

Enforceability of State-Imposed Restrictive Covenant

Legal Opinion: GHM-0057

Index: 3.346

Subject: Enforceability of State-Imposed Restrictive Covenant

October 23, 1992

MEMORANDUM FOR: Howard Mayfield, Director, Technical Support
Division, HMIT

FROM: Donald A. Franck, Chief Attorney, Loan Management and
Property Disposition Section, GHM

SUBJECT: Brandywyne Village
East Boston, Massachusetts
Project No. 023-55020
L-1244

This memorandum is in response to your September 23, 1992 request for a legal opinion concerning the captioned project.

Brandywyne Village (the "Project") has a mortgage insured under Section 221(d)(3) of the National Housing Act. In 1989, Brandywyne Village Associates (the "Owner") submitted to HUD a plan of action requesting Federal incentives pursuant to the Emergency Low Income Housing Preservation Act of 1987 (ELIHPA). In accordance with Section 248.213(b)(6) of Title 24 of the Code of Federal Regulations, the plan of action included an appraisal of the Project which was conducted on May 1, 1989. The Boston Office reviewed the Owner's appraisal and concluded that it did not contain adequate supporting documentation. On April 16, 1990, the Boston Office conducted its own appraisal of the Project and, on April 4, 1991, revised this appraisal. The Regional Inspector General's Office then audited the Boston Office's revised April 4, 1991 appraisal. The Boston Office issued preliminary approval of the Owner's plan of action on February 14, 1992. At this time, it is unclear which appraisal was relied upon.

Each of the appraisals derived a different value for the Project and, according to the memorandum from Linda D. Cheatham, Director, Office of Insured Multifamily Housing Development, to John A. Mastropietro, Regional Administrator-Regional Housing Commissioner, Boston Regional Office, each of the appraisals was deficient in certain respects. Because none of the appraisals was conducted in accordance with Departmental policy, Linda Cheatham's memorandum directs the Boston Office to conduct another appraisal of the Project in light of the concerns raised by the Regional Inspector General's audit and taking into consideration the recommendations made by the Office of Insured Multifamily Housing Development.

Your September 23, 1992 memorandum raises certain issues with respect to conducting this new appraisal and you have requested that we respond to the following:

1. given the Department's policy that an appraisal establishes a property value which, for purposes of providing incentives under ELIHPA, cannot later be modified, may the Boston Office conduct a new appraisal of the Project, or is HUD constrained to rely upon the original appraisal, although it was done incorrectly;
2. if the original appraisal and the value derived from that appraisal is binding upon the Department, may HUD nevertheless (a) adjust the amount of the Owner's equity by deducting from equity upgrade improvements and conversion costs and (b) perform a capital needs assessment to determine amount of loan proceeds to be escrowed to complete Project repairs; and
3. if HUD may conduct a new appraisal, despite Departmental policy which makes an appraisal binding, should the Project be appraised as of the date of the original appraisal, or as of the date the new appraisal is conducted.

As to the first question, the Department's general policy is that, for purposes of preservation, an appraisal, once conducted, is binding upon the Owner and the Department and cannot be modified at a later date due to changes in market conditions. While there is no statutory or regulatory authority which dictates this policy, this position is implied by the nature of the preservation program. An appraisal is the cornerstone of the preservation process. The appraised value of a Project determines whether or not an owner may receive Federal incentives under ELIHPA. An owner's equity and the sale price it may command for the property under ELIHPA are both derived from the project's appraised value. The appraised value is used to calculate the amount of an equity take-out loan an owner may receive, as well as the amount of the owner's annual authorized return. Because the appraisal affects an owner's eligibility for incentives, as well as the level of incentives it may receive if eligible, the appraisal must be conducted early in the preservation process and cannot be modified at a later date.

The foregoing policy is based on the assumption that an appraisal is conducted correctly and the only reason for a modification would be a fluctuation in property values. Where an appraisal violates the Department's statutes, regulations or administrative guidance, it would be arbitrary and capricious for the Department to maintain that an owner is bound by that appraisal.

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In the immediate case, the Owner's appraisal was inadequately documented and the appraisals conducted by the Boston Office and the Regional Inspector General's Office both

violated the Department's administrative guidance. Because the Project was never correctly appraised for purposes of ELIHPA, a proper appraisal must be conducted before the Department may issue final approval of the Owner's plan of action and provide incentives. This is not contrary to the Department's policy that appraisals may not be modified as a result of changes in market conditions.

Because of our response to this issue, it is unnecessary to address the second question. When conducting the new appraisal, the Boston Office should deduct upgrade improvements and conversion costs from the Owner's equity and conduct a capital needs assessment in accordance with current Departmental administrative guidance.

As to the third question, we suggest that the corrective appraisal establish the value of the project as of April 16, 1990, the date of the first corrective appraisal conducted by the Boston Office. Section 248.213(b)(6) of the Department's regulations requires an owner to submit an appraisal as part of the plan of action. Assuming that the appraisal has been conducted properly and the owner is eligible to receive ELIHPA incentives, the level of incentives would be based on the value of the property as determined at the time of the appraisal. If there were minor problems with the appraisal, in the normal course of events the field office would attempt to amend the appraisal through discussions with the owner's appraiser and the value of the property would be established as of the date of the appraisal. If it were impossible to amend the appraisal, either because a resolution could not be reached or the problems were of such a nature that a new appraisal would be required, the field office would either request the owner to submit a new appraisal or have field office staff conduct a corrective appraisal. In this instance, the value of the project would be determined as of the date of the corrective appraisal.

In this case, the first corrective appraisal was conducted on April 16, 1990. If the corrective appraisal had been done properly, the plan of action would have been approved based on the value of the Project on April 16, 1990. Because the Department did not correctly conduct this appraisal, or its revision, or the subsequent appraisal, the Project must be re-appraised. In conducting a new appraisal on this Project, it would be reasonable for the Boston Office to establish the value of the Project as of April 16, 1990, the date that value would have been determined in the absence of any error on the part of HUD.

It should be noted that there is no statutory or regulatory

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provision requiring the Department to use the date of the original appraisal when conducting a corrective appraisal and your Office is not required to abide by our response to this issue. However, we advise that whether you adopt our recommendation and determine value as of the date of the original

appraisal or decide to use the date of the new appraisal, your Office should be consistent in its decision. If any additional cases arise where a project has been incorrectly appraised and a new appraisal is required, the same standard should be applied as in this circumstance.

If you have any further questions regarding this matter, please contact Susan M. Sturman at 708-3667.