

**PRESERVATION ISSUES IN PROJECT-BASED SECTION 8  
CONTRACT EXPIRATIONS**

by

Elizabeth Ann Houston

Bachelor of Arts  
College of Public and Community Services  
University of Massachusetts, Boston  
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Signature of Author \_\_\_\_\_

Elizabeth Ann Houston  
Department of Urban Studies and Planning  
July 31, 1992

Certified by \_\_\_\_\_

Langley Keyes  
Professor of City Planning  
Department of Urban Studies and Planning  
Thesis Supervisor

Accepted by \_\_\_\_\_

Lawrence S. Bacow  
Chairperson

  
MASSACHUSETTS INSTITUTE  
OF TECHNOLOGY

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ABSTRACT

Housing policy evolves through programs, each created to respond to the specific shortcomings of previous programs and policies, and to embody the current dominant political philosophy. In keeping with this history, the Section 8 Rental Assistance program grew out of the problems of the Section 221(d)(3) and Section 236. Affordability in Section 221(d)(3) and Section 236 projects was provided through use restrictions embedded in the low-interest 40 year mortgage. The maturing of 20 year prepayment restrictions threatened the affordability of this stock, sparking national debate that resulted in the Low Income Housing Preservation and Resident Homeownership Act. LIHPRHA balances the needs of tenants with the rights of owners.

This thesis explores whether LIHPRHA, created to preserve the very projects Section 8 was designed to replace, can provide a preservation model for Section 8 program. Housing experts offer divergent answers to the question: some contend that the preservation issues are similar in both types of subsidy programs, others insists that the two must present different preservation issues given the inherent differences in the two types of programs.

Differences between Section 8 and its predecessors raise five recontracting issues: 1) the degree of choice offered owners, 2) Section 8's disparity with other government programs and with the market, 3) the cost of the subsidies, 4) term limits on subsidies and use restrictions, and 5) conflicts in HUD's role as both subsidy provider and mortgage insurer. Resolution of these issues will occur within the context of: 1) the experience gained implementing LIHPRHA; 2) the dominant political philosophy at the time contracts begin to expire; 3) the state of the real estate market; and 4) demographics and the demand for Section 8 housing.

LIHPRHA provides a basic road map for Section 8 contract expirations. The debates that preceded LIHPRHA honed a philosophical orientation to preservation. LIHPRHA provides a procedural framework for assessing preservation worth at a project level. The experience with Section 221(d)(3) and Section 236 programs does not, however, provide a technical answer to the Section 8 contract expiration dilemma.

Thesis Supervisor: Langley Keyes

Title: Professor of City Planning, Dept. of Urban Studies &  
Planning

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## DEDICATION

It is only in producing a thesis that dedications take on meaning. The contributions of my family have an invisible hand in this work. To my husband, Henry, who provided support and managed to keep our home together during a long year of commuting to Boston. Thank you for the gift of this year.

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## CHAPTER 1

### Introduction

Housing policy is characterized by an evolution of programs, each created to respond to the specific shortcomings of previous programs and policies, and to embody the current dominant political philosophy.<sup>1</sup> In the wake of a protracted government withdrawal from a commitment to affordable housing<sup>2</sup>, preservation of the existing subsidized housing stock has become a critical concern of current housing policy. The majority of affordable units produced over the past 30 years are privately owned and publicly subsidized. Owners promised to provide affordable units for a specified number of years, in exchange for government subsidies to underwrite their costs. The issue of preservation concerns the loss of affordable stock once that initial commitment expires.

The first public/private approach to affordable housing, employed in the Section 221(d)(3) and Section 236 programs of the 1960s and early 1970s, reduced mortgage costs through low interest, long term notes backed by federal mortgage insurance. Use restrictions to insure affordable rents for

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<sup>1</sup> Allen R. Hays, The Federal Government and Urban Housing (Albany, NY: State University of New York, 1985) 80.

<sup>2</sup> For the purpose of this thesis, the term "affordable housing" will refer to housing priced to accommodate tenants in federally-defined moderate to very low income categories. Moderate income households earn 80% to 95% of the median income; low income household have an income at 50% to 85% of median; and very low income households are below that level.

moderate income tenants were embedded in 40 year mortgage with a 20 year prepayment prohibition. By the late 1960's both programs were plagued by high default rates as owners struggled with mounting operating costs and stagnant tenant incomes<sup>3</sup>. In keeping with historic practice of housing policy formulation addressing the shortcomings of prior programs, the Section 8 Rental Assistance Program<sup>4</sup> grew out of the problems of the Section 236 and 221(d)(3) programs<sup>5</sup>. Under the Section 8 program, subsidies were provided from the income side rather than the debt side, filling the gap between a fair market rent established by HUD and the tenant's share, based on income. Project-based rental subsidies were awarded in 20 to 40 year contracts. The majority of new and substantially rehabilitated projects were financed with federally insured mortgages that had 20 year subsidy contracts and 40 year mortgages. These mortgages remain in effect, absent any use restrictions, after the rental subsidy ends. Projects financed through state housing finance agencies avoid this situation with coterminous subsidy contracts and mortgages.

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<sup>3</sup> Hays 124 - 125.

<sup>4</sup> The Section 8 Program included three approaches to providing rental assistance: Project-based New Construction, Substantial Rehabilitation and Moderate Rehabilitation subsidies; Existing subsidies, awarded directly to tenants for use in the private market; and Loan Management Set-Aside subsidies for troubled HUD financed projects. This thesis focuses on Project-based subsidies. For more discussion on the Section 8 program, see Chapter 2.

<sup>5</sup> Hays 137.

Preservation became an issue for housing projects developed under the Section 221(d)(3) and Section 236 programs beginning in the early 1980s. It was at this time that prepayment restrictions began to mature, sparking fear that owners would choose to prepay, returning a substantial segment of the affordable stock to the open market. A national debate ensued over the respective rights of owners and needs of tenants.<sup>6</sup> Out of this debate, and experience gained in two emergency legislative measures<sup>7</sup>, grew a piece of legislation - the Low Income Housing Preservation and Resident Homeownership Act (LIHPRHA) - designed to "create a permanent and comprehensive program which preserves privately owned, low income housing projects while not unduly restricting the owners' mortgage prepayment rights."<sup>8</sup> Implementation of LIHPRHA is accomplished through a lengthy, complicated, micro-managed process.

LIHPRHA applies to most of the 508,000 units of housing<sup>9</sup>

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<sup>6</sup> "Prepayment of HUD, FmHA Mortgages Sparks Debate Among Owners, Tenants, Others," Housing and Development Reporter (Dec. 28, 1987) 580.

<sup>7</sup> The Emergency Low Income Housing Preservation Act of 1987, Title II of the Housing and Community Development Act of 1987 imposed a two year moratorium, that was extended with minor amendments for a third year.

<sup>8</sup> "Prepayment of a HUD-Insured Mortgage by an Owner of Low Income Housing; Interim Rule" Federal Register, Vol. 57, No. 68 (Wednesday, April 8, 1992) 24 CFR Parts 50, 219, 221, 236, 241, and 248. Summary 11992.

<sup>9</sup> Prepayment is prohibited in projects that were developed by non-profits, received Flexible Subsidy assistance, currently receives Rent Supplement assistance, and certain projects that have

produced under Section 221(d)(3) and Section 236<sup>10</sup>. On the horizon looms the potential loss of 1,107,000 Section 8 units.<sup>11</sup> Can the LIHPRHA approach work in the Section 8 program, itself created as a solution to problems in the below-market-rate mortgage programs addressed through the legislation? Housing experts offer views on the relevance of LIHPRHA to Section 8 contract expirations: some contend that the preservation issues are similar in both types of subsidy programs, others insists that the two must present different preservation issues since Section 8 was created to respond to the problems and shortfalls of the Section 221(d)(3) and Section 236 programs. Just as straight line forecasts lose validity when the basic conditions or factors change, so do regulatory precedents. Tenant representatives and advocates of affordable housing<sup>12</sup> believe there won't be a preservation problem. These individuals suggest that LIHPRHA articulates a commitment to, and provides a framework for, preservation.

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been sold or defaulted on the mortgage during the life of the mortgage.

<sup>10</sup> United States, General Accounting Office, Fact Sheet for the Chairman, Subcommittee on Employment and Housing, Committee on Government Operations, House of Representatives, "Rental Housing: Potential Reduction in the Privately Owned and Federally Assisted Inventory", June 1986, : GAO/RCED-86-176FS, 6 & 7.

<sup>11</sup> U.S. General Accounting Office 7.

<sup>12</sup> Vince O'Donnell, Director of Development, Community Economic Development Assistance Corporation, Boston MA, telephone interview, June 8, 1992 and July 7, 1992; and Larry Yates Director of Field Services, Low Income Housing Information Service, Inc., Washington, DC, telephone interview June 8, 1992.



They perceive the issue as simply one of appropriations and fully expect the Section 8 contracts to be renewed. Such advocates generally acknowledge that renewal will most likely be voluntary, since owners will have fulfilled all contracted obligations. Some, however, hope for mandatory renewals.

The second group of experts<sup>13</sup>, generally representative of owner interests, suggest that Section 8 contract expirations pose substantially different issues than those present in the expiring use restrictions regulated through LIHPRHA. Owner representatives fear they will not have a choice about recontracting, and that the terms and conditions of any new contract might be less favorable than the current program. Their concerns raise five interconnected issues and policy resolution in one area will likely impact on the others.

**1. Climate of Renewals - Mandatory or Voluntary:** Owners suggest that the issue of voluntary or mandatory renewal, while legally similar for both the earlier mortgage-based programs and Section 8 projects, has substantially different public policy implications in the case of contract renewals.

The LIHPRHA experience portends a mandatory solution.

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<sup>13</sup> Howard Cohen, Esq. and Kathleen Sheehan, Esq., Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C., Boston, MA, personal interviews May 2, 1992, May 12, 1992, and July 1, 1992; David A. Smith, President, Recapitalization Advisors, Boston, MA, personal interview June 23, 1992; Jay Regan, Treasurer, State Street Development Corp., Boston, MA, July 14, 1992, Marty Jones, Senior Vice President, Corcoran Jennison Co. Inc., telephone interviews July 23, 1992 and July 28, 1992.

However, both tenant and owner representatives see different policy implications for intervention in the expiration of a contract that has been completely honored and intervention in the right to prepay a mortgage that is mid-term.

**2. Section 8 Advantageous Disparity:** Section 8 contracts are more generous in rent level and allowable owner dividends than the insured-mortgage programs like the Section 221(d)(3) and Section 236 programs, leading some analysts to critique Section 8 as a windfall for owners. The disparity between federal programs has critical importance in relation to the concern over mandatory or voluntary renewal. In the absence of mandatory contract renewal, the government will have to provide additional incentives adequate to induce owners to voluntarily sacrifice project control. The condition of the market when contracts expire will influence the cost of these incentives.

**3. Cost of Renewals:** The parity issue raises concerns about the cost of renewal. Some experts assert that Section 8 New Construction and Substantial Rehabilitation rents are very high, perhaps above the federal cost limits established in LIHPRHA<sup>14</sup>. Not only will the balance of cost and benefit be at issue, but the required level of appropriations might make Congress reluctant to refinance the program.

**4. Term Length:** The length of the renewal contract term,

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<sup>14</sup> Interviews with Howard Cohen, Kathleen Sheehan, Jay Regan and Marty Jones.

and the term of the use restrictions attached to the subsidies will impact on owners' interest in renewal. Will the contract and restrictions be coterminous? Renewal of Section 8 Loan Management Set Aside subsidies indicate that contracts might have five year terms in order to provide a palatable appropriations price tag. Yet LIHPRHA requires use restrictions for the balance of the useful life of the project. Owners, particularly if faced with a soft market, fear they will approach negotiations with a government able to require long-term use restrictions for a short-term subsidy contract.

**5. HUD Dual Role:** Finally, in formulating a policy, HUD must contend with an inherent conflict of interest in which it is often party to both a 20 year subsidy contract, and insurer of a 40 year private mortgage. As subsidy grantee, HUD will negotiate for contracts at the lowest possible cost, and if costs outweigh benefits, may not seek to renew them. As mortgage insurer, HUD, in the guise of the Federal Housing Administration (FHA), will want to protect the notes from default by guaranteeing adequate income to the project. It will want to insure the owner remains interested in the project, and has adequate resources to cure any problem.

The range of opinion about what the future holds for Section 8 projects highlights the importance of beginning to explore the issue now.

Although it is true that the earliest expiration is several years away, owners of these properties are

doubtlessly keenly observing the shifting rules being applied to the earlier generation of projects. At a minimum they confront substantial uncertainty about the conditions under which they will be able to sell their properties or convert them to market-rate projects. Under these conditions they may well assume the worst and begin systematically pulling their equity out of the buildings through deferred replacement investments and limited maintenance.<sup>15</sup>

Such a result will not serve the interests of anyone involved, not tenants, not owners, and not HUD.

This thesis will explore why there are two such different views of what will happen when Section 8 contracts expire. The issues at stake represent legal, public policy, and financial considerations. Each party to a project contract - the owner, the tenants, the government - brings a unique desired outcome that reflects their different interests. In part their competing concerns are driven by perceptions of, and interest in, the conditions of recontracting, including the degree of choice offered owners, Section 8's disparity with other government programs and with the market, the cost of the subsidies, and the methods used to establish term limits on subsidies and use restrictions.

Literature is scarce on this subject, consisting primarily of legislative history, regulations, and responses to both. A literature review has been supplemented by interviews with preservation experts representing both owner and tenant perspectives, Section 8 project owners, and legal

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<sup>15</sup> Source unknown.

counsel.

Chapter one will lay a ground work for the thesis: establishing a premise about the role of precedent in government policy; setting a context for preservation by making a case for the continued need for affordable housing; and filling out the positions of each side in the debate over Section 8 renewals. Chapter two will establish the technical foundation for the analysis by reviewing the origin, structure, and expiration issues of the Section 8 program. Chapter three looks at the expiration issue in the context of competing interests among participants. Chapter four will evaluate each of the five issues in terms of precedent, and relevant legal, policy, or financial considerations. Chapter five will suggest some parameters for addressing the issue of contract expirations. It will explore where precedents have been established, as well as where Section 8 contract expirations will lay new ground. The interrelationship of these issues will likely effect the potential range of outcomes for resolving the expiring contract problem.

## CHAPTER 2

### Section 8: Origin, Structure and Expiration

The Section 8 program was created to solve problems encountered in the earlier mortgage insurance programs, and as an expression of the New Federalism policies of then President Nixon. This historic and philosophical background provides a context for evaluating the program, and each participant's understanding of the "deal". Players include the owner, the government represented by both HUD and Congress, the lender, and the tenant. After reviewing the history and programmatic workings of the Section 8 program, the interests and perceptions of each of these players in relation to the Section 8 contract will be explored. This background provides a foundation for analyzing the contract expiration issue.

#### The Insured Mortgage Programs:

The Section 8 program was a response to the difficulties plaguing the Section 221(d)(3) and Section 236 programs. Both of these programs had employed similar strategies: reduced financing costs achieved through below-market-rate federally insured mortgages were translated into lower rents for low and moderate income tenants. The Section 221(d)(3) Below Market Interest Rate (BMIR) program, active between 1961 and 1968, was designed to serve moderate income tenants, bridging the income gap between public housing tenants and the Market. It

provided an upfront subsidy to reduce interest rates to 3 percent on privately written, FHA subsidized 40 year mortgages, in exchange for rent caps and obligation to rent to tenants with moderate incomes (for the most part 80 - 95% of median income for the area)<sup>16</sup>; for-profit owners accepted limits on distribution of surplus funds at 6% of equity, and were permitted to prepay the mortgage at year 20; non-profit owners received 100 percent financing, and were not allowed to prepay or distribute surplus funds.<sup>17</sup>

In 1968 the Section 236 program replaced Section 221(d)(3), remaining active until 1973. It provided subsidies to reduce mortgage interest rates to 1 percent in exchange for limits on rents. Tenant incomes were targeted to below 80 percent of median, slightly lower than the Section 221(d)(3); very low income tenant rents were assisted through the Rent Supplement Program. Returns on equity in the Section 236 program were limited to 6 percent, as in the Section 221(d)(3) program.

By 1970, problems began to threaten projects developed under both the insured mortgage programs.

Steady upward pressure on costs and rents reduced the potential market of eligible tenants, preventing the most needy families from benefiting from the program, and created an additional incentive for project managers to skimp on

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<sup>16</sup> National Low Income Housing Preservation Commission, Preventing the Disappearance Of Low-Income Housing (Washington, DC: 1988) 1.

<sup>17</sup> National Low Income Housing Preservation Commission 87.

maintenance and services.<sup>18</sup>

In addition, the foreclosure rates were rising rapidly. Problems in the Section 236 program, as well as associated problems in the Section 235 and public housing programs set the stage for President Nixon's housing moratorium in 1973 and the legislation that was to emerge in its wake.

Over the course of Nixon's first term in office (beginning in 1968), his orientation to domestic programs became increasingly conservative<sup>19</sup>. In contrast to Nixon's conservatism, Congress maintained a strong liberal base<sup>20</sup>. Nixon's opposition to the mortgage programs was countered by strong Congressional support for expansion of the housing programs. In contrast, Nixon supported only the Section 23 Leased Housing Program which was based on subsidized rental in the private market<sup>21</sup>.

#### **The Origins of Section 8:**

After an 18 month long housing moratorium, President Nixon agreed to reopen a federal role in housing<sup>22</sup>. The Housing and Community Development Act of 1974 was the result

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<sup>18</sup> Hays 125.

<sup>19</sup> Hays 108 - 110.

<sup>20</sup> Hays 108.

<sup>21</sup> Hays 140.

<sup>22</sup> Nixon housing concessions were made in an attempt to increase popularity and stave off impeachment proceedings. Hays 146.



of compromise reached two days before Nixon resigned, and was signed into law by the new President Gerald Ford<sup>23</sup>. The Act signaled a significant redirection of federal housing policy with the creation of the Section 8 Rental Assistance Program. Unlike the earlier FHA-insurance programs that relied on low-interest mortgages, the Section 8 program provided rental assistance subsidies to tenants to make housing affordable. The direct subsidy of tenants' rent was a clear reaction to the income problems that had plagued preceding programs. The program guaranteed rental income at a fair market price established by HUD, with the tenant paying only that portion equal to 25% of their income.

The original Section 8 program was composed of three variations on a single theme, similar primarily in their impact on participating tenants' housing cost. The Project-based Section 8 program was designed to stimulate production, with subsidies attached to units. Initially, it had two components, New Construction and Substantial Rehabilitation. In 1978 a moderate rehabilitation component was added<sup>24</sup>. The second variation, the Existing program, provided subsidies directly to tenants for use in the private market. The third variation, the Loan Management Set Aside (LMSA) program, provided subsidies to projects developed through earlier mortgage-insurance programs (the Section 221(d)(3) and Section

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<sup>23</sup> Hays 146.

<sup>24</sup> Hays 146.

236 programs). While each represents an important policy initiative, this thesis focuses on the preservation of the project-based New Construction and Substantial Rehabilitation program.

Under Section 8 the tenant's share of rent was set at 25 percent of that tenant's income, for households earning under 80 percent of the area median. Eligibility requirements were fairly broad since Section 8 was intended as both a low and moderate income programs. It was designed to avoid both the exclusion of low income people, a charge leveled at Section 236 programs, and the concentration of very low income people found in public housing. Mixed income projects, combining subsidized and market-rate units, were given priority in new construction programs.<sup>25</sup> The subsidy for each household was to fill the gap between the tenant's share and a reasonable 'economic rent' for the unit which HUD established based on building costs, age, and amenities. Economic rents were not permitted to exceed limits known as Fair Market Rents (FMR), an amount based on rents in comparable units of that particular size and type in the project's geographic area. "FMR's ran substantially higher for New Construction than for units in the Existing Housing program."<sup>26</sup> The Section 8 statute also gave HUD officials the authority to set the rents in individual projects as much as 20 percent higher than local

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<sup>25</sup> Hays 147.

<sup>26</sup> Hays 158.

FMRs, if warranted by market conditions.

Project based subsidy contracts were written with 20 to 40 year terms. Prior to 1980 they also provided five-year renewal periods, allowing the owner to "opt-out" of the program before the contract expired. Renewal was simply a roll-over of the original contract. Contract renewal resulted in no change in terms, although new contracts were governed by changed rules limiting distribution of surplus cash dividends and prohibiting five year opt-outs. "HUD experience [has been] that relatively few of the owners eligible to opt out of Section 8 contracts actually [have done] so. More often, HUD [has been] besieged by owners wanting to renew expiring contracts."<sup>27</sup>

It was initially anticipated that the HUD approval and rent subsidy contract would be sufficient guarantees of project soundness to attract private mortgage money. However, private lenders proved reluctant to get involved on this basis alone, and the program was increasingly linked to other forms of government subsidy and guarantees.<sup>28</sup>

The Tandem Plan, authorized in 1974, providing traditional GNMA (Government National Mortgage Association or Ginnie Mae) below-market mortgage writedowns, was frequently used<sup>29</sup>.

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<sup>27</sup> "Payment of HUD, FmHA Mortgages Sparks Debate Among Owners, Tenants, Others," Housing Development Reporter, Vol. 15, No.32, 580.

<sup>28</sup> Hays 148.

<sup>29</sup> The Tandem program, authorized by the Brooke-Cranston Act of 1974, authorized GNMA to "purchase below-market-rate mortgages from private lenders at par - above what those loans were worth on the market" - and resell them "at their true discounted value to Fannie Mae. The net effect of buying at par and selling at a

Section 221(d)(4), an FHA insurance program originally designed for unsubsidized units in high risk areas, was also paired with Section 8 contracts<sup>30</sup>. Additional sources of financing included local housing authority-issued bonds, and state housing finance agencies, receiving special set-aside of subsidies.

From a policy perspective the Section 8 program reflected the differences between the philosophy of the Nixon Administration and the Johnson Administration's vision of a Great Society. Where Johnson's War on Poverty emphasized direct federal leadership and control in housing, Nixon's New Federalism emphasized reduced regulation and unfettered profits for private owners. Rent limits and tenant income eligibility standards constituted the only real restrictions on project management. The public/private partnership programs developed in the earlier era, the Section 221(d)(3) and Section 236 mortgage insurance programs, have restricted project dividend distributions as well as rent levels and tenant incomes.

Developers who contracted to build or rehabilitate a project received a guarantee of virtually 100 percent occupancy at a fair rent as well as some ability to choose tenants...However, the real key to participation on the supply side lay imbedded in

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discount was a financing subsidy by the federal government over and above the operating cost assistance..." David Listokin 165. Also see Hays 148.

<sup>30</sup> David Listokin, "Federal Housing Policy and Preservation: Historical Evolution, Patterns, and Implications," Housing Policy Debate vol. 2, issue 2, 1991, 165.

the U.S. tax code"<sup>31</sup>

In particular, accelerated depreciation and the deductibility of mortgage interest were made available to developers, thereby encouraging tax syndication. These federal income tax incentives encouraged private participation in affordable housing production, and offered an avenue to further subsidize development.

The Section 8 program was slow to get started.

It took over a year for HUD to develop and promulgate regulations and for local agencies and developers to gain a clear enough understanding of the new rules to apply in large numbers. Thus, Section 8 did not begin to make a major contribution until 1976.<sup>32</sup>

Once "initial glitches" were ironed out, however, the program went into high gear. Construction of new units began to rise rapidly after 1977. The Substantial Rehabilitation program began to have visible role in 1977, but did not contribute a significant number of units.

By 1980, the Section 8 program was revised to include limits on owner dividends. In 1981 Section 8 eligibility was redefined to target very low income households, below 50 percent of median, and rent was raised to 30 percent of income, signalling the conservative shift in housing policy. Federal emphasis shifted in 1982, from the supply side to the

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<sup>31</sup> Karl E. Case, "Investors, Developers, and Supply-Side Subsidies: How Much is Enough?," Housing Policy Debate, Vol. 2, Issue 2 (Fannie Mae Office of Housing Policy Research) 342.

<sup>32</sup> Hays 150.

demand side, signalling the end of the New Construction and Substantial Rehabilitation programs. The President's Commission on Housing declared that:

Today....the largest problem is not the quality of housing in which most people live but its affordability...The purpose of federal housing programs should be to help people, not to build projects."<sup>33</sup>

Production ceased to play a significant role in national housing policy after this time, with a promise of resumption only coming seven years later with the Cranston-Gonzales National Affordable Housing Act of 1990.

The Housing and Urban-Rural Recovery Act of 1983, which terminated authorization of the Section 8 New Construction and Substantial Rehabilitation programs, effectively set a ceiling on the number of privately owned housing units that would be contractually reserved for non-elderly, non-handicapped, low-income households. Thereafter, the number of such units could only decline.<sup>34</sup>

It is quite difficult to secure a consistent count of the productive capacity of each federal program. The production and removal of units necessitates a snapshot count rather than a measure of total production. Further, the layering of subsidies (for example, in one Section 2321(d)(3) project Section 8 Loan Management Set-Aside subsidies might have replaced Rent Supplements, which in turn had replaced Flexible Subsidies) make it difficult to attribute production results.

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<sup>33</sup> David Listokin 166.

<sup>34</sup> Anthony J. Blackburn, "Tax and Direct Expenditures: Perspectives On Prepayment Proposals," Housing Policy Debate, Vol. 2, Issue 2, 329.

In fiscal year 1985 a General Accounting Office inventory of privately owned rental units with project-based federal assistance counted a total of 1,890,000 units; 347,000 units (18%) were characterized as HUD-insured and assisted inventory; 820,000 units (43%) were Section 8 New Construction, Substantial Rehabilitation and Moderate Rehabilitation inventory; 287,000 units (15%) classified by GAO as Section 8 inventory but also reasonably a part of the HUD insured inventory, included Loan Management Set-Aside projects, HUD property disposition projects, and rent supplement conversion projects. The balance of 436,000 units (23%) were comprised of FmHA Section 515 multi-family inventory and HUD-held inventory. The Section 8 project-based stock was heavily weighted with 614,000 New Construction units; Substantial Rehabilitation program contributed 114,000 units, and the Moderate Rehabilitation program represented 92,000 units.<sup>35</sup> The point of all these numbers is that during a short period of time, the Section 8 production programs had "generated the most units of subsidized housing produced in the United States in a short period of time."<sup>36</sup> The potential loss of over three-quarters of a million Section 8 units, or

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<sup>35</sup> United States General Accounting Office, Fact Sheet for the Chairman, Subcommittee on Employment and Housing, Committee on Government Operations, House of Representatives, "Rental Housing: Potential Reduction in the Privately Owned and Federally Assisted Inventory", June 1986 (GAO/RCED-86-176FS) 6 & 7.

<sup>36</sup> National Anti-Displacement Project, Low Income Housing Information Service, "Section 8: Projects At Risk of Conversion," Special Memorandum, (Washington DC: LIHIS, August 1990) 8.

more realistically, even a significant percentage of the units, will have a dramatic impact on the stock of housing affordable to low income people.

#### Section 8 Expirations:

Project-based Section 8 contracts will expire in four successive waves, reflecting both the date the programs were put into effect and the term lengths typical of each program.<sup>37</sup> The first wave will be the expiration of Loan Management Set-Aside contracts added to projects developed under the earlier mortgage insurance programs. This wave will be strong throughout the decade of the 90s, peaking in the last five years. The LMSA program represents about 390,000 units<sup>38</sup>. The second wave of Section 8 contract expirations will be in the Moderate Rehabilitation program. Almost all of the contracts on the 12,700 Moderate Rehab units will expire between 1995 and 2004. The third and largest wave will be the expiration of contracts in the Section 8 New Construction program. Forty-four percent of these units will expire in the period 2000-2004, with significant expirations both before and after that period. Approximately 680,000 units from the New Construction program will be expiring. "The bulk of these

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<sup>37</sup> National Anti-Displacement Project LIHIS, 8-9.

<sup>38</sup> These numbers are based on a 1990 count which differs from the 1985 GAO inventory both due to actual changes in the stock and methods of counting projects with multiple subsidies. Source: Anti-Displacement Project LIHIS, 8-9.



units are in fairly good condition and without major financial problem..."<sup>39</sup>. The fourth wave will be the expiration of the Substantial Rehabilitation contracts, representing 122,500 units. These expirations will also peak in the period 2000-2004, but there will be relatively more expirations after that period than under the New program. "Like the New construction program, this program has provided a generally well-maintained stock of badly needed affordable housing"<sup>40</sup>. The majority of the Section 8 project-based rental assistance contracts will be expiring in the next 15 years, between 1990 and 2005.

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<sup>39</sup> National Anti-Displacement Project LIHIS, 5 - 6.

<sup>40</sup> National Anti-Displacement Project LIHIS, 5 - 6.

### CHAPTER 3

#### Expiration in the Context of Competing Interests

Larry Yates, Director of Field Services for the Low Income Housing Information Service, has stated that the Section 8 "dilemma can be resolved with a minimum of conflict or it can be ignored, with catastrophic results."<sup>41</sup> By 1992 he declared the problem resolved<sup>42</sup>. The HUD insured-mortgage prepayment alarm of Section 221(d)(3) and Section 236 was sounded by tenant advocates. As observed earlier, they believe the Section 8 contract expiration will not present significant preservation problems: Contracts will simply be renewed. Since LIHPRHA represented new restrictions on owners, it is this group that is more likely to sound the next preservation warning bell.

To understand why there are differing views about the future of Section 8 contract renewal, it is necessary to look at the motivations of each of the participants in a Section 8 project. There are four parties involved in each project: the owner, the tenant, the government, and the lender. A fifth party, usually not directly involved but critical to the project, is Congress, through creation of program and appropriation of funds. Each party brings a set of interests that will inform their approach to the contract expiration.

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<sup>41</sup> National Anti-Displacement Project, LIHIS, 5.

<sup>42</sup> Interview with Larry Yates.

**Owners:**

To Owners, Section 8 subsidies represent a strong and reliable cash stream. Owners of New Construction projects contracted before November 1979, and Substantial Rehabilitation projects contracted before January 1980 have the further advantage of no limits on distribution of surplus cash as dividends.<sup>43</sup> For owner's, the major interest is to maximize returns, both in the form of annual dividends and the residual value of property. In any renewal situation, the owner will want to retain as much flexibility as possible, maximizing their ability to respond to market changes.

When existing contracts expire, assuming a voluntary renewal process, a number of factors will govern an owner's actions. Some will simply want out of the subsidized housing business, disenchanted with the administrative requirements, regulatory changes, or management of housing for the targeted population.<sup>44</sup> Most will be governed by a desire to maximize the profitability of the project, weighing four primary factors. Those are:

**1. Restrictions On Use Embedded in the Mortgage:** Projects financed through State Housing Finance Agencies or Public Housing Authority-backed bonds may have use restrictions and prepayment prohibitions that will influence contract renewal

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<sup>43</sup> "Section 8 Contracts Revised to Reflect New Regulations, Enforcement Alternatives," Housing Development Reporter Vol.8, no. 16, 311.

<sup>44</sup> Interview with David Smith and Howard Cohen.

decisions. Most FHA insured financing - either through the Tandem Plan or Section 221(d)(4) - does not contain restrictions, allowing the owner to maintain the favorable financing terms regardless of whether or not the project is used as affordable housing.

**2. Value of the Property in the Market:** In projects with market value that exceeds the value that could be gained through the Section 8 contract, the owner has incentive to walk away from renewal options. In such a case, many owners already indicate they would accept vouchers provided to low income tenants to allow them to gradually transition out of building.<sup>45</sup>

**3. Tax Consequences:** Where a plan to maximize the value of the property involves a sale, tax consequences will be a factor in weighing profitability. Many projects will face capital gains tax on a fully depreciated property.

**4. Value of New Subsidy Contracts:** New Section 8 contract renewals will also be evaluated against the property's value in the market. Important terms of the contract in this comparison include rent level, method of calculating increases, limits on dividends, stipulations regarding residual receipts accounts, use restrictions tied to the contract and length of the contract.<sup>46</sup> In projects that have operated with dividend restrictions (contracted after the

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<sup>45</sup> Interview with Howard Cohen and David Smith.

<sup>46</sup> Interview with Jay Regan.

1979 regulatory change), access to any existing residuals account will also be critical.

**Tenants:**

Tenants are primarily concerned with the preservation of their homes, and tenant advocates with the preservation of affordable units. Preservation is particularly critical in the case of Section 8 units, since they serve low and very low income tenants, and units are typically better than found in comparably priced (to the tenant) public housing projects. Larry Yates, of the National Low Income Housing Information Service, believes that "Congress will continue to appropriate funds for [Section 8 renewals]; there is a clear consensus about their importance. The result of lost units would be more explicitly harmful than in EUR projects, because Section 8 subsidies serve very poor people.

Larry Yates cautions, however, that if the owner comes to the legitimate end of his or her contract, Congress hasn't been able to find a way to require the owner to stay in. Tenant control over their housing through home ownership or non-profit ownership, an important objective that found support in the LIHPRHA legislation, is not as viable for Section 8 projects.<sup>47</sup>

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<sup>47</sup> Interview with Larry Yates.

**HUD:**

As representative of both the subsidy and the mortgage insurance, HUD brings sometimes conflicting interests to the discussion. As a lender and mortgage insurer, HUD's Federal Housing Administration is interested in protecting the security of the mortgage. This is particularly true given the recent history of FHA multifamily programs.

At this point, the losses in the FHA multifamily mortgage insurance programs have been well publicized...From our interviews, it is clear that many experts believe that the problems with the multifamily insurance programs had much less to do with the design of the programs or the risks inherent in rental housing than with HUD's inability to manage the programs.<sup>48</sup>

FHA will want to preserve adequate profitability to insure the owner remains interested in, and committed to the project. The Agency will also want to insure that the owner has adequate personal worth to support the project should any problems arise.

As a subsidy provider, HUD incorporates three potentially conflicting interests: 1) preserving units for low and very low income units; 2) being "fair" to owner; and 3) doing both in a cost-effective manner.

The Secretary of HUD is ultimately responsible for creating a coherent department policy between the subsidy and mortgage divisions. As a member of President's cabinet, the

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<sup>48</sup> Denise DiPasquale and Jean L. Cummings, "Accessing Capital Markets for Affordable Rental Housing, A Report to the Low and Moderate-Income Housing Finance Task Force," December 1990, Joint Center for Housing Studies, Harvard University, 33.

policy should reflect the philosophy of the current administration. All federal multifamily housing programs fall under the auspices of the Assistant Secretary for Housing (the Federal Housing Commissioner). The respective subsidy and mortgage interests will be represented by the commissioner's deputy assistance secretary for multifamily housing programs, with responsibility for the Section 8 production programs, and the deputy assistant secretary responsible for mortgage activity.

**The Private Lender:**

The private lender in a federally insured mortgage is neutral to the consequences of contract renewal. The lender's investment is protected by the FHA insurance, shifting all risk back to HUD.

**Congress:**

Congress is a critical player. It must pass the legislation and appropriate funds for any renewal program. This dual role of creating the ground rules and allocating the resources makes it appropriate, then, that Congress take responsibility for resolving the complex web of interests that defy neat distillation. Legislators must interpret and represent the public good. They must balance the need to create and maintain affordable housing, their obligations to developers, and for balancing the budget. They must be

responsive to requests for support from individual owners and tenant groups. Owners may represent important financial support, and tenants can represent large blocks of voters. The range of interests represented by the parties involved in a Section 8 project will determine the scope of the debate over the contract renewal process. The issues will concern the contractual context - voluntary or mandatory - for renewal, the terms of the contract, including rent level, method for determining increases, restrictions imposed on the project, and contract length. Both HUD and Congress will have to weigh the cost, political and financial, with the benefit of preserving the housing. The final solution must satisfy the financial, legal, and policy perspectives encompassed by these issues.

Under the much less than ideal conditions now prevailing, with no replacement project-based housing available and with no buy out arrangements in place, it is apparent that federal policy must attempt, as a matter of political necessity, to limit the extent of prepayment by the owners of subsidized projects over the next few years.<sup>49</sup>

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<sup>49</sup> Anthony J. Blackburn, "Tax and direct Expenditures: Perspectives On Prepayment Proposals," Housing Policy Debate, Vol. 2, Issue 2 (Fannie Mae Office of Housing Policy Research) 337.



**CHAPTER 4**  
**Five Preservation Issues for Section 8**

The divergent prophecies concerning the fate of Section 8 contract renewals stem from different perceptions of the preservation issues involved in such recontracting. Five issues mark the difference between the potential Section 8 recontracting and Congress's policy for Section 221 (d) (3) and Section 236 preservation as expressed by LIHPRHA:

- 1) owner choice in recontracting;
- 2) parity between Section 8 contract terms and incentives and other federal programs;
- 3) meeting the cost of new subsidies;
- 4) term or length of the new contract - both subsidy and use-restrictions, and correspondence between length of subsidy and use-restrictions; and
- 5) reconciliation of HUD's conflicting interests as subsidy provider and mortgage insurer.

The final plan will grow from answers to these questions, based on the economic and political climate at the time of expirations, as well as the philosophical perspectives guiding housing policy. The most important lessons for Section 8 recontracting will come from the experience of implementing LIHPRHA. Although too early to assess its shortcomings, an examination of the approach to preservation taken in LIHPRHA provides a framework for looking at Section 8 issues. Other precedents set during the evolution of the

Section 8 program also provides valuable information. Finally, it is helpful to look at the legal issues, public policy and economic implications that will guide a recontracting plan.

Any preservation plan is grounded in a premise of a continuing need for affordable housing not met by development of new stock.<sup>50</sup> Further, preservation policies are imbedded in the current anti-production policies. If policy makers take on a renewed commitment to production, affordable units lost to expiring Section 8 contracts might be replaced. Many housing professionals contend that a production orientation is a far healthier response, both for creating vital projects and for stimulating the economy. Robert Kuehn, a private

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<sup>50</sup> Preservation of existing affordable housing has become a necessary priority in the wake of the federal withdrawal from a commitment to housing, expressed both through the erosion of funding and through the 1986 Tax Reform Act, which substantially removed tax incentives for affordable housing development.

"America is increasingly divided into two nations: first a nation of housing 'haves,' and second a nation of housing 'have-nots.' Most Americans are well housed and enjoyed the benefits of continued economic growth, but the prosperity of these Americans does not reflect the plight of the growing number of low- and moderate income households." William C. Apgar, "The Nation's Housing: A Review of Past Trends and Future Prospects for Housing in America," Building Foundations: Housing and Federal Policy, ed. Denise DiPasquale and Langley C. Keyes (Philadelphia: University of Pennsylvania Press, 1990) 25.

Summarizing the findings reported in The State of the Nation's Housing: 1991, William Apgar, Jr. observed "[T]he current recession and real estate slump have done little to ease the nation's housing affordability problems. Moreover, once the long-awaited economic recovery takes hold, home prices and rents will move up again, further limiting the housing opportunities of the nation's poor." Karen Wiener, "The Crisis Isn't Over; The Continued Need for Affordable Housing in Massachusetts," (Boston: Citizens Housing and Planning Association, 1991) Forward.

affordable housing developer, argues that preservation efforts misdirect the need for a dynamic economy. From his view, the task is to produce in order to creates vitality and avoid developing stagnant stereotypes of certain stock as "low-income."<sup>51</sup>

Nonetheless, federal government has largely abandoned production of affordable housing over the last decade. At this stage, absent a dramatic shift in national housing policy, preservation is the only means of maintaining the existing stock of affordable housing.

**Mandatory or Voluntary Renewals: The Legal Context:**

Owners suggest that the mandatory compliance with LIHPRHA required by Section 221(d)(3) and Section 236 projects may not offer an appropriate model for Section 8 contract expirations. They concede that the legal issues may be similar, but assert that there are significant policy difference between the two preservation scenarios.

LIHPRHA requires owners of projects under its jurisdiction to participate in a highly regulated process that significantly modifies their ability to exercise a contractual right to prepay. Emily Achtenberg, noted expert on expiring use restrictions, notes that as a result of several potential "exit-points" in the process, "LIHPRHA is not a mandatory

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<sup>51</sup> Robert Kuehn, President, Keen Development Co., personal interview, July 20, 1992.

preservation program."<sup>52</sup> Owners are allowed to pre-pay if such action would have no adverse impact, the market value exceeds the preservation value, HUD is unable to fund preservation incentives within a specified time period, or there is no willing or able purchaser. Such exit-points do not, however, relieve an owner of the duty to comply with the LIHPRHA process. A critical issue facing Section 8 recontracting is whether a similar process will be imposed on project owners, and if one is, whether it will be voluntary or mandatory. The legal context appears similar in both instances - grounded in the Fifth Amendment "takings" provisions<sup>53</sup>.

Under LIHPRHA, only the right to prepay is disturbed. The balance of the mortgage remains intact. The loss of this right is compensated through incentives offered in LIHPRHA. The preservation issue in the Section 8 context occurs after the completion of the contract, rather than at a point midway through the contract. When Section 8 contracts expire, all relationships will be severed between owner and government. To force recontracting raises Fifth Amendment due process concerns and poses a number of public policy dilemmas.

Marty Jones, former HUD Multifamily Property Representative, currently Senior Vice President at Corcoran

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<sup>52</sup> Emily P. Achtenberg, Preserving Expiring Use Restriction Projects in Massachusetts: A Handbook For Tenant Advocates, Community Groups and Public Officials Interim Edition (Boston: Citizens Housing and Planning Association, 1991) I-6, I-7.

<sup>53</sup> Interview with Howard Cohen.

Jennison Co., Inc., speculates that there may be significantly different expectations of residual value for Section 8 projects that will translate into a greater willingness to test mandatory provisions in court. She believes that the historic poor location and maintenance of Section 221(d)(3) and Section 236 projects reflect owners' anticipation of little additional value at the prepayment date. The shifting perception of potential residual value, according to Jones, can be seen in the significantly better location, construction and maintenance of Section 8 projects. Such expectations, if supported by market potential, may make a big difference in how owners respond to contract expirations.<sup>54</sup>

Legal challenges to the LIHPRHA predecessor statute, the Emergency Low Income Housing Preservation Act or ELIHPA, offer insight into claims that might be brought against a mandatory recontracting in Section 8. In Orrego v. U.S. Department of Housing and Urban Development<sup>55</sup> the Illinois District Court upheld the constitutionality of ELIHPA. At issue in Orrego was a request by residents in a Section 221(d)(3) project that a prepayment of the mortgage be voided under provisions of the ELIHPA legislation. In arguing that ELIHPA unconstitutionally limited his prepayment option, the owner argued that it violated the Contracts Clause, denied due process rights, and

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<sup>54</sup> Interview with Marty Jones.

<sup>55</sup> Orrego v. U.S. Department of Housing and Urban Development, 701 F.Supp. 1384 (N.D. ILL. 1988).

constituted an illegal taking.

The Court rejected each of these assertions. First, it found that by its own terms, the Contracts Clause did not apply to the federal government<sup>56</sup>. The owner's claim of a constitutionally protected substantive right to prepay was also dismissed. In examining this issue, the Court held that Congressional legislation "adjusting the burdens and benefits of economic life" are presumed constitutional<sup>57</sup>. The Court went on to say that a statute will withstand such scrutiny if "Congress enacts it pursuant to a rational legislative purpose, in a manner that is neither harsh nor oppressive."<sup>58</sup> The Emergency Preservation Act was enacted by Congress to "maintain the level of low income housing available under federal programs, and the Act therefore fulfills a legitimate government concern other than saving the government money."<sup>59</sup> The prepayment provision was "simply part of a regulatory program over which Congress retained authority to amend in the exercise of its power to provide for the general welfare."<sup>60</sup> Finally, the court ruled that the Act did not work an unconstitutional taking of property under the Fifth Amendment

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<sup>56</sup> U.S.A. Constitution, Article I, Section 10, cl. 1 says, "no state shall...pass any...Laws impairing the obligations of Contracts..." (emphasis added).

<sup>57</sup> 201 F. Supp. 1395.

<sup>58</sup> 701 F. Supp. 1395.

<sup>59</sup> 701 F. Supp. 1396.

<sup>60</sup> 701 F. Supp. 1397.

because it "did not unconstitutionally deprive" the owner "of a property right." The owner will continue to own the property, and receive a reasonable return on its investment.<sup>61</sup> In sum, the Court concluded that Section 221(d)(3) and Section 236 owners have no absolute right to prepayment.

Mandatory Section 8 recontracting would likely involve similar claims, according to Howard Cohen, an attorney specializing in subsidized housing.<sup>62</sup> Cohen argues that the real difference between prepayment and contract expiration lies not in the law, but in public policy implications.

From a policy perspective, mandatory recontracting looks like more than a simple taking. It might more aptly be compared to conscription, since required "labor" in the form of ongoing management is required of owners. Yet, conscription might still be acceptable if it were necessary to achieve a particularly important public purpose.

Conscription of unwilling parties has practical disadvantages. It can be costly if the work to be done involved extensive discretion or judgement calls. Compulsory recontracting that provoked hostility from owners could require costly monitoring to insure fulfillment of the public purpose. Section 8 contracts already require many aspects of

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<sup>61</sup> 701. F.Supp. 1396.

<sup>62</sup> Interview with Howard Cohen.

management<sup>63</sup>, including:

- restrictions on tenant income levels;
- consent to comply with the provisions of the Section 8 regulations and other associated federal rules and regulations that establish tenant/landlord relationship restrictions, including stronger non-discrimination, and tenant protection requirements than most states impose on private owners;
- restricted rent levels, and possibly profit caps.

Thus to insure that projects comply with both the spirit and letter of the Section 8 program HUD could be forced to undertake a high level of monitoring in a setting of mandatory recontracting.

Monitoring would also be complicated by the very nature of the business. Management is concerned with very concrete product oriented things: physical management, including property maintenance, fiscal management and administrative compliance; but it is also concerned with process issues: the interaction with tenants, establishing a place in the community, creating the ambiance of project. Product is easy to monitor. It is far more difficult to regulate the process aspects of management.

Since 1960s it has been a public policy goal to encourage private profit motivated ownership of affordable housing. The

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<sup>63</sup> National Housing Law Project, The Subsidized Housing Handbook, (Berkeley, CA: NHLP, 1981) 1.2.



rational for this approach has been to harness the cost-effective productive capacity of the private sector<sup>64</sup> and overcome the perceived inefficiencies and obvious problems of public housing. Private ownership was thought to be more efficient than public ownership, and the involvement of the private sector was hoped to increase public support for the government programs.

Yet private developers charge that the intensity of regulation attendant to most government programs hampers the possibility of achieving any efficiency. Further, owners complain of changing rules, citing the Tax Reform Act of 1986 and LIHPHA as the most egregious examples. David Smith, President of ReCapitalization Advisors, Inc. of Boston, and national expert on recapitalizing subsidized housing, claims that "Contracts with the government are often unilaterally renegotiated."<sup>65</sup> The premium for legislative risk becomes quite high with such a history, further forcing developers/investors to maximize profits early in a deal. This intensifies the traditional business maximum that "sooner

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<sup>64</sup> Margery Austin Turner and Veronica M. Reed, Housing America: Learning from the Past, Planning for the Future; (Washington, DC: The Urban Institute, 1990) p?. and also David A. Smith, "Subsidized Housing Preservation: Where It Came From, Where Its Going," Real Estate Finance vol.7, no. 3 (Fall 1990) 14.

<sup>65</sup> Interview with David Smith. Smith makes a stronger argument in a 1990 Real Estate Finance article, claiming "Congress's actions have convinced property owners that developing government-assisted housing is foolish" the government always changes the rules to the owner's disadvantage." "Subsidized Housing Preservation: Where It Came From, Where Its Going," 16.

is better than latter". Constantly changing rules also undermines faith in government contracts and support for programs. Smith argues that "If the government permits the economic confiscation of..[insured mortgage projects]... because it lacks the political will to pay for what it wants, it will shut itself out of the private market."<sup>66</sup> The courts have express similar sentiments.

The need for mutual fair dealing is no less required in contracts to which the government is party, than in any other commercial arrangement...To say to these appellants, 'The joke is on you. You shouldn't have trusted us' is hardly worthy of our great government.<sup>67</sup>

These tensions suggest that the private/public partnership as a model for producing and preserving affordable housing may have run its course.

One means of ending public/private tensions is for government to simply seek a different kind of partner. There is some recent indication that public policy is shifting to favor non-profit ownership, reflecting sentiment that private profit motives and public purpose are not entirely compatible. The Cranston-Gonzalez National Affordable Housing Act offers an unprecedented role for non-profits in producing and managing affordable housing. Writing for National Multi

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<sup>66</sup> David A. Smith, 17.

<sup>67</sup> Maxima Corp. v. United States, no. 86-1292 (1st Cir. 1988) (quoting St. Regis Paper Co. v. United States, 368 U.S. 208, 229 (1961); from David Smith, "Syndication Topics: The Emergency Low-Income Housing Preservation Act of 1987: Good Intentions, Terrible Law," Real Estate Review Vol. 19, No. 1 (Spring 1989) 17 - 18.

Housing Council, Richard Hugh attributes this policy tilt to the growing capacity and strong lobby of non-profits, but most significantly to policy conflicts over expiring use issues, "Compounded by the HUD influence-peddling scandals, the failure of large FHA co-insurers, the collapse of major syndicators...have culminated in a burgeoning distrust of the motives of the private for-profit sector."<sup>68</sup>

Another route around the mandatory renewal obstacle might be to legislate rent limits in Section 8 projects, with incentives available in the form of subsidies to insure that owners were able to receive a fair return. This carrot and stick approach circumvents judicial hesitancy at imposing a contract on owners, yet achieves the low income housing preservation goal.<sup>69</sup>

#### Disparity In Section 8 Profitability:

LIHPRHA provides several incentives for owners to preserve the affordability of their projects. Owner profitability is encouraged under the new law by establishing rent ceilings and dividend limits at higher level than allowed in the original mortgage instrument. Rental subsidies

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<sup>68</sup> Richard J. High, "Feds Turn Toward Non-Profits, National Multi Housing Council 34.

<sup>69</sup> Lawrence Bacow, Esq., Chairman, Interdepartmental Degree Program in Real Estate Development, Massachusetts Institute of Technology, personal interview July 14, 1992; Henry Korman, Esq., Staff Attorney, Massachusetts Law Reform Institute, personal interview, July 17, 1992.

guarantee income and dividends are offered a measure of protection through provisions that allow them to be paid out prior to replacement reserve set-asides. Section 8 contracts already pay relatively high rents and dividends are simply unregulated, at least for pre-1979 New Construction and pre-1980 Substantial Rehabilitation projects. If LIHPRHA is to be the model for resolving the Section 8 contract expiration problems, policy makers will have to decide whether this disparity between the Section 221(d)(3) and Section 236 programs, and the Section 8 program will be corrected or continued.

Section 8 project-based rents are often significantly above rents in other private subsidized units, and above the market, according to owners surveyed<sup>70</sup>. They claim that rents often exceed the ceilings established in LIHPRHA.<sup>71</sup> High rents in these projects were justified by high construction costs in inflationary times. Rents were "increased like clock work" through an Annual Automatic Adjustment Factor (AAAF).<sup>72</sup> Recontracting, therefore, raises questions about initial rent levels and adjustment mechanisms. Marty Jones points out that two years ago, during the real estate boom, rents were in line with the market. She observes that "The market is so lousy

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<sup>70</sup> Interviews with Marty Jones, Jay Regan and Howard Cohen.

<sup>71</sup> Interviews with Howard Cohen, David Smith, Jay Regan.

<sup>72</sup> Interview with David Smith.

now, its hard not to be above it."<sup>73</sup>

Further, the Section 8 program does not limits distribution of annual surplus cash-flow on New Construction projects contracted prior to November 1979, or Substantial Rehabilitation projects contracted before January 1980. Regulatory changes in 1979 and 1980 added restrictions on owner profitability for Section 8 projects constructed after those dates, bringing them in line with other subsidy programs. Nevertheless, recontracting raises questions about whether the favorable disparity for older projects will be maintained or eliminated to conform to LIHPRHA and other subsidy programs.

LIHPRHA establishes clear guidelines about what constitutes a fair return, and how to determine the upper limit for rent. Rents may not exceed the federal cost limit, defined as the greater of 120% of the Section 8 Fair Market Rent or 120% of the "prevailing rents in the relevant local market area."<sup>74</sup> Rents must also provide adequate income to support debt service on the original insured mortgage, any rehabilitation loans, project operating expenses, adequate reserves, and a "fair return" for owners who choose to forego prepayment in favor of the preservation incentives. If required income exceeds federal cost limits, the project will have to undergo a mandatory sale, resulting in loss of the

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<sup>73</sup> Interview with Marty Jones.

<sup>74</sup> LIHIS 3 - 4.

affordable units.<sup>75</sup>

"Owners cannot receive a higher amount of incentives than 'can be supported by a projected income stream equal to the federal cost limit.'"<sup>76</sup> For projects which qualify for LIHPRHA incentives, annual rent adjustments will be made by applying an automatic annual adjustment factor (similar to the process utilized in Section 8) set by HUD. The authorized dividend distribution under LIHPRHA is limited to 8% return on "preservation equity"<sup>77</sup>. The Act also guarantees an income, allowing the dividend to be distributed before payment into mandatory operating reserves.<sup>78</sup> The resolution of the disparity issue will depend on both changes in the economy and the dominant political philosophy when the contracts begin to expire. If LIHPRHA's goal of "maximum preservation of stock at minimum achievable cost"<sup>79</sup> remains the aim in the Section 8 context, then the concept of a maximum "upset" price beyond which government should not go simply to preserve a

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<sup>75</sup> LIHIS 5.

<sup>76</sup> LIHIS 5.

<sup>77</sup> Preservation equity establishes a new owner equity sum to reflect appreciation. Basically it represents the fair market value at the highest and best use for residential purposes if the property is to be preserved for low income use, or general highest and best use if the property is to be sold; less debt secured by the property.

<sup>78</sup> LIHIS 7-8.

<sup>79</sup> Kenneth R. Harney, "Introduction to Session 3; Estimating the Costs: Perspectives on Preservation of the Nation's Lower Income Housing Stock," Housing Policy Debate Vol. 2, No. 2, 324.

project<sup>80</sup> should still hold. However, the measure of the maximum price will depend on the state of the rental market when contracts begin to expire, and on the value placed on preservation. A policy shift in favor of a strong production program, for example, will reduce the value of preservation by adding new affordable units to existing stock. In such an environment, the upset price might be measured by the cost replacing a subsidized project-based unit rather than in relation to the cost of subsidizing rents in the market. If the goals driving housing policy extend beyond merely providing affordable units to include such aims as expanding or upgrading the housing stock, creating jobs, or directing the location of low-income housing, the "minimum achievable cost" simply may not be a deciding factor.

The increased regulation of Section 8 dividends in 1979 and 1980 reflect corrections as the program matured. This fits the model of programs evolving in response to shortcomings, and provides a precedent for imposing restrictions at recontracting. Given this historical context, owners interviewed for this thesis were philosophical about the potential reduction in project profitability at recontracting. Jay Regan, Treasurer at State Street Development Company, anticipates some type of regulation, and hopes the federal government will be fair and reasonable. He assumes renewal will not be at the same level.

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<sup>80</sup> Kenneth Harney 323.

### The Cost of Recontracting:

The cost of recontracting must survive two tests. First, it must be deemed a reasonable price for the housing provided. Second, it must engage the political will of Congress. This last issue itself has two components: Congress's willingness to appropriate money, and whether preservation is politically palatable to congressional constituencies. Under LIHPRHA reasonable price is measured by a cost limit test, discussed previously, and a windfall profits test designed to prevent incentives from being granted to projects where market conditions alone are expected to prevent prepayment by the owner. Specifically, the windfall profits test is designed to insure preservation incentives are not granted, 1) when adequate low cost housing is available in the private market; 2) the abundant supply of market units prevents conversion; unless 3) the government desires to accomplish other public purposes through preservation.<sup>81</sup>

While the concept of a ceiling on rents could be applied to Section 8 recontracting, the actual limits established in LIHPRHA might prevent preservation because they are lower than rents currently paid under Section 8 contract.

Jones and Regan, owners of elderly projects, note that the majority of current Section 8 tenants are elderly, and all are low income<sup>82</sup>. Both expressed the opinion that concern

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<sup>81</sup> LIHIS 15.

<sup>82</sup> Interviews with Marty Jones and Jay Regan.



for elderly tenants will moderate both owner and government positions. Jones summed up the issue: Owners find it difficult to evict elderly tenants and the popularity of programs for the elderly will increase pressure on Congress to appropriate funds.

Incentives provided in LIHPRHA have not been put to the full appropriations test. Concern has been raised about Congressional willingness to appropriate adequate funds for the years with maximum prepayment costs. In May 1991, Bruce J. Katz, senior counsel for the Senate housing subcommittee, indicated there would be sufficient funding for the prepayment program in fiscal 1992, but "the \$2.6 billion that HUD says is needed in fiscal 1993 is another matter..."<sup>83</sup> Vince O'Donnell, Director of Development at the Community Economic Development Assistance Corporation, and an expert in preservation issues, expects that the overlay of the current economy with regulations which tie preservation incentives to appraised property value will encourage owners to postpone undertaking the LIHPRHA process until the economy improves. Thus, the cost of incentives would rise as the real estate market improves.

Section 8 contracts, on the other hand, will expire on a set date. There will not be a 20 year period during which owners can exercise a renewal option. Reallocations for the

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<sup>83</sup> "Housing Preservation: Resident Focus in Prepayment Rule An attempt to Level Field, HUD Says," Housing Development Reporter (May 27, 1991) 4.

Section 8 program must be made in the space of ten years. In addition, costs will be higher because the Section 8 program represents far more preservation units than are eligible to prepay under the mortgage insurance programs.

**Term Length:**

Term length for Section 8 renewals will be governed by restraints imposed by the federal budget process. The total cost authorized for multi-year programs is charged against budget limits for the first year, rather than against actual outlays for each fiscal year of operations. "In renewing funds for Section 8s the battle is over budget authority," observes the Anti-Displacement Project of the Low Income Housing Information Service.<sup>84</sup>

The appropriations constraint limited the term of Section 8 Loan Management Set-Aside (LMSA) contracts renewals - a pool of subsidies provided to previous insured-mortgage properties facing financial difficulties - to five year terms. Congress had indicated a willingness to renew the contracts in a like-kind/like-term manner, that is, with the original conditions and for the original term; It was unable to do so because of the cost of appropriations.<sup>85</sup> Congress did make a commitment

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<sup>84</sup> Anti-Displacement Project of the Low Income Housing Information Service, "Expiring Section 8 Contracts: Renewing the Promise of Affordable Housing," Special Memorandum, (Washington, DC: LIHIS, 1990) 6.

<sup>85</sup> National Anti-Displacement Project LIHIS 8.

to continue to renew LMSA subsidies in five year increments. Although the LMSA renewals indicate some willingness on the part of Congress, there are significant differences between LMSA subsidies and New Construction and Substantial Rehabilitation subsidies. First, the rents for LMSA subsidies are lower since the initial cost of Section 221(d)(3) and Section 236 projects were markedly below the cost of Section 8 New Construction and Substantial Rehabilitation projects. Second, projects with LMSA subsidies limit dividends through the original mortgage, removing any incentive to maintain high rents.

Use restrictions under LIHPRHA do not correspond to subsidy commitments or mortgages. Instead, in exchange for preservation incentives, owners must preserve the housing's low and moderated income character for its remaining useful life (at least fifty years) with adequate income for maintenance and operations.<sup>86</sup> This extension of use restrictions beyond the direct provision of government resource reflects a shift in policy perspective regarding the benefits the government expects from its investments. Current thinking, as expressed in LIHPRHA, is that capital contributions should reap benefit for the full life of that project. Operating subsidies present a somewhat different question that will have to be explored.

If these two precedents were carried forward into Section

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<sup>86</sup> LIHIS 7-8.

8 recontracting, owners might be offered five year subsidy contracts, albeit with a Congressional promise of rollovers, and fifty year use-restrictions written as covenants that flow with the land. As discussed earlier, owners assume a high degree of legislative risk in any dealing with government programs. A rollover commitment would appear to offer little comfort to owners facing such a trade off. However, a soft market when contracts expire would place HUD in a strong position to negotiate tough terms, should it so choose.

**Dual Role of HUD:**

HUD will enter contract negotiations constrained by its conflicting position as subsidy provider and insurer of the mortgage. Section 8 New Construction and Substantial Rehabilitation project with federally insured mortgages were principally written with 20 year subsidy contracts and 40 year mortgage notes. At year 20 the majority of the original mortgage will remain to be paid<sup>87</sup>. HUD, in its role as lender through FHA, will want to protect this note from

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<sup>87</sup> Marty Jones offered three projects as illustration of the mortgage balance due in year 20 on a 40 year GNMA Tandem Plan mortgage with a 7.5% interest rate: Keystone Properties, a 220 units elderly development, had an original mortgage of \$37,900/unit, in year 20 the mortgage balance is \$30,500. Cobble Hill, a 224 mixed family/elderly project began with a \$54,100/unit mortgage, and will owe \$43,200/unit in year 20. Millbrook Square, with 146 elderly units began with a mortgage of \$50,100/unit, will have a balance of \$39,800/unit in year 20. In each of these projects, approximately 80 percent of the original mortgage remained to be paid at the end of 20 years of amortization. Interview with Marty Jones.

default by insuring adequate income to the project to cover debt and operating expenses, and to provide sufficient profits to maintain the owner's interest. HUD's role as Section 8 subsidy provider, conversely, will be to negotiate the lowest possible cost, and if costs outweigh benefits, to forego recontracting. This inherent conflict will blunt HUD's ability to negotiate the lowest cost subsidy contract. Tension between FHA and the balance of HUD is notorious, dating back to 1965 when FHA came under HUD's jurisdiction.<sup>88</sup> Jones, formerly on the HUD Region I staff, points out that policy decision of this significance will be made at the level of the Secretary and Congress, bypassing the traditional line-staff animosities.

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<sup>88</sup> Interviews with Marty Jones; Langley Keyes, Professor, Massachusetts Institute of Technology, July 15, 1992.

## CHAPTER 5

### Questions and Solutions: Philosophical, Procedural, Technical

In many respects, the experience of preserving Section 221(d)(3) and Section 236 projects does provide a basic road map for looking at Section 8 contract expirations. The debates that preceded legislation for the two earlier programs honed a philosophical orientation to preservation that balances the needs of tenants with the rights of owners. LIHPRHA provides a procedural framework for assessing preservation worth at a project level. The experience with Section 221(d)(3) and Section 236 programs does not, however, provide a technical answer to the Section 8 contract expiration dilemma. This is as expected, given the inherent differences in the program, stemming from Section 8's creation to correct problems in the Section 221(d)(3) and Section 236 programs.

The seriousness of the technical differences should not be minimized, for Section 8 presents unique preservation challenges. This thesis has examined five issues that grow out of the differences between Section 8 and its predecessors. How each of these issues plays out when contracts expire will depend on four sets of variables.

#### **1. Experience Implementing LIHPRHA:** LIHPRHA regulations

have yet to be put to the test.<sup>89</sup> Implementation will reveal shortcomings that will guide formulation of Section 8 preservation.

**2. Dominant Political Philosophy:** By the time Section 8 New Construction and Substantial Rehabilitation contracts begin to expire in 1996<sup>90</sup> the United States may face a far different political landscape than currently exists. Presidential elections in the fall of 1992 and 1996 hold promise of shifts in policy at the Executive level, as do biannual Congressional elections. A strong federal housing production program could obviate the need for preservation as a strategy for insuring adequate affordable housing stock.

**3. Economy and Real Estate:** Similarly, in the intervening four years, the economy may shift rapidly, as is exemplified by the past four years of boom and bust cycles. A strong real estate market will increase the market value of projects, raising the price tag for preservation. By the same token, a soft market will strengthen the government's hand in negotiating concessions on price and use restrictions when recontracting.

**4. Demographics and the Demand for Section 8 Housing:** The bulk of contracts expire in the five years preceding 2006, the year baby boomers begin to turn 60. This aging of the

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<sup>89</sup> Regulations issued April 8, 1992 are only four months old at this writing.

<sup>90</sup> 178 New Constructions units will expire in 1995, a sum too small to garner national attention.

population will create an explosion in demand for elderly housing at both a market and affordable rate. Marty Jones notes that Section 8 housing is predominantly elderly, and by design often included significant common space, making it ripe for conversion to assisted living communities.<sup>91</sup>

Although the 20 year trend of a widening disparity in incomes does not promise to abate, the level of demand for affordable housing may shift. A burgeoning low income elderly population might increase pressure on the government to preserve Section 8 projects. Increased demand and a powerful elder lobby could raise the threshold of a palatable price tag for preservation.

These four variables provide a context for examining the five issues related to differences in the Section 8 program and the insured-mortgage programs, drawing conclusions about how recontracting might proceed.

**Context for Recontracting: Mandatory or Voluntary:** The legality of a mandatory recontracting does not appear to be a central issue. Just as the Court ruled in Orrego that ELIHPA did not constitute an unconstitutional taking under the Fifth Amendment, mandatory recontracting would similarly no be unconstitutional according to an attorney specializing in this area of law. However, such a taking would likely engender more legal challenges than did ELIHPA and LIHPRHA, given the

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<sup>91</sup> Interview with Mary Jones;



generally higher residual value Section 8 properties<sup>92</sup>. As a policy issue, however, mandatory recontracting looks very different from prepayment prohibitions. Such a policy would have to demonstrate sufficient public purpose to justify conscripting owners into signing contract renewals to provide and manage housing. This policy poses practical problems: monitoring compliance of an unwilling party to a contract can be costly and difficult. Further, mandatory renewal works against the public policy goal of encouraging public/private partnerships. Finally, the courts are reluctant to mandate affirmative action<sup>93</sup>, and so might be reluctant to require a contract be signed.

These issues surrounding "mandatory" renewal can be approached in three ways: First, incentives can be designed to attract an adequate level of voluntary owner participation to insure housing preservation goals are met. Second, a carrot and stick approach can be employed by regulating tenant rents when contracts expire and offering owners the option of a subsidy renewal, thereby avoiding mandatory recontracting yet insuring rents remain affordable. Third, the preservation issue may signal that the public/private-for-profit partnership has run its course. Housing policy evolution may look to partners with more compatible goals. The emergence of priority for non-profits under LIHPRHA may signal this shift

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<sup>92</sup> Interview with Marty Jones.

<sup>93</sup> Interviews with Lawrence Bacow and Henry Korman.

in perspective.

**Disparity in Section 8 Profitability:**

Limits on rents and owner dividends under the original Section 221(d)(3) and Section 236 programs were repeated in the LIHPRHA legislation. In contrast, the Section 8 program has high, although limited, rents, and on many of its projects, unlimited dividends. Policy makers will have to decide whether to correct or continue this disparity in profitability between Section 8 and the insured-mortgage programs when designing contract renewals. Precedent set in the 1979/1980 Section 8 regulatory changes to limit dividends, and in LIHPRHA, indicate that public policy values some limit on owner profitability. This bodes for restrictions, balanced by concern for FHA-insured mortgages, and, under voluntary renewal, owner willingness to accept significantly lower returns.

**Cost of Recontracting:**

LIHPRHA applies two tests to evaluate the level of incentives necessary to insure projects continue to serve low and moderate income people while providing owners with an 8 percent return on equity. The federal cost limit test sets a maximum "upset price" and the windfall profits test insures that incentives are reasonable. The formula is expected to work, in part, because Section 221(d)(3) and Section 236

projects were, from present perspective relatively inexpensive to build and therefore do not carry enormous debt.

Section 8 projects, however, were comparatively expensive and the recontracting issue emerges half way through the mortgage amortization, with a substantial majority of the original debt still to be paid. If a measure of comparability in operating costs is presumed, then the significantly higher debt on Section 8 projects will produce far more units that exceed the LIHPRHA cost limits. Although the technical application of the federal cost limit and windfall profits test may not work for Section 8, the process of regulating an "upset price" after which incentives exceed a reasonable cost, is applicable to Section 8 renewals.

**Term Length:**

A significant barrier to Section 8 recontracting will be the cost of appropriating funds for the full term of the contract. Requirements that funds be drawn against the federal budget in the years in which they are authorized, rather than expended, will serve to limit the term length of renewal. Precedent with Section 8 LMSA contract renewals points to five year contracts with a promise to recontract at the end of that period. A substantial issue for owners is the precedent established under LIHPRHA to extend use-restrictions beyond the provision of subsidy. Negotiations over the relative length of use-restriction and contracts terms will be

resolved in the context of the relative strength of owners and HUD in recontracting.

**Dual Role of HUD:**

HUD's dual role as subsidy provider and mortgage insurer will constrain its negotiating position in recontracting. Traditional tensions between FHA and the balance of HUD surface in the Section 8 contract expiration. While, the importance of the Section 8 housing stock insure that the conflict will be resolved as a policy decision formulated by the Secretary of HUD and Congress, the resolution of that conflict and the implementation emerging from it cannot help but be impacted by the dual institutional role.

Just as the Section 8 program was built on the lessons and shortcomings of the Section 221(d)(3) and Section 236 programs, so too will a preservation plan for Section 8 be built on the lessons and shortcomings of the LIHPRHA process. As stated in Chapter 1, U.S. housing policy evolves through programs, each created to respond to the specific shortcomings of previous programs, and to the dominant political philosophy. The solution to Section 8 contract expirations will not be an exception to this rule.

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