACCOUNTABILITY OFFICE, PROJECT BASED RENTAL ASSISTANCE, HUD SHOULD UPDATE ITS POLICIES AND PROCEDURES TO KEEP PACE WITH THE CHANGING HOUSING MARKET, *available at* <http://www.gao.gov/cgi-bin/getrpt?GAO-07-290> (last visited April 16, 2007) at 27 (April 2007).

74. OFFICE OF MGMT. AND BUDGET, EXEC. OFFICE OF THE PRESIDENT, PROPOSED BULLETIN FOR GOOD GUIDANCE PRACTICES, *available at* [http://www.whitehouse.gov/omb/inforeg/regpol/good\\_guidance\\_preamble.pdf](http://www.whitehouse.gov/omb/inforeg/regpol/good_guidance_preamble.pdf) (last visited Jan. 20, 2007) [hereinafter “Good Guidance Preamble”].

75. *Id.*

76. *Id.* at 2.

77. Final Bulletin for Agency Good Guidance Practices, 72 Fed. Reg. 3,432 (Jan. 25, 2007) [hereinafter “Good Guidance Final Bulletin”].

78. *See* Good Guidance Preamble, *supra* note 74, at 5-10; Good Guidance Final Bulletin, *supra* note 77, at 3,437-40.



other emergencies require immediate implementation.<sup>79</sup> Greater agency openness would likely increase the flow of information between the Department and the regulated parties, and an increase in agency accountability would likely serve to enhance its rulemaking authority. The new Good Guidance Practices take effect on July 24, 2007 with a limited exception for certain significant guidance documents.<sup>80</sup>

In addition, former HUD General Counsel Keith E. Gottfried<sup>81</sup> supported a movement towards greater regulatory transparency and recognized the troubles caused by closed and obscure rulemaking processes.<sup>82</sup> Mr. Gottfried also proposed the issuance of “no-action” letters, which would provide approval of proposed transactions and would serve as a basis for program participants to rely upon HUD determinations.<sup>83</sup> This would also provide a set of precedents for program participants to draw upon when developing proposals for their properties and would serve to ease confusion over agency policies and priorities. Openness would serve to benefit both the Department and program participants.

## V. CONCLUSION

The current MFH regulatory posture can be a difficult environment for housing providers. A significant number of multifamily FHA-assisted housing units are at a risk of loss as many FHA-insured mortgages near the end of their terms, and there are declining inducements for housing owners to continue to be regulated by HUD. Thus, the Department appears to be at a crossroads. If it continues down the current path, the costs of complying with HUD regulations appear likely to rise. This would induce more housing providers to opt out of HUD programs. Because the cost of producing new affordable housing is much higher than preserving and improving the existing stock, the risks posed by a potential loss of more affordable housing units cannot be overstated. As an alternative, HUD may embrace more open rulemaking policies and seek to reduce the growing indirect costs of HUD regulations. All parties involved would likely gain from a more cooperative approach in working to solve the nation’s challenging housing problems.

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79. See Good Guidance Preamble, *supra* note at 74, at 7; Good Guidance Final Bulletin, *supra* note 77, at 3,439 and 3,440.

80. See Good Guidance Final Bulletin, *supra* note 77, at 3,432 and 3,440.

81. Mr. Gottfried stepped down as HUD General Counsel effective November 3, 2006.

82. Keith E. Gottfried, *HUD and Regulatory Transparency*, 15 J. AFFORDABLE HOUSING COMMUNITY DEVELOPMENT L., 225, 227-231 (2006); Joseph P. Poduska, *Regulatory Transparency Priority for HUD General Counsel; No-Action Letters Suggested for Guidance*, 34 HOUSING DEVELOPMENT REPORTER 446 (2006).

83. *Id.*