

# Department of Housing and Community Development

## Initial Statement of Reasons (ISOR) Uniform Multifamily Regulations Title 25 Section 8315

### INTRODUCTION

The Department of Housing and Community Development (the “Department” or “HCD”) operates three programs that provide financing for lower-income multi-family rental housing developments: Multifamily Housing Program (“MHP”);<sup>1</sup> federal Home Investment Partnership Program (“HOME”);<sup>2</sup> and the Joe Serna Jr., Farmworker Housing Grant Program (“Serna”).<sup>3</sup> In 2003 the Department adopted what are termed the Uniform Multifamily Regulations (“UMR’s”) governing a variety of topics common to multifamily loan underwriting and project management.<sup>4</sup> Included in the UMR’s is section 8315 of Title 25 of the California Code of Regulations which establishes policies as to when and under what circumstances HCD will subordinate its deeds of trust and other restrictions to other financing.

The purpose of the proposed amendment is to revise the UMR subordination policy only.

### BACKGROUND

Pursuant to statute and regulations, loans from Serna, HOME, and MHP (collectively, the “Programs”) are secured by a deed of trust; and the underlying projects are subject to various conditions and restrictions regarding maintenance, use, occupancy, and rents (collectively the “HCD Covenants”) to assure, among other things, the continued affordability of the projects to lower-income households. Compliance with the HCD Covenants is secured by the recordation of a regulatory agreement as a lien on the rental housing development (the “HCD Regulatory Agreement”). For the most part, rental housing developments assisted by the Programs also receive loans from conventional private lenders and loans and/or grants from other governmental entities. Private lenders, as a condition of making their loans, require that their deeds of trust be recorded in first lien position, giving them the greatest security in the event of a default and foreclosure sale. Prior to the adoption of Section 8315, it was HCD’s long-standing practice to record its deeds of trust and the HCD Regulatory Agreements (collectively, the “HCD Loan Documents”) junior to private lender deeds of trust. It also had been HCD’s practice to require that all local government grant or loan documents be recorded junior to HCD’s Loan Documents.

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<sup>1</sup> See 25 Cal. Code of Regs. Div. 1, Ch. 7, Subchapter 4, commencing with Sec. 7300.

<sup>2</sup> See 25 Cal. Code of Regs. Div. 1, Ch. 7, Subchapter 17, commencing with Sec. 8200.

<sup>3</sup> See 25 Cal. Code of Regs. Div. 1, Ch. 7, Subchapter 3, commencing with Sec. 7200.

<sup>4</sup> See 25 Cal. Code of Regs. Div. 1, Ch. 7, Subchapter 19, commencing with Sec. 8300.

The adoption of Section 8315 changed HCD's policy with respect to subordination to local government documents.

Current Section 8315 reads as follows:

*Section 8315. Subordination Policy.*

*(a) The Department may execute and cause to be recorded a subordination agreement subordinating the Department's lien so long as the subordination does not increase the Department's risk beyond that contemplated in the Program loan or grant commitment, as may be amended from time to time, and so long as the subordination would further the interest of the Program. However, and except for Projects assisted by the U.S. Department of Housing and Urban Development under the Section 811 or Section 202 programs, the Department shall not enter into a subordination agreement or other agreement that contains any of the following:*

*(1) Any limitation of, or condition on, the Department's exercise of its remedies including, but not limited to issuing a notice of default based on a breach under the Department's loan documents, including a default based solely on a breach of the senior lienholder's documents.*

*(2) An agreement that the senior lienholder's acceptance of a deed in lieu of foreclosure would result in the senior lienholder taking title to the Rental Housing Development free and clear of the Department's lien(s).*

*(3) An agreement permitting any modification or supplement of the senior lienholder's lien without the prior written consent of the Department except an agreement that permits a senior lienholder to make advances to: (i) cure a default under a lien with a higher priority than the Department's lien; (ii) pay delinquent taxes on the security property; (iii) pay delinquent hazard or liability insurance premiums for the security property; or (iv) to protect the health and safety of the tenants.*

*(4) An agreement that would require the Department to undertake additional obligations to any party.*

*(b) The Department's lien shall not be subordinated to the liens of a local government lender unless the amount of the local government loans is more than twice the amount of the Department's total assistance to the Project (including both loans and grants).*

*(c) As used in this section:*

*(1) "Department's lien" means a deed of trust, regulatory agreement, or other agreement securing payment or performance under an award of*

*Program funds that has been recorded in the office of the recorder of the county in which the Rental Housing Development is located.*

*(2) "Lien of a local government lender" means a recorded deed of trust or covenant running with the land that affects the maintenance, use, or occupancy of the Rental Housing Development.*

In summary, Section 8315 provides that all local government loan or grant documents and covenants must be subordinated to HCD's Loan Documents unless the total amount of the local government's loans are twice the amount of HCD assistance (i.e., combination of all HCD loans and grants). Following is the discussion from the Initial Statement of Reasons underlying the adoption of Section 8315:

The priority of liens on real property generally is determined by the order of recording in the local property records ("first in time, first in right"). However, these priorities can be altered through the use of a subordination agreement. Subordination agreements also are used between lenders to cover other topics such as use of insurance or condemnation proceeds. Historically, the final terms, conditions and wording of a particular subordination agreement between HCD and an institutional senior lender are negotiated on a deal-by-deal basis. However, HCD historically and traditionally has the California Land Title Association (CLTA) form subordination agreement used as a basis to negotiate from. This is because this form is commonly known, understood and accepted in California.

Within the last several years, more funds have become available for rental housing developments under FWHG, MHP and HOME, and there have been more projects using a combination of 4% tax credits and bond financing, in addition to 9% tax credits. This expansion has led to more out-of-state investors and financial institutions becoming involved in HCD-financed projects. When HCD dealt with only a handful of usually California-based institutional lenders and their lawyers, it was able to negotiate a standard subordination agreement acceptable to the particular senior lender for all of its HCD deals. With the expanded number of players, HCD has spent countless hours negotiating the details of subordinations with out of state lenders and their legal counsel. Moreover, many of these lenders have requested concessions from HCD that are not commonly agreed to here in California. These negotiations have delayed closings and caused frustrations to both HCD and its customers.

Based on HCD's experience and practice in administering its rental housing lending programs for over 20 years, HCD has a clear idea of what are the minimal protections necessary to protect the state's interest in its loans. Moreover, the base subordination agreement used by HCD, the CLTA form, is an industry standard in California.

Subsection (a) establishes in regulation for all three programs the statutory direction given to the FWHG program in Health and Safety Code Section 50517.5(d)(4)(D). In effect, this establishes a performance, rather than a prescriptive standard. However, paragraphs (a)(1)-(4) have been added to address specific issues that consistently have arisen primarily with out of state lenders and investors. The CLTA form subordination agreement does not: (1) require a subordinating lender to obtain the senior lender's approval to exercise the junior lender's remedies; (2) prohibit a junior lender from declaring a default when a borrower defaults on the senior lien; (3) nor require a junior lender to agree that acceptance by the senior lender of a deed-in lieu of foreclosure will erase the junior lien.

By virtue of its senior position, a senior lender's lien is not jeopardized by the exercise of a junior lender's remedies and/or a junior lender's foreclosure. A junior lender's foreclosure will wipe out the equity of the borrower, and the junior lender will step into the shoes of the borrower as equitable owner of the property; but the property remains subject to the lien of the senior lender. In contrast, if a senior lender forecloses on its lien, the junior lender's lien is erased and the junior lender receives repayment only to the extent that the proceeds of a foreclosure sale exceed the amount owing on the senior loan. Moreover, in tax credit deals, the limited partner investor requires that the HCD loan be "nonrecourse," meaning HCD may only look to the property as security for repayment of its loan. Thus, if there are insufficient sale proceeds to repay the HCD loan upon foreclosure of the senior lien, HCD is precluded from looking to other assets of the borrower or its partners for repayment.

HCD needs the ability to utilize all of its remedies to forestall a foreclosure by a senior lender that likely would wipe out the HCD lien. It is not just the repayment of the HCD loan that is at stake. Foreclosure also wipes out the HCD regulatory agreement that requires the property to remain in use as affordable housing. If the regulatory agreement is foreclosed out, the HCD-assisted units may all be rented at market rate resulting in tremendous economic dislocation for lower income households. Also, acceptance of a deed in lieu of foreclosure does not have the automatic result of wiping out junior liens as does a foreclosure sale. There is no advantage to HCD in agreeing to such a position, yet some senior lenders still attempt to extract this concession.

Finally, with respect to (a)(3), the form CLTA subordination agreement does provide that a junior lender agrees that the senior loan may be modified, renewed, supplemented or extended. Yet California case law has held that a senior lender cannot take actions that would prejudice a junior lender without the junior lender's concurrence. However, HCD would rather avoid having to file a lawsuit to determine whether or not a senior lender action in some way prejudices HCD. Instead, HCD has had success negotiating language with senior lenders that they will not take these actions without the prior written notice and consent of HCD.

Having these provisions in regulation will reduce the time spent on negotiating subordination agreements on a deal-by-deal basis and will notify potential borrowers in advance of exactly what HCD's subordination policy is. This will allow these potential borrowers to in turn notify other lenders in a transaction at an earlier stage, thus avoiding protracted delay at the end of a loan closing transaction.

Subsection (b) memorializes the existing MHP policy on subordination to local government lenders, as currently specified in section 7306(e). Prior to MHP, HCD had traditionally required local government lenders to subordinate, regardless of the size of their loan. This policy may have prevented some local governments from participating in HCD projects, especially when they were asked to make very large loans, which put more of their resources at risk. To encourage participation by local governments, MHP adopted a regulatory provision allowing HCD to subordinate to local governments that were willing to make loans twice the size of the MHP loan. This provision seems to have worked well in MHP, and hence is being incorporated into these uniform regulations.

Subsection (c) is necessary for clarity and so the terms as used in this section are not confused with the terms used elsewhere in Subchapter 19, or the program regulations for FWHG, MHP or HOME. It is necessary to deal with both deeds of trust and regulatory agreements since HCD records both as do most local government lenders.

Finally, by way of background, it should be noted that a borrower must comply with all of the requirements of the private first lender documents, HCD's Loan Documents, and the documents of local governments providing loans or grants to a project – regardless of the order of recording of the various documents. Only in the event of a foreclosure does the order of recording become important.

### **PROBLEM – PURPOSE – FACTUAL BASIS**

It has been brought to HCD's attention that the current UMR subordination policy may be overly restrictive with respect to various forms of local assistance to a rental housing development. Construction of affordable rental housing projects is not possible without both local government financial and political support. These projects often need a general plan or zoning change. And they often encounter local citizen opposition that can be assuaged through local covenants running with the land dealing with maintenance, use and occupancy issues. In the case of redevelopment agencies, there are various statutory requirements for the recordation of maintenance, use and occupancy requirements.

These local covenants are beneficial in that they: further local public policy goals that usually are consistent with HCD's goals; help foster local support for the project; and provide for improved project construction and operation oversight, since local administrators are much closer to a project than is HCD staff located in Sacramento.

In addition to loans, local governments also provide value to projects in such forms as: grants; land assembly; land donations; land write downs; and installation of infrastructure. As a quid pro quo for this project assistance, local governments impose a variety of conditions related to maintenance, use and occupancy.

To foster greater local support for affordable rental projects and in recognition of the additional financial and non-financial contributions made to affordable rental projects by local governments, HCD proposes to amend subsections (b) and (c) Section 8315 as follows:

*(b) The Department's lien(s) shall not be subordinated to the liens of a local government lender governmental entity unless the amount of total local governmental assistance to the Project the local government loans is more than twice the amount of the Department's total assistance to the Project (including both loans and grants).*

*(c) As used in this section:*

*(1) "Department's lien" means a deed of trust, regulatory agreement, or other agreement securing payment or performance under an award of Program funds that has been recorded in the office of the recorder of the county in which the Rental Housing Development is located.*

(2) "Lien of a local government lender" means a recorded deed of trust, regulatory agreement, reversion, or other recorded agreement securing payment or performance, or a covenant running with the land that affects the maintenance, use, operation, or occupancy of the Rental Housing Development. Except that covenants in favor of a community redevelopment agency regarding the use, maintenance, operation, or transferability of a Rental Housing Development, or prohibiting discrimination, shall not constitute liens subject to the requirements of this section.

(3) "Total local governmental assistance" means the sum of the principal amounts of loans and grants plus other direct project costs paid for by the local governmental entity and approved by the Department including, but not limited to, costs of site preparation, demolition, environmental remediation, and land acquisition. The value of assistance in the form of land write-downs or donations shall be limited to the cost paid by the public agency to acquire the land, less any sales proceeds paid to the agency; or in the case of a leasehold, the cost paid by the public agency less the present value of projected lease payments.

In paragraph (1) of subsection (c), redevelopment agency covenants pertaining to use maintenance, operation, nondiscrimination and transferability have been "carved out" from coverage for the reasons set forth above and the fact that their recordation is required by law.<sup>5</sup>

In paragraph (2) of subsection (c), valuation of land write-downs or donations is limited to acquisition costs paid by the public agency in order to give credit for the local out-of-pocket financial contribution but not account for any fluctuation in the value of the property. Also, in some cases, local governments have leased back land and are receiving recompense of acquisition costs through rent payments. Therefore to accurately account for out-of-pocket expenses, the cost of acquisition would be reduced by the present value of projected lease payments.

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<sup>5</sup> See e.g., Health and Safety Code Secs.: 33435, 33436 (pertaining to nondiscrimination); 33437 (pertaining to use and project completion); 33437.5 (pertaining to anti-speculation); 33438, 33439 (pertaining to enforcement).