Legal Opinion: CIM-0104

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Subject: Effect of NY Rent Control Laws on LIHPRHA Appraisal

October 25, 1994

Kenneth G. Lore, Esq.
Brownstein, Zeidman & Lore
1401 New York Avenue, N.W. Suite 900
Washington, D.C. 20005-2102

Re: Tower West Apartments
New York, NY
FHA Project No. 012-11088

Dear Mr. Lore:

The purpose of this letter is to respond to your letters to Helen Dunlap, Deputy Assistant Secretary for Multifamily Housing Programs, and to follow up our meeting on August 1, 1994. Upon learning that HUD was considering redoing the appraisals for Tower West Apartments, you wrote to Ms. Dunlap on November 12, 1993. Subsequently you wrote to Ms. Dunlap on January 10, April 8, July 15, and August 2, 1994.

With respect to the effect of rent control on the appraisal for Tower West Apartments, you maintained that the initial legal regulated rents for purpose of the appraisal should be market-level rents. You agreed with John P. Dellera's, then New York Regional Counsel, conclusion that the initial legal regulated rent is governed by Section 2521.1(l) of the Rent Stabilization Code (the "RSC") which provides that the initial legal registered rent shall be the rent last charged to the tenant in occupancy. You explained, however, that Section 26-512(b)(3) of the Rent Stabilization Law (the "RSL") interprets Section 2521.1(l) of the RSC, which provides that for housing accommodations other than those described in Sections 26-512(b)(1) and (2), the initial legal regulated rent shall be the rent reserved in the last effective lease or rental agreement. You went on to explain that Section 26-512 must be read together with Section 26-513(a) of the RSL, which provides in part that the owner has a right to appeal the initial legal regulated rent where "the presence of unique or peculiar circumstances materially affecting the initial legal regulated rent has resulted in a rent which is substantially different from the rents generally prevailing in the same area of substantially similar housing accommodations." You asserted that the fact that a property which has been restricted to below-market rents for more than twenty years is a unique and peculiar circumstance materially affecting the initial legal regulated rents. Thus, you indicated that since the Project's rents have been held to an artificially low level far below market level rents, the initial legal regulated rents

should be set at market levels.

Next, you asserted that the proper application of the RSC to the appraisal of the Project would not result in a reduction of the Project's preservation value as determined by the appraisers and if it did, the applicable provisions of the RSL would be preempted by Section 232 of the Low Income Housing Preservation and Homeownership Act of 1990, as amended, 12 U.S.C. Sections 4101 et seq. ("LIHPRHA"). Lastly, you argued that HUD was precluded from reopening the rent control and preemption issue at this stage in the LIHPRHA approval process.

I will address the issues in the following order: (1) whether the initial legal regulated rents for purposes of determining the preservation value for the Project should be market-level rents, and if not; (2) whether Section 232 of LIHPRHA would preempt the applicable provisions of the RSL; and (3) whether HUD is precluded from reopening the appraisal process.

I. Initial Legal Regulated Rent Levels

The HUD Office for New York and New Jersey wrote to then State of New York Division of Housing and Community Renewal ("DHCR") Commissioner, Angelo J. Aponte, in an effort to determine the effect of the RSL and the RSC upon the appraisals for the Project. To summarize, Commissioner Aponte indicated in his response that the initial legal regulated rent would be determined to be the last rent charged to and paid by the tenant before prepayment and termination of the Federal assistance. Furthermore, Commissioner Aponte explained that the initial legal regulated rent could be adjusted after taking into consideration all factors bearing upon the equities involved. The conclusion reached by Commissioner Aponte that the initial legal regulated rents should be a fair market rent, however, was based on his determination of the equities assuming LIHPRHA would be in place rather than as required by LIHPRHA that the mortgage had been prepaid and all Federal assistance had been terminated.

Commissioner Aponte indicated in his letter "that the appraised rents of such housing accommodations would be established at the fair market rent of comparable unassisted housing accommodations." Commissioner Aponte explained, assuming the jurisdictional prerequisites (generally, presence of six or more units and constructed prior to January 1, 1974) were met, the rents in such projects would be regulated in accordance with the RSC. He indicated that under Section 2521.1(l) that the initial legal regulated rent would be determined to be the last rent charged to and paid by the tenant:

"For housing accommodations which rentals were previously regulated under the PHFL [the Mitchell-Lama law], or any other state or federal law, other than the RSL or the City Rent law, upon the termination of such

regulation, the initial legal registered rent shall be the rent charged to and paid by the tenant in occupancy

on the date such regulation ends. For housing accommodations which are vacant on the date the building first became subject to the RSL and this Code, such rent shall be the rent charged and paid by the most recent tenant, in addition to rental subsidies, if any, which shall be subject to vacancy guidelines increases, and shall not be subject to a Fair Market Rent Appeal pursuant to section 2522.3 of this Title."

Commissioner Aponte noted that the RSC, under Section 2522.7, also maintained flexibility in the setting of first rents by taking into consideration the equities involved. Section 2522.7 states:

"In issuing any order adjusting or establishing any legal regulated rent, or in determining any applications by tenants pursuant to section 2523.5(f) of this Title (Renewal Lease Rights Determinations), or in determining when a higher or lower legal regulated rent shall be charged pursuant to an agreement between the DHCR and governmental agencies or public benefit corporations, the DHCR shall take into consideration all factors bearing upon the equities involved, subject to the general limitation that such adjustment, establishment, or determination can be put into effect with due regard for protecting tenants and the public interest against unreasonably high rent increases inconsistent with the purposes of the RSL, for preventing imposition upon the industry of any industry-wide schedule of rents or minimum rents, and for preserving the regulated rental housing stock." (Emphasis added.)

Commissioner Aponte explained that it would be appropriate to take into account the equities involved in the context of prepayment under the LIHPRHA program in establishing the initial legal regulated rents. Commissioner Aponte considered the following factors:

(1) whether or not the tenants are protected from unreasonably high increases in initial rents;

(2) whether or not the physical condition of the property will be preserved;

(3) whether or not the property will remain preserved as affordable housing; and

(4) whether or not the property will receive increased federal or other governmental assistance.

Commissioner Aponte determined when the above factors are affirmatively present because the Project will be subject to continued supervision under the LIHPRHA program, that the initial legal regulated rents should be set in the same manner as when a vacancy occurs in an apartment subject to the Rent Control Law ("RCL") and such unit transfers from the more strict Rent Control

system to the less restrictive Rent Stabilization system. Section 2521.1(a)(1) of the RSC provides:

> "For Housing accommodations which on March 31, 1984, were subject to the City Rent Law, and became vacant after that date, and which are no longer subject to the City Rent Law, and are rented thereafter subject to the RSL, the initial legal registered rent shall be the rent agreed to by the owner and the tenant and reserved in a lease or provided for in a rental agreement subject to the provisions of this Code, provided that such rent is registered with the DHCR pursuant to Part 2528 of this Title [footnote omitted] (Registration of Housing Accommodations), and subject to a tenant's right to a Fair Market Rent Appeal to adjust such rent pursuant to section 2522.3 of this Title."

Consequently, Commissioner Aponte concluded that the initial legal regulated rents pursuant to the RSC should be a fair market rent, subject to subsequent guidelines and other lawful increases.

In an October 15, 1993 response to a request from Mr. Martin Sckalor of the HUD New York Office asking whether appraisals that are made to determine the preservation value of the Project under LIHPRHA should be based upon market-level rents in the area or upon the below-market rents, John P. Dellera, then New York Regional Counsel, concluded that the initial legal regulated rents should be the below-market rents. Mr. Dellera asserted that the RSL applies to housing accommodation whose rentals were previously regulated under the Mitchell-Lama law, or any other State or Federal law. Once subject to the RSL, the initial legal registered rent would be set at the rent level charged to the tenant in occupancy on the date regulation under the other State or Federal law ends.

On December 23, 1993, Mr. Dellera wrote to Gary Turk, Deputy Counsel, DHCR, to ask whether the RSL authorizes an adjustment of the initial legal regulated rents for former Mitchell-Lama projects which have become subject to Rent Stabilization. In a January 27, 1994 response, the Deputy Counsel stated that initial legal regulated rents could not be adjusted. The Deputy Counsel made clear that his opinion letter did not represent an official agency determination and it was non-binding on the Office of Rent Administration. He explained that an official determination may be issued only at such time as a DHCR proceeding has been

instituted and all affected parties have been afforded notice in accordance with agency rules and procedures. Subject to this disclaimer, the Deputy Counsel concluded that the initial regulated rent for former Mitchell-Lama projects should be the rent reserved in the last effective lease or other rental agreement. In other words, the initial legal regulated rent should be the rent charged to and paid by the tenant in occupancy on the date the Federal regulation terminates. The Deputy Counsel stated that it was the DHCR's position that the initial legal regulated rents established pursuant to Section 2521.1(l)

of the RSC are not subject to challenge or appeal by either tenants or owners, but that owners would be eligible to apply for hardship increases under Sections 2522.4(b) or (c) of the RSC.

As indicated above Commissioner Aponte determined that because the equitable factors he listed would be affirmatively present, the initial legal regulated rents should be set in the same manner as when a vacancy occurs in an apartment subject to the RCL and such unit transfers from the more strict Rent Control system to the less restrictive Rent Stabilization system. Commissioner Aponte's opinion indicates that, in the absence of these equitable factors, the initial regulated rent upon prepayment of the mortgage would be determined to be the last rent charged to and paid by the tenant.

We do not question Commissioner Aponte's interpretation of the RSL and RSC, which clearly is a matter within the DHCR's competence and outside ours. Commissioner Aponte's conclusion that his stated equitable factors were affirmatively present, however, is clearly based on a misunderstanding of the assumptions that Federal law imposes on the preservation appraisal process. The only indication in Commissioner Aponte's letter why any of the enumerated factors would be present is in the reference to "the setting of the rents in a development that will be subject to the continued supervision under the LIHPRHA program" (emphasis added). But this assertion of continued supervision under LIHPRHA is clearly at odds with Section 213(c) of LIHPRHA's instruction to assume repayment of the existing federally-assisted mortgage, termination of the existing low-income affordability restrictions, and simultaneous termination of any Federal rental assistance. As a result, there is still a question about the amount of the initial legal regulated rents for the Project for purposes of determining the preservation value under LIHPRHA. Consequently, Ms. Dunlap wrote to Donald M. Halperin, the current DHCR Commissioner, seeking clarification from Commissioner Halperin of the appropriate standard for setting the initial legal regulated rents, taking into account the correct LIHPRHA assumptions, namely that the mortgage has been prepaid and all Federal assistance has been terminated.

II. Laws of General Applicability and Preemption

In your letters, you argued that the RSL would not result in a reduction of the Project's preservation value, i.e. setting rents at the rent last charged to the tenant prior to prepayment and termination of Federal assistance, and if it did, the applicable provisions of the RSL would be preempted by Section 232 of LIHPRHA. Section 213(c) of LIHPRHA requires, in determining a project's preservation value, that appraisers "assume repayment of the existing federally-assisted mortgage, termination of the existing low-income affordability restrictions, and costs of compliance with any State or local laws of general applicability." You contended that a law which targets Federally- or State-assisted projects, or both, for special adverse treatment is not a law of general applicability. You also asserted that laws which are not limited solely to Federally-assisted projects, but which are targeted to a very

limited universe of low-income projects that includes both Federally-assisted and certain State-assisted low-income projects and which do not apply to the great majority of multifamily rental projects, are preempted under Section 232 of LIHPRHA. You, therefore, concluded Section 2521.1(l) of the RSC, which applies only to Federally- and State-assisted projects comprising a very small percentage of multifamily housing stock, is not a law of general applicability and is preempted.

It is our position that applying State and local laws "of general applicability" during the appraisal process in Section 213 of LIHPRHA is separate and apart from not preempting State and local laws "of general applicability" under Section 232 of LIHPRHA. We read the two statutory provisions separately and believe that each statutory provision is intended to accomplish a different purpose as is discussed below. The sole test of whether the cost of compliance with a particular State or local law should be considered by appraisers under Section 213 is whether the law is of general applicability.

A. Laws of General Applicability

Appraisers of LIHPRHA properties must consider the cost of compliance with State and local laws of general applicability. Section 213(c) of LIHPRHA requires, in determining a project's preservation value, that appraisers "assume repayment of the existing Federally-assisted mortgage, termination of the existing low-income affordability restrictions, and costs of compliance with any State or local laws of general applicability." We conclude that the appropriate standard for determining whether a State or local law is of general applicability depends on whether the law in question applies to housing that is not LIHPRHA-eligible, but is similarly situated to the projects being appraised. A comparison must be made between the law that would have been applied to LIHPRHA-eligible projects had LIHPRHA not been enacted and the law that is applied to housing that is similarly situated. LIHPRHA-eligible projects, by definition, receive some sort of Federal government assistance. Had LIHPRHA not been enacted, the owners of LIHPRHA-eligible projects could have terminated the assistance on the projects and any accompanying use restrictions. In appraising the LIHPRHA-eligible projects under Section 213, the appraisers must assume that LIHPRHA had not been enacted and that all Federal restrictions on the projects have terminated. Thus, it is the State and local laws that do not specifically target LIHPRHA-eligible projects that apply to housing that has terminated its governmental assistance and restrictions that should be considered by appraisers under Section 213(c) as being generally applicable.

In order to make the determination of whether a law is of general applicability, the following two questions must be answered:

1. What State or local laws would apply to the LIHPRHA-eligible project if LIHPRHA had not been enacted and the

Federal assistance and restrictions on the project were terminated?

2. Are the State or local laws in response to question 1 also applicable to housing that is not LIHPRHA-eligible, but is similarly situated by virtue of terminating use restrictions?

If the answer to the second question is in the affirmative, the law would be deemed generally applicable for purposes of the appraisals conducted under Section 213(c) of LIHPRHA.

A law that appears on its face to be generally applicable, but that in its effect singles out LIHPRHA-eligible projects for disparate treatment is not "of general applicability" as that term is used in LIHPRHA. In order for a State or local law to be classified as generally applicable for purposes of Section 213(c) of LIHPRHA, it need not apply to all housing within a certain geographic area. The law, however, cannot apply to such a narrow class of housing so as to effectively single out only LIHPRHA-eligible projects. State or local laws that on their face appear to be generally applicable must be reviewed on a case-by-case basis to ensure that they also are generally applicable in their effect.

B. Preemption

As explained above, it is our position that applying State and local laws "of general applicability" during the appraisal process in Section 213 of LIHPRHA is separate and apart from not

preempting State and local laws "of general applicability" under Section 232 of LIHPRHA.

Section 232 of LIHPRHA expressly preempts certain State and local laws that are not of general applicability and that are inconsistent with LIHPRHA. Section 232 is intended to ensure that there is a uniform Federal preservation policy. Conf. Rpt. No. 943, 101st Cong., 2d Sess. 460 (1990). It accomplishes this purpose by dictating the effect of State and local laws on implementing plans of action approved under LIHPRHA. Section 232(a) preempts certain State or local laws that are: inconsistent with LIHPRHA; restrict or inhibit prepayment or the ability of an owner to receive its annual authorized return; or are limited in their applicability to "eligible low income housing for which the owner has prepaid the mortgage or terminated the insurance contract." Notably, prepaying the insured mortgage, terminating the mortgage insurance contract, receiving an annual authorized return and other incentives are actions an owner of eligible low income housing can take only in accordance with a plan of action approved under LIHPRHA. Section 232, therefore, becomes relevant in the stage in the LIHPRHA processing when a plan of action is submitted and approved and not at the earlier stage when the appraisals are conducted.

Section 232 is inapplicable during the appraisal process. There simply is no State or local law to preempt. Section 213(c)

establishes the standards to be used by appraisers determining the preservation value of eligible low income housing. By directing appraisers to consider generally applicable State and local laws, Congress not only declined to preempt those laws, but decided to adopt those laws as the Federal standard for determining a project's preservation value. Preemption of State or local laws, therefore, is not appropriate under Section 213(c). The sole test to be applied by appraisers in determining whether a particular State or local law should be considered in the appraisal is whether the law is one of general applicability. If a law does not meet the test of general applicability, it is not preempted, it is merely disregarded in determining preservation value.

III. Reopening the Appraisal Process

With respect to the status of the HUD appraisal, as you know Housing has contracted for an appraiser to do an appraisal to be conducted in an expedited manner because Housing determined that the appraisal HUD received from its first appraiser was not a complete independent appraisal in accordance with LIHPRHA and the Appraisal Guidelines, 57 Fed. Reg. 19970 (May 6, 1992), (the "Guidelines"). The Guidelines make clear that the appraisal must conform to the Uniform Standards of Professional Appraisal Practice ("USPAP").

The Guidelines provide that the appraisals will be reviewed by HUD staff to ensure that the Guidelines have been followed and that all pertinent data has been considered and properly applied in both appraisals. "The review will address appraisal deficiencies, such as inadequate support for conclusions, lack of adherence to these guidelines, inconsistencies, etc." 57 Fed. Reg. at 19981. Housing has informed our office that Housing Field Office staff reviewed the appraisal and notified the appraiser of the deficiencies in a February 18, 1993, letter. While the appraiser responded, the information was still inadequate to ensure the reliability of the information provided by the appraiser. The response from the appraiser did not supply information sufficient to complete the appraisal. Hence, the appraiser was fired.

Housing's review of the appraisal report prepared by the first appraiser by the Field Office staff disclosed that the appraiser's report was based upon information that was extracted from the sponsor's appraisal report of August 20, 1992. The following deficiencies in the appraiser's report were noted by the Housing Field Office staff:

1. HUD-92273, Estimates of Market Rent by Comparison. Adjustments for size, age of buildings and location were excessive and were not adequately supported by data.

2. HUD-92274, Operating Expense Analysis Worksheet. Financial statements on expense comparables were not provided. No adjustments were made to the expense comparables to reflect the subject project's

characteristics. The subject management fee was inconsistent with NYC management fee schedules. Also, the trending adjustment was inaccurate.

3. HUD-92264. There was no background information on the sales comparables used in the Market Comparison Approach to Value, nor was there any verification of the subject Effective Gross Income used in the appraisal report.

4. Capitalization Rate. The subject cap rate reflected an equity dividend rate that was lower than the mortgage interest rate. This is inconsistent with standard appraisal practice. Also, absent were any extractions of equity dividend rates from market sales comparables.

5. A complete analysis of project conversion costs was not provided; nor were these costs discounted as part of the analysis. HUD Appraisal Guidelines state that the discounting of project conversion costs must be calculated.

6. A complete analysis of upgrade repairs was not provided.

According to the Chief Appraiser of the New York Office, the appraiser's report represented only an estimated one-third of the work necessary for a complete extension preservation appraisal. This incomplete appraisal report did not comply with HUD's Appraisal Guidelines or the Appraisal Institute's USPAP Standards. Accordingly, HUD does not have an acceptable appraisal report for Tower West Apartments. Consequently, HUD has the responsibility to recontract in order to receive a complete independent appraisal under LIHPRHA and the Guidelines. HUD cannot negotiate a preservation value with the owner and agree to a Plan of Action which would require the expenditure of Federal monies on the basis of an appraisal that did not comply with Federal law.

Sincerely,

Monica Hilton Sussman
Deputy General Counsel