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Preserving Rural Rental Housing

OWNER CONVERSION OF RURAL RENTAL PROPERTIES TO MARKET RENTS: BOTH TENANTS AND OWNERS TURN TO THE COURTS

by Timothy Thompson

It should not be surprising that the federal law that governs prepayment of these mortgages has generated litigation.

The existing supply of affordable rural rental housing is shrinking across the country as owners of projects in the federal Rural Housing Service's Section 515 program pay off their mortgages early, escape the program, and boost rents. It should not be surprising that the federal law that governs prepayment of these mortgages has generated litigation. The current law attempts to balance the competing interests of owners desiring to escape government regulation with the need to protect tenants from the resulting consequences. However, this balancing was one-sided against owners, said the federal Court of Claims in a recent ruling that could expose the government to millions of dollars in damages.

Tenants Seek to Enforce Protections

As described elsewhere in this issue of *Rural Voices,* federal law permits owners to prepay their Section 515 mortgages only in certain circumstances. Even then, prepayment is often supposed to be subject to restrictions that protect current tenants from escalating rents. On a number of occasions, including in Minnesota, Washington, Oregon, Idaho, and Michigan, tenants have gone to court to challenge improper owner prepayments, suing both the RHS for its misapplication of federal law and owners for sidestepping tenant protections. In most cases, tenants have achieved success in either preventing or effectively reversing the prepayment, through court orders restoring their projects to the Section 515 program or at least enforcing tenant protections.

In a recent Oregon case, because the owners of six RHS projects could not agree with RHS on property appraisals, the owners paid off two loans and threatened to pay off the rest, all without tenant protections. Tenants in several of the projects sued challenging a misapplication of federal law, and it now appears that prospects are bright for a settlement that would restore at least several of these projects to the Section 515 program.

Even where prepayments properly occurred, tenants have not always been protected as federal law requires. In a Minnesota case

where the owner illegally increased rents after a proper prepayment, tenants obtained a court order blocking the rent increase. The tenants were then able to negotiate a settlement resulting in a sale of the project to a nonprofit dedicated to keeping the building affordable.

In fact, tenant enforcement of their own rights has become a key facet of the prepayment structure. RHS has acknowledged that it lacks the resources to police owner compliance with these restrictions, and has inserted language in the restrictions providing that tenants themselves can seek to enforce these restrictions in court where necessary.

Not all tenant lawsuits have been successful, despite compelling claims. Tenants in Albany, Minnesota found themselves falling through a hole in the RHS safety net when their Section 515 landlord discovered an easier way to get out of the federal program. The owner defaulted on his loan to RHS and when the agency responded by accelerating payment on his loan, he paid off the loan free from the restrictions of the prepayment process. The tenants sued, asserting that this end run around the process was in fact a prepayment, which should have led to protections against excessive rents. But the court rejected the tenants' claim.

Despite several setbacks, the good news for rural tenants is that the courts have usually responded where tenant rights have been violated. The bad news is that most tenants cannot easily obtain a lawyer to challenge these system failures, assuming tenants even realize their rights have been infringed. The cases mentioned above probably represent a fraction of the cases around the country where federal protections are being disregarded. Housing advocates can play a valuable role by monitoring Section 515 prepayment activity and helping tenants find lawyers where necessary. In addition, the Housing Preservation Project (see contact information below) is available to assist local counsel with these cases on behalf of tenants.

Owners Challenge Restrictions

Owners turn to the courts for very different reasons, of course. Although owner representatives were involved in the drafting of the current federal law, many owners have long objected to the law. In their view, they entered the Section 515 program relying on the right to prepay their mortgages freely, and believe that Congress cannot later "change the rules of the game" by restricting those rights. Despite the fact that owners received significant benefits by participating in the Section 515 program and knew they could be subject to changes in federal law, courts have been lending a sympathetic ear to owner arguments of this kind. That has led to three kinds of legal challenges.

In some cases owners have sought to nullify the restrictions altogether on constitutional grounds. The Eighth Circuit Court of Appeals in the *Parkridge* case rejected that claim, holding that the prepayment statute was constitutional because in the only situation where it prevents prepayment it also provides that the owner must sell but at fair market value. While the court suggested owners may be entitled to money damages, owners still have to follow the prepayment process required by the law.

A second approach by owners has been to bypass the RHS prepayment process and sue to eliminate any restrictions by asking the court to "quiet title" (remove encumbrances on the property such as rent restrictions), pursuant to state law procedures. Most notably, the Ninth Circuit Court of Appeals in *Kimberly Associates* has recently approved this strategy by owners. There the court rejected arguments by tenants that this was an improper way to challenge the statute, and rejected RHS's arguments that special defenses available to the federal government should defeat the owners' case. From the tenants' point of view, this approach is particularly alarming because it essentially nullifies the federal prepayment process.

The third approach consists of a half dozen lawsuits filed in the federal Court of Claims by groups of owners with hundreds of Section 515 projects across the country. In these cases owners are not attempting to escape the statutory restrictions, but seek money damages based upon losses they claim as a result of having to comply with the law. Their argument is that the after-the-fact imposition of restrictions on their right to prepay constitutes both an unconstitutional taking of their property and a breach of their contract by the government.

In a long awaited ruling at the end of August, the Court of Claims issued a 72-page decision following a trial in *Franconia Associates v. The United States.* This decision is a major victory for owners unhappy with prepayment restrictions, and could expose the federal government to millions of dollars in damages, in both this case and also those following on its heels.

The *Franconia* court's view of the federal prepayment law

becomes clear from the outset when the court quotes from the Eagles' song "Hotel California": "You can check out anytime you like, but you can never leave." The court first finds the government liable for breaking their contracts with these owners. In the court's view, the owners had an unfettered right to prepay their mortgages and escape the Section 515 program, and in passing laws in 1987 and 1992 restricting those rights, Congress welched on the deal.

In reaching these conclusions, the court rejected several arguments by the government. One was that the law in most cases did not prevent prepayment, but merely regulated it, offering owners several reasonable options. The other was that in legislating Congress is traditionally granted considerable leeway to change certain rules where necessary; the idea is that the sovereign power of the United States to change the law as it affects contracts remains intact unless surrendered by Congress in unmistakable terms. This "unmistakability doctrine" defense was rejected by the court, on the grounds that it does not apply where Congress is targeting pre-existing contract obligations in order to get itself a better deal. It did not matter to the court that Congress was doing so in order to pursue the unquestionably worthy public goal of protecting innocent tenants.

Having found the government liable for breach of contract, the court spent the bulk of its ruling on calculating the owners' damages for lost profits. The court again rejected most of the government's objections, including the argument that the court should consider the failure of most of the owners to take advantage of the reasonable options available to them under the prepayment law (in legal terms, a duty to "mitigate" or minimize damages). In a battle of the experts over which theoretical model for calculating lost profits was most fitting, the court generally sided with the owners' expert on most issues. Because of the complexity of these models, the court ended its long decision by directing the parties to submit their final calculations for each owner's damages before the court could issue final judgments.

Although a final judgment has not yet been issued, most of the damage calculations have now been completed. The average damages award per property exceeds $400,000 and the total damages amount to over $13 million. If this award ultimately stands, it is most likely to be paid out of Department of Justice funds rather than from the RHS budget.

It is too soon to know the full implications of the *Franconia* ruling, but they are likely to be profound. The government, of course, has the right to appeal, and with a decision of this complexity, there is no shortage of issues that might look different to a higher court. Still, this decision delivers a major body blow to Congress's approach to preserving Section 515 projects as affordable housing. It also raises tough policy questions about the wisdom of basing an affordable housing program on for-profit owners who have different long-term goals than has the program itself.

Conclusion

Those concerned about the future of the Section 515 program should pay close attention to the courts. Tenants and housing advocates will inevitably have to turn to the judiciary to protect their rights in some of these prepayment cases. More ominously, though, the *Franconia* decision, and the wake it will create, could unsettle federal preservation policy in the most fundamental ways. Owners, RHS officials, and Congress will all be studying the implications of *Franconia,* as well as other pronouncements from the bench on these issues. Others concerned about the continuation of Section 515 housing must do their legal homework as well.

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