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SUBSIDIZED RENTAL PROJECTS IN DEFAULT: RIGHTS AND REMEDIES

Alan S. Ganz*
Marc A. Primack**

When a government subsidized multi-family housing project is in default, the rights and remedies of the parties differ greatly from those when a traditionally financed project is in default. Not only are governmental parties involved—possibly a state entity as well as the Department of Housing and Urban Development—but the legal relationships of the mortgagor and mortgagee are more complex due to the existence of contractual relationships supplemental to the mortgage agreement, state and federal statutes, and court decisions unique to subsidized housing. The authors examine the practical considerations arising from the various legal relationships and discuss the options of both state housing finance agencies and project owners when subsidized projects are in default.

Federally subsidized multi-family housing has become an important part of the nation’s housing stock.1 The subsidies are administered by the United States Department of Housing and Urban Development (HUD) under the provisions of section 8 of the United States Housing Act of 19372 (section 8), section 101 of the Housing and Urban Development Act of 19653 (section 101) and section 236 of the National Housing Act4 (section 236). The extent of federal spending in this area is reflected by the amounts HUD committed during fiscal 1980. During that period, HUD paid $271,197,000 in rent supplements, $2,104,220,000 under section 8, and $656,053,000 under section 236.5 As of September 30, 1979, HUD had paid subsidies for 7500 projects

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** B.A., University of Chicago (1973); J.D., Stanford University (1977).

The authors' Chicago law firm is outside counsel for the Illinois Housing Development Authority. They gratefully acknowledge the help of Director Donald W. Hoaglund and Assistant Director and General Counsel Robert J. Wittebort, Jr.

1. One study conducted in 1970 found that 19.3% of rental housing in Chicago was federally subsidized, 16.0% in New York, and 19.9% in Atlanta. See D. MANDELKER & R. MONTGOMERY, HOUSING IN AMERICA: PROBLEMS & PERSPECTIVES 342 (1973). Doubtless, since 1970 the percentage of the housing stock subsidized by federal largess has risen significantly.


5. Letter from Charles Patterson, Housing Information Coordinator, HUD, to Alan S. Ganz (Nov. 19, 1980).
under regulatory agreements. These projects contained approximately 786,600 residential units. Some of the subsidies authorized by these acts are channeled through state housing finance agencies (HFAs). These state bodies are, however, more than mere conduits for rent subsidies. HFAs also help finance privately owned housing projects with funds obtained by issuing revenue bonds secured by first mortgages. At the present time, approximately thirty HFAs are financing such privately owned multi-family projects. These projects comprise over 292,000 units with an outstanding indebtedness of approximately $9 billion.

Subsidized financing of privately owned projects imposes legal duties upon owners not present with traditional financing. In addition to the obligations undertaken by the owner of a traditionally financed multi-family project through the mortgage, mortgage note and assignment of rents, the owner of subsidized housing incurs duties under a regulatory agreement entered into with HUD, an HFA, or both. Whereas traditionally an owner is free to rent to whom he or she pleases and to use project income in any manner as long as debt service is paid and waste is not committed, the owner receiving subsidies is restricted by provisions limiting the types of tenants, usually in terms of income, who may live in the project, the owner's economic return, and the use of project income.

Although HUD and HFA mortgages and notes never place personal liability for payment of the debt upon the owner, regulatory agreements typically hold the owner responsible for any misapplication of funds. Thus, if an owner defaults, HUD or the HFA may be able to foreclose on the

6. See notes 11-15 and accompanying text infra.
7. Letter from Marilyn Melkonian, Deputy Assistant Secretary, Multi-family Housing Programs, HUD, to Alan S. Ganz (Dec. 28, 1979).
8. See 42 U.S.C. 1437f(b) (1976) (authorizing the Secretary of HUD to enter into "contribution contracts" with state public housing agencies to make assistance payments to owners of low income dwelling units).
9. See, e.g., ILL. REV. STAT. ch. 67½, § 314 (1979) (authorizing Illinois Housing Development Authority to issue negotiable revenue bonds and notes to achieve its purposes, inter alia, "making of mortgage or other loans for the construction of housing to be occupied by low and moderate income persons" and "rehabilitation of existing structures so occupied").
10. See State Statute and Size Chart, Appendix A infra.
11. See, e.g., FHA Form No. 3136 (revised Sept. 1969) ("Regulatory Agreement for Limited Distribution Mortgagees under Section 236 of the National Housing Act, as amended").
12. See, e.g., IHDA Form No. LD-5(A) (revised Aug. 1975) (Illinois Housing Development Authority's "Regulatory Agreement (Limited-Profit Rental)") [hereinafter cited as IHDA Form No. LD-5(A)].
13. Id. ¶¶ 8 (c), (d).
15. See, e.g., IHDA Form No. LD-5(A), ¶¶ 10, 13.
16. Id. ¶ 4(b).
17. Throughout this Article the term default will include both default under the mortgage and breach of the regulatory agreement. Although there is a technical difference between the two, regulatory agreements generally contain an acceleration clause that permits the HFA to declare a default upon breach of the agreement. Thus, the practical effects of breach of the
mortgage as well as bring suit for violation of the regulatory agreement. Upon breach of the agreement, the HFA typically has the rights to accelerate the mortgage, to collect the rents and apply them to the project, to take possession of the project and to sue for specific performance of the agreement under traditional equitable principles or pursuant to statute.

Default is frequent enough to be a major problem. As of October 31, 1979, HUD has filed 884 actions and HFAs seventeen to acquire title to subsidized projects. Although HUD has no cumulative statistics as to the number of suits in which it has brought a cause of action based upon a regulatory agreement, it is aware of such claims being raised in eight pending actions. HFAs have filed at least six such suits. Of these, the Illinois Housing Development Authority has filed four. The purpose of this Article is to discuss the options of both the HFA and the project owners when subsidized projects are in default. The Article discusses considerations agreement are identical to those of a default under the mortgage. See, e.g., IHDA Form No. LD-5(A), ¶ 16. Although there are other possible breaches, such as breaches of construction contracts, they are outside the scope of this Article. Similarly, this Article will not discuss suits on construction bonds, tenants' rights, or suits on letters of credit secured by owners. Cf. Edgewater Constr. Co. v. Wilson Mortgage Corp., 44 Ill. App. 3d 220, 357 N.E.2d 1307 (1st Dist. 1976).

18. See, e.g., IHDA Form No. LD-5(A), ¶¶ 16(a)-(d).

19. Although the Illinois Housing Development Act requires that limited partnership agreements contain language purporting to grant the Illinois Housing Development Authority power to appoint a managing partner of the partnership owning a project when default occurs, ILL. REV. STAT. ch. 67 , § 302(k)(2) (1979), and the typical regulatory agreement purports to give the Illinois Housing Development Authority power to, inter alia, apply to any court for specific performance of the agreement, see, e.g., IHDA Form No. LD-5(A), ¶ 16(d), it was held in Illinois Hous. Dev. Auth. v. Arbor Trails Dev., 84 Ill. App. 3d 97, 103-06, 404 N.E.2d 1097, 1101-04 (3d Dist. 1980), that traditional rules of equity would determine the availability of injunctive relief for the Authority. In response to Arbor Trails, the Illinois legislature enacted P.A. 81-1254, 1980 Ill. Leg. Serv. 303 (West). Section 1 of P.A. 81-1254 amended § 7.8 of the Illinois Housing Development Act, ILL. REV. STAT. ch. 67, § 307.8 (1979), to provide that "[u]pon application to a court of proper jurisdiction, injunctive relief shall issue in aid of the Authority's powers . . . notwithstanding any other provisions of law." The Act took effect July 5, 1980. Thus, today equitable relief can be obtained by the Illinois Housing Development Authority under traditional equitable principles or pursuant to P.A. 81-1254. See notes 166 & 167 and accompanying text infra.

20. Letter from Marilyn Melkonian, Deputy Assistant Secretary, Multi-Family Housing Programs, HUD, to Alan S. Ganz (Dec. 28, 1979). In addition, about 71% of the approximately 2,000 mortgages held by HUD through assignments after projects had encountered financial difficulties are currently delinquent. Hearings on Management of HUD's Multi-Family Properties - The Clifton Terrace Case, Before a Subcomm. of the Senate Comm. on Appropriations, 96th Cong., 1st Sess. 17, 257 (1980) [hereinafter cited as Hearings on Multi-Family Properties].


22. Letter from John P. Kennedy, Assistant General Counsel, Multi-family Mortgage Insurance, HUD, to Alan S. Ganz (Dec. 17, 1980). Of these eight actions in which regulatory agreements are involved, two are actions filed by HUD and six are actions in which HUD filed counterclaims.

23. See Suit Foreclosure Chart, Appendix B infra.

24. Id.
arising when there is a simple financial default, a breach of the regulatory agreement, or both.

THE ROLES OF THE PARTIES

Multi-family subsidized housing is dependent upon the cooperation of governmental and private parties. In essence the governmental role in creating subsidized housing is to induce private parties to commit their funds and efforts toward construction that would not occur with conventional financing or be paid for with unsubsidized rents. The primary participants in this industry are: (1) the federal government acting through HUD and federal income tax policies; (2) state governments acting through HFAs; (3) private entrepreneurs who build the projects; and (4) private investors who purchase HFA bonds and notes or proprietary interests in projects. Thus, in order to understand the ramifications of a default, an understanding of the expectations, functions and liabilities of the primary parties is necessary.

The Governmental Parties

The federal government’s commitment to large scale housing projects dates to the 1930’s when legislation was enacted authorizing federal mortgage insurance and low rent public housing. The continuing goal of these and subsequent federal housing programs has been to provide “a decent home and a suitable living environment for every American family.” This federal purpose has been implemented through a variety of programs that have employed, either separately or in combination, direct subsidies to public or private owners, mortgage insurance, and income tax benefits.

By 1960, only Pennsylvania and New York had created housing finance programs. By 1966, other states had enacted legislation creating HFAs.
These agencies' activities were coordinated with the federal housing programs by the Housing and Community Development Act of 1974 through provisions in the Act that allowed qualified HFAs to administer parts of federal housing programs. The availability of subsidies from the federal government spurred the HFAs to accelerate efforts to mitigate the "serious shortage of decent, safe, and sanitary housing available at low and moderate rentals to persons and families of low and moderate income."  

Typically, HFAs are corporate entities and not part of the state government. They generally are minimally dependent upon the tax revenues or credit of their respective governments to defray operational costs or to secure obligations. HFAs obtain revenues needed to finance multi-family housing projects by issuing bonds secured by the HFA's assets and by first mortgages on projects which the bond proceeds are used to finance. Further, after a state government has made an initial appropriation to enable its HFA to commence activities, the operating expenses of the HFA are met from fees charged mortgagors. Because interest on HFA bonds is not taxed by the federal government, investors in such bonds accept lower

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36. For example, ILL. Rev. Stat. ch. 67¼, § 320 (1979) makes it clear that the State of Illinois is not liable for obligations issued by the Illinois Housing Development Authority; however, the Illinois statute provides for a legally unenforceable "moral obligation" of the state to make up any deficiency in funds available to pay the principal and interest on Illinois Housing Development Authority obligations. Id. § 326.1. For general discussions of "moral obligation" bonds, see Development of State HFAs, supra note 28, at 473-74; Salsich, Housing Finance Agencies: Instruments of State Housing Policy or Confused Hybrids?, 21 St. Louis U. L.J. 595, 598-604 (1978). Because states are only "morally" liable on HFA obligations, HFAs are not dependent upon the credit of their respective states.  
38. See, e.g., ILL. Rev. Stat. ch. 67¼, § 307.4 (1979). The Illinois Housing Development Authority meets its current operation expenses by charging mortgagors a Development Loan Fee of 1½% to 2% of the amount of the mortgage loan and an annual Service Fee of ½% to ¾% of the maximum principal amount of the mortgage loan.  
39. I.R.C. § 103 (gross income does not include interest on state obligations). Section 103 has been amended by the Mortgage Subsidy Bond Tax Act of 1980, signed into law on De-
interest rates than they would if the interest were taxable. The lower interest rates that HFAs obtain by selling tax-exempt bonds are passed on to mortgagors in the form of lower than conventional mortgage interest rates.

In addition to providing mortgagors with lower than conventional interest rates, HFAs implement HUD subsidy programs. The two most important subsidy programs are those administered under section 236 and section 8. The section 236 program reduces rentals for lower income families through mortgage interest reduction payments made by HUD to or on behalf of mortgagors. The interest reduction subsidy, which may be offered with rental subsidies, is approximately the difference between payments that would be due on a mortgage loan at one percent interest and payments that would be due on a loan at the actual current interest rate. The lower interest rate is ultimately beneficial to tenants because it permits the owner to establish lower rents than would otherwise be possible.

The section 8 programs operate through rent subsidies funneled through an HFA pursuant to contracts between HUD and an HFA and between an

cember 5, 1980. See [1980] 9 Fed. Taxes (P-H) ¶ 59,703; [1980] Hous. & Dev. Rep. (BNA) 594-97. The Act provides certain limitations on the tax-exempt status of municipal bonds. Relevant for the purposes of this Article is the provision limiting the exemption to obligations substantially all the proceeds of which are used for multi-family rental housing in which specified percentages of the units are to be occupied by low and moderate income persons. Id. at 597.

It should also be noted that under current law interest on HFA obligations is taxable if the HFA has elected to receive benefits under 42 U.S.C. § 1440 (1976) (providing for guarantees of HFA obligations and certain grants). See id. § 1440(b)(2). In this way, Congress has attempted to induce HFAs to allow income on their bonds to be taxed.

40. See Development of State HFAs, supra note 28, at 472-74.
43. Since January 1973, HUD has not entered into any new § 236 contracts. Section 8 has become the most significant federal housing assistance program. Hance & Duvall, supra note 34, at 721-22.
45. Id. § 1715z-1(c).
46. A project owner for the purposes of § 236 is an “owner of a rental housing project designed for occupancy by lower income families.” 12 U.S.C. § 1715z-1(a) (1976).
47. Section 236 provides certain formulas for setting subsidized rentals. 12 U.S.C. § 1715z-1(f) (1976). Briefly, a developer must establish, with the approval of the Secretary of HUD, a “basic rental charge,” calculated for each dwelling unit based on the payment of principal and interest due on a mortgage bearing interest at 1%. The developer must also establish a “fair market rental charge,” calculated on the basis of the payments due on the mortgage on which the developer is actually obligated. The actual rental for each dwelling unit must fall between these two calculated rental charges and must equal 25% of the tenant’s income. Id. § 1715z-1(f)(1). The statute also allows alterations of the actual rental to allow for contingencies, such as 25% of a tenant’s income not exceeding the “basic rental charge” or separate utility metering of dwelling units resulting in real rental costs exceeding 25% of a tenant’s income. Id. §§ 1715z-1(f)(1), (2). Further, § 236 permits additional payments to the project owner to offset increasing operating expenses, including utility costs and local taxes. Id. § 1715z-1(f)(3).
48. 42 U.S.C. § 1437(b) (1976). In areas where no HFAs exist, HUD is authorized to perform the functions of HFAs and to enter into contracts directly with project owners. Id. § 1437(b)(1). It is not unusual, however, for both HUD and an HFA to administer § 8 programs in the same area.
SUBSIDIZED RENTAL PROJECTS IN DEFAULT

HFA and a project owner. The subsidies are paid to, or for the account of, a project owner and result in lower rents for lower and moderate income families who live in the projects.

HFAs are delegated significant responsibilities under section 8. These responsibilities include financing, approving site, design and construction quality, determining economic feasibility, and supervising management. HUD has increasingly relied upon HFAs for financing developments under section 8. In fact, by the mid-1970’s HUD had earmarked for HFAs to administer over one-fourth of available section 8 funds, or approximately $225 million.

The Developer

The potential profits of a developer who successfully completes a project are substantial. For the purposes of the following discussion, it is assumed that the developer has no economic ties with the general contractor, architect or managing agent. To the extent that the developer and these other parties are identical or related, the developer will realize additional profits.

A developer must face the problem of raising capital. Most HFAs will grant a mortgage of up to ninety percent of the replacement value of a pro-

49. Id. § 1437f(b)(2). The principal contracts in this arrangement are: (1) Agreement to Enter into Housing Assistance Contract—between an HFA and an owner; (2) Annual Contributions Contract—between HUD and an HFA, see id. §§ 1437c, 1437d, 1437f(b), 1437g; 24 C.F.R. §§ 883.401-.411 (1980); and (3) Housing Assistance Payment Contract—between HFA and owner, see 42 U.S.C. §§ 1437f(c)-(e) (1976); 24 C.F.R. §§ 880.501-.507, 881.501-.507, 883.601-.607 (1980). Through an additional agreement HFAs often require mortgagors to pledge their § 8 subsidy payments as security for their mortgage loans.

50. Calculations used to determine the amounts of the subsidies, called “monthly assistance payments,” are set out in § 8. Id. § 1437f(c)(3).

51. A project owner for the purpose of § 8 is “any private person or entity, including a cooperative, or a public housing agency, having a legal right to lease or sublease newly constructed or substantially rehabilitated dwellings . . . .” Id. § 1437f(f)(4).

52. “Lower-income families” are generally those whose income does not exceed 80% of the median income for the area. Id. § 1437f(f)(1).

53. The “maximum monthly rent” the owner is entitled to receive may not, except under “special circumstances,” exceed by more than 10% the “fair market rental” established periodically by the Secretary of HUD and published in the Federal Register. The “maximum monthly rent” is a required term of the Housing Assistance Payment Contract, which must also provide that the “maximum monthly rent” shall be adjusted from time to time to reflect fluctuations in the “fair market rental”. Id. §§ 1437f(c)(1), (2).


56. Id. §§ 883.309, .310, .406.

57. Id. §§ 883.401-.411.

58. Id. §§ 883.701-.713.

59. Hance & Duvall, supra note 34, at 722.
Although this would result in a ten percent equity requirement, a developer is rarely required to contribute even this amount of cash because developers are typically given a Builder's and Sponsor's Risk Fee of eight to nine percent of the replacement cost which is applied against the equity requirement. Thus, the developer generally is required to put up only one to two percent of the replacement cost in cash. Additional costs for letters of credit as security for various contractual obligations and for possible construction cost overruns often increase the developer's cash requirements.

The cash required by private developers is generated by the sale of limited partnership interests to investors. The gross sale price of limited partnership interests typically amounts to twenty-five percent of the mortgage amount. Fees for organizing, building and initial rent-up of the project, sometimes established in the partnership agreement, are the major source of the developer's profit. If, in fact, the developer has created a limited partnership, the entity is usually structured so that the developer is the general partner. Should the project be sufficiently profitable, distributions might be made. Although these distributions are usually limited by statute, it is usual for the limited partnership agreement to provide that the developer, as a general partner of the limited partnership, is entitled to one or two percent of any distributions. The project's residual value is also a potential source of profit for the developer. Typically, the partnership agreement provides that when the project is sold or refinanced the general partner will receive fifty percent of the profits remaining after the limited partners are returned their investments. The balance of profits is then shared by the limited partners. Because the HFA's mortgage and note nor-

60. See, e.g., ILLINOIS HOUSING DEVELOPMENT AUTHORITY, HOUSING: A COMMUNITY HANDBOOK 43 (1974).

61. In Illinois, the Builder's and Sponsor's Risk Fee is 10% of the sum of construction costs, various fees, and financing and carrying charges. Id. at 46, 96.

62. A limited partnership is defined as "a partnership formed by two or more persons ... having as members one or more general partners and one or more limited partners." UNIFORM LIMITED PARTNERSHIP ACT § 1. The general statutory requirements are the signing and filing of a certificate indicating: (1) the business' name, character and location; (2) the name and residence of each partner; (3) the partnership term; (4) the quantum of each limited partner's tangible contribution; (5) the partner's share of profits; and (6) procedures for changing partnership personnel. See UNIFORM LIMITED PARTNERSHIP ACT § 2.

63. A developer normally must advance the option cost of the project's land and the cost of architectural plans and specifications. After the mortgage loan is initially closed, that is, when all documents reflecting the loan are executed, limited partners make their first capital contributions. These contributions are used to reimburse the developer for the foregoing costs.

64. In states, such as Illinois, where real estate is commonly owned in land trusts, the actual owner/mortgagor of a project is a land trust in which a limited partnership typically owns the beneficial interest. For most purposes the existence of the land trust can be disregarded. This Article generally discusses limited partnerships as though they owned legal title to projects. The use of land trusts, however, has been important in the context of Chapter XII bankruptcy reorganizations. See notes 150-152 and accompanying text infra.

65. In Illinois, annual distribution is generally limited to 6% of the entity's equity in the project. ILL. REV. STAT. ch. 67½, § 308 (1979).
mally do not permit prepayment for twenty years, this source of profit is deferred. Nonetheless, it can ultimately be substantial.

Investors in Projects

Individuals are motivated to invest in subsidized housing projects by the tax shelter permitted by limited partnership ownership. The limited partnership is attractive for investors because it not only confers tax advantages but also limits their liability. Investing in a project's limited partnership is, however, appropriate only for persons who can enjoy the tax benefits and afford the risks involved. Private placement memoranda for limited partnership interests generally indicate that such a person should have a net worth (exclusive of home, furnishings and automobile) of at least $100,000, and gross income of $35,000. Minimums are established through state suitability standards for limited partnership offerings in real estate. Although a given project might produce sufficient income to enable an investor to receive cash distributions or might substantially appreciate in value, these possibilities raise long-term considerations and, for most investors, are probably less important reasons for investing than tax benefits.

Generally, the limited partnership is disregarded as a taxable entity, and partners are individually responsible for their distributive share of income, losses, deductions and credits. This tax feature of the limited partnership enables the limited partner to have the benefit of partnership deductions and losses to offset non-partnership income, and to take these deductions in amounts that can greatly exceed the limited partner's actual tangible contribution to the partnership. The availability of deductions, the ability to take advantage of such deductions under the method for calculating basis, and the general disregard of a limited partnership as a taxable entity create an attractive tax shelter.

A limited partner is virtually assured of obtaining short-term deductions that compare favorably in amount with equity invested. These deductions include: (1) accelerated depreciation, which can be calculated on the double declining balance method allowed for new residential housing; (2) interest

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66. The prepayment moratorium is intended to ensure that the project is used as low income housing for at least twenty years.
67. See I.R.C. § 704(a).
68. As a general rule, a limited partner assumes no liability beyond his or her capital contribution and, perhaps, interest on that contribution. See generally Comment, The Limited Partnership, 45 YALE L.J. 895 (1936).
69. See, e.g., 1A BLUE SKY L. REP. (CCH) ¶ 23,207 (the standards reported are set forth in Illinois Securities Department Bulletin No. 314, Feb. 1980).
70. I.R.C. § 701.
71. Id. §§ 702, 704. See generally D. KAHN, BASIC CORPORATE TAXATION 432-51 (2d ed. 1973).
72. I.R.C. § 167(j). Note that excess depreciation on some subsidized housing receives the benefit of a special recapture rule. See id. § 1250(a)(1)(B)(ii); notes 106-107 and accompanying text infra. See 26 C.F.R. § 1.167(j)-1 (1980).
payments on the mortgage loan;\textsuperscript{73} (3) real estate taxes;\textsuperscript{74} and (4) various construction period expenses.\textsuperscript{75}

The other two aspects of the tax treatment crucial to the successful use of limited partnerships as tax shelters are the computation of a limited partner's basis in the project and the general disregard of the partnership as a taxable entity. A limited partner's basis is generally the cost of the interest in the partnership, increased by income (and decreased by losses) attributable to the interest.\textsuperscript{76} Most significantly, a limited partner's tax basis includes a proportionate share of the partnership's nonrecourse liabilities, at least when they do not exceed the fair market value of the collateral subject to them.\textsuperscript{77} Accordingly, the limited partner's tax basis is augmented by a share of the mortgage loan for the project. The general disregard of the partnership as a taxable entity results in individual tax liability of the partners for their distributive share of income, losses, and certain deductions and credits.\textsuperscript{78}

These features combine to enable a limited partner to offset non-partnership income with partnership losses and deductions and to take these deductions in amounts that greatly exceed that partner's cash contribution to the partnership. Serious tax consequences may, however, result from a misstep in structuring or operating a limited partnership.\textsuperscript{79} If it were taxed as a corporation, it would have to pay federal income taxes on net partnership income. Moreover, limited partners would be unable to take personal de-

\textsuperscript{73} I.R.C. § 163.
\textsuperscript{74} Id. § 164.
\textsuperscript{75} See Parks v. United States, 434 F. Supp. 206 (N.D. Tex. 1977); Lay v. Commissioner, 69 T.C. 421 (1977); Francis v. Commissioner, 36 T.C.M. (CCH) 704 (1977); Trivett v. Commissioner, 36 T.C.M. (CCH) 675 (1977). Note the special consideration concerning the deductibility of fees involved when a partnership makes payments to a partner for services rendered. See I.R.C. §§ 707(a), (c); Pratt v. Commissioner, 550 F.2d 1023 (5th Cir. 1977).
\textsuperscript{76} I.R.C. § 705.
\textsuperscript{77} See 26 C.F.R. § 1.752-1(c); Rev. Rul. 77-110; 1977-1 C.B. 58. But see Brountas v. Commissioner, 73 T.C. 491 (1980). The proportionate share of nonrecourse liabilities corresponds to the limited partner's share in partnership profits. Note that nonrecourse liabilities are liabilities that partnership assets are subject to, but for which limited and general partners are not liable. This is the typical situation under subsidized housing mortgages and regulatory agreements.
\textsuperscript{78} I.R.C. §§ 702, 704.
\textsuperscript{79} A limited partnership will shelter its members only if the Internal Revenue Service (IRS) accepts the characterization of the entity as such. In accordance with Morrisey v. Commissioner, 296 U.S. 344 (1935), the IRS considers six characteristics for tax classification purposes: (i) Associates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability.” Treas. Reg. § 301.7701-2(a) (1962). The presence of these characteristics indicates that a business is a corporation; their absence indicates a different form of business enterprise. Because the first two characteristics are common to both corporations and partnerships, the remaining four become determinative. It can be problematic for a limited partnership to avoid the trait of limited liability. See Treas. Reg. 301.7701(d)(2) (1962); Cabinet & Coffey, Housing Partnerships: Shelters from Taxes and Shelters for People, 20 CASE W. RES. L. REV. 723, 738 (1969). These criteria are not easy to apply. See Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975); Larson v. Commissioner, 66 T.C. 159 (1976);
ductions for net partnership losses, and distributions to them would be taxed as dividends to the extent the partnership had earnings and profits.80

**FINANCIAL DEFAULT WITHOUT VIOLATING THE REGULATORY AGREEMENT**

Assume that the housing project has been built. All mortgage loan funds have been properly expended, agreements have been complied with and the project is structurally sound. Nevertheless, the project is financially delinquent. How should an HFA approach the problem?

Initially, it is important to determine the financial facts. An audit or financial investigation should be performed by a certified public accountant. Such financial data may furnish a basis of agreed facts from which the parties can bargain. In addition, the management department of the HFA, 81 working with the project's management agent, should attempt to forecast the future finances of the project. This forecast can give the HFA an idea of the amount of funds needed for the project to succeed. For example, in addition to curing financial delinquencies, improvements to the project might be necessary to enhance the marketability of its units. Once the required background data is obtained, the HFA and the owners should begin an open exchange of information and positions. At this point, the parties will have two basic courses: the partnership can provide additional capital for the project or there can be a foreclosure by the HFA. Each of these options must be considered in greater depth.

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Therefore, the organizers of and investors in a limited partnership would find it highly desirable to obtain an advance IRS ruling on whether the limited partnership form would be respected for tax purposes; however, the IRS has adopted a policy that so severely restricts the availability of advance rulings regarding this question that they are practically unavailable for tax shelter limited partnerships. Specifically, advance rulings on a limited partnership's classification can be obtained only when the conditions set forth in Rev. Proc. 72-13, 1972 C.B. 735, and Rev. Proc. 74-17, 1974-1 C.B. 438, are satisfied. It is unlikely that a tax shelter limited partnership would meet the following condition set forth in Rev. Proc. 74-17, 1974-1 C.B. 438: "The aggregate deductions to be claimed by the partners as their distributive shares of partnership losses for the first two years of operation of the limited partnership will not exceed the amount of equity capital invested in the limited partnership."

80. Another pitfall for investors is the possibility that the "hobby loss" provision of I.R.C. § 183 would preclude them from getting the benefit of the limited partnership deductions. As a matter of deference to Congress' national housing policy, however, the IRS has decided not to pursue this challenge, at least with respect to § 236 housing. See Rev. Rul. 79-300, 1979-2 C.B. 112.

81. HFAs often organize themselves into functional departments. For example, the Director of the Illinois Housing Development Authority is empowered to create a legal department, a production department, a marketing and management department, a credit and audit services department, a finance and investment department, an accounting department and a human services department. 44 Ill. Reg. 452, 453 (1980).
Preventing Foreclosure Through Workout Arrangements
Requiring Additional Investment

A prime consideration that arises when an owner and an HFA attempt to structure a workout arrangement is whether the owner will commit additional capital to the project. Foreclosure normally causes serious financial harm to the partners of a limited partnership. Accordingly, limited partners will generally agree in a workout arrangement either to furnish additional capital or to relinquish some of their interests through a resyndication in an attempt to avoid foreclosure.

Additional capital invested in the project by existing partners could cure some financial defaults and permit physical improvements necessary for a project’s long-term success. Obviously, too, the HFA’s flexibility in structuring a workout agreement should increase when the owner demonstrates a substantial additional financial commitment to the project.

If an owner is unable or unwilling to raise additional capital from existing partners, then sales of partnership interests to third parties may be required. Restructuring the partnership agreement may, however, create additional problems. In any arrangement restructuring the ownership of a limited partnership, the danger of inadvertently terminating the partnership is present. For federal tax purposes, termination occurs if “within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.” Although the words “sale or exchange” seemingly apply to both direct and indirect transactions, the IRS has not interpreted them so broadly that partnership resyndication necessarily triggers partnership termination. If, however, a resyndication does terminate a partnership for tax purposes, the effect on the partners can be costly. Because only the first-user of property gains the maximum benefits of using the double declining balance method of calculating depreciation, the resyndication could reduce their tax benefit.

Even if the first-user status of a partnership is preserved, a resyndication may have other adverse tax consequences for limited partners. Most resyndications involve an infusion of new capital into the partnership through the sale of new partnership interests, thus diluting the ownership of the original limited partners. This dilution is recognized by the IRS as conferring a ben-

83. A typical resyndication might involve a contribution by one partner and the withdrawal of another. Arguably, these steps should be “stepped” into one indirect “sale or exchange” for purposes of I.R.C. § 708(b)(1)(B); however, they might not be so combined because the contribution of property to the partnership for interests in the partnership generally does not constitute a “sale or exchange.” See Treas. Reg. § 1.708-1(b)(1)(ii) (1956); Rev. Rul. 75-423, 1975-2 C.B. 260. By contrast, a direct sale or exchange of a partnership interest from one partner to another would clearly be a “sale or exchange.” Id.
84. First-user status is required by I.R.C. § 167(j)(2)(A)(ii) for the taxpayer to employ the most accelerated depreciation formula for § 1250 property, which includes residential property.
efit upon the original limited partners for which they might be taxed, even though they receive no payments or distributions. 85

At the time when partnership resyndication is contemplated, a further consideration for limited partners is that their activities must be consistent with their position as limited partners. Otherwise, a resyndication can have ramifications for the limited partnership under both federal tax law and a state limited partnership act. The tax issue is chiefly whether a resyndication will cause the limited partnership to be treated as having "centralized management," one of the criteria distinguishing corporations from other associations. 86 Beyond tax considerations, intrusion by limited partners into the management of a limited partnership can cause these partners to be deemed general partners, thereby subjecting them to general liability. 87 Accordingly, they should not become so involved in the management or control of the partnership that their position as limited partners is jeopardized. In essence, resyndication can be an attractive way for limited partners to avoid foreclosure of the housing project, but they cannot play a leading role in bringing about the resyndication. 88

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85. The dilution reduces partnership liabilities allocated to the original limited partners. In accordance with I.R.C. § 752(b), this decrease in liability is the equivalent of the distribution of money, which generally would reduce the basis of a partnership interest. Gain is not normally recognized, except to the extent that the distribution exceeds the partner's adjusted basis. Id. § 731(a)(1). Gain may, however, be recognized separately in respect to "unrealized receivables, which include excess accelerated depreciation." Id. § 731(c). This may cause immediate recognition of ordinary income by the partner to the extent of the allocable depreciation recapture. Clearly, a cash distribution exceeding a limited partner's adjusted basis is treated as ordinary income by the partner to the extent of the allocable depreciation recapture. Rev. Rul. 73-300, 1973-2 C.B. 215. A constructive distribution, as occurs in a diluting resyndication, may be treated similarly. See Rabinowitz & Berenson, The Failing Real Estate Investment and the Federal Income Tax, 34th ANN. N.Y.U. INST. ON FED. TAX. 357, 387-88 (1976).

86. See note 79 supra. Limited partnerships that are organized and operate under a statute corresponding to the Uniform Limited Partnership Act usually will not be found to have centralized management, unless the limited partners own substantially all the partnership interests. Treas. Reg. § 301.7701-2(c)(4) (1962). A determination that a limited partnership has become a corporation would have adverse tax consequences for the limited partners. See notes 78-80 and accompanying text supra.

87. The Uniform Limited Partnership Act provides that a limited partner's liability remains limited unless he or she "takes part in the control of the business." UNIFORM LIMITED PARTNERSHIP ACT § 7. See Feld, The "Control" Test For Limited Partnerships, 82 HARV. L. REV. 1471 (1969) [hereinafter cited as Feld].

88. It is unsettled how much control the limited partner must exercise in partnership affairs before he or she incurs liability under the Uniform Limited Partnership Act's control test. One commentator observed that the decisions are of little help in clarifying the contours of this test. See Feld, supra note 87, at 1476.
Foreclosure

In the event that defaults are not cured or a workout arrangement is not consummated, then the HFA may resort to foreclosure.\(^8\) Because foreclosure changes the ownership of a project, it has substantial repercussions for each of the parties interested in the project's financing—HUD; the HFA and its bondholders; and the owners of the project, both general and limited partners. The consequences of foreclosure for each party must be examined separately.

HUD

The primary contribution that HUD makes to an operating project is its subsidy payments. Under section 236,\(^9\) these subsidies are in the form of interest reduction payments and under section 8, in the form of rent supplements.\(^9\) Foreclosure interrupts, at least temporarily, subsidy payments for a section 236 project. During foreclosure proceedings two requirements of section 236 could be violated: that the project be subject to a mortgage and that it be owned by a private entity.\(^9\) The requirement that the project be subject to a mortgage appears to constitute the more important obstacle to continued payments under section 236. Conceivably, the results of foreclosure could vary among the states because it appears that the times when this and other requirements of section 236 cease to be met are governed by applicable state law.\(^9\) In Illinois, for example, the property probably would not be considered subject to a mortgage after the entry of a foreclosure decree or after foreclosure sale.\(^9\) Nevertheless, the section 236 payments

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8. See, e.g., ILL. REV. STAT. ch. 67½, § 307.12 (1979) (granting Illinois Housing Development Authority power to acquire real property, or any interest therein, by mortgage foreclosure).


92. Section 1715z-1(b) provides that "interest reduction payments may be made with respect to a mortgage . . . on a rental or cooperative housing project owned by a private nonprofit corporation or other private nonprofit entity, a limited dividend corporation or other limited dividend entity, or a cooperative housing corporation . . . ." 12 U.S.C. § 1715z-1(b) (1976) (emphasis added). See also 24 C.F.R. § 236.10 (1980).

93. Section 236 provides that the term "mortgage" as used in that section has the same meaning as in 12 U.S.C. § 1707. 12 U.S.C. § 1715z-1(j)(2)(C) (1976). Section 1707 defines mortgage as "first mortgage on real estate" and provides that "the term 'first mortgage' means such classes of first liens as are commonly given to secure advances on . . . real estate, under the laws of the state, in which the real estate is located . . . ." Id. § 1707(a).

94. See, e.g., Johnson v. Zahn, 380 Ill. 320, 325, 44 N.E.2d 15, 18 (1942); Gaskin v. Smith, 375 Ill. 59, 65, 30 N.E.2d 624, 627 (1941); Wayman v. Cochran, 35 Ill. 151, 154-56 (1864). In Wayman, the court held that when a mortgagee recovered judgment on a note secured by a mortgage and subsequently sued to foreclose on the mortgage, it was error for the lower court to enter judgment, upon sale of the subject property, for the amount of the principal debt and for interest until the date of sale at 10%, the interest rate specified by the note. 35 Ill. at 156. Rather, the court held that interest should be allowable at 6%, the legal interest rate. The court reasoned, apparently, that the decree of foreclosure terminated the mortgage and therefore released the property from the mortgage's provisions. Id. at 154. Logically, if a decree of foreclosure ends the legal existence of a mortgage, the property is no longer subject to the
will be resumed provided the project is sold to an eligible owner and is again subject to a mortgage.\textsuperscript{95}

A project can be eligible for section 8 subsidy payments even though it is neither privately owned nor subject to a mortgage.\textsuperscript{96} The authorizing legislation for section 8 does not prevent continuation of subsidy payments during foreclosure proceedings. Further, the implementing regulations indicate that, possibly subject to HUD approval, subsidy payments continue in that circumstance.\textsuperscript{97}

**HFAs**

The two primary considerations for an HFA in deciding whether or not to foreclose a project are the foreclosure's potential impact on providing housing for persons of low and moderate income\textsuperscript{98} and on the investment of the mortgage. The Wayman case could therefore be used to argue that because a foreclosure decree terminates a mortgage, such a decree would terminate HUD's authority to make payments under § 236.

Under the Johnson and Gaskin cases, on the other hand, it could be argued that only an actual foreclosure sale terminates a mortgage and that only then would HUD's obligation cease. In both of these cases the supreme court stated that only after foreclosure sale had the mortgage expended its force and the property become no longer subject to the provisions of the mortgage. Johnson v. Zahn, 380 Ill. at 325, 44 N.E.2d at 18; Gaskin v. Smith, 375 Ill. at 65, 30 N.E.2d at 627.

Title will not vest in the mortgagee or its successor, however, until the delivery of the sheriff's deed, after the statutory redemption period accorded the mortgagor expires. ILL. REV. STAT. ch. 77, § 18e (1979). The equity of redemption can be waived, however, by a corporate trustee. Id. § 18b. Title could pass directly to a successor owner-mortgagor without the HFA actually having title. Cf. id. § 30.

\textsuperscript{95} 24 C.F.R. § 236.505 (1980) (incorporating 24 C.F.R. § 236.40(d) (1980)).

\textsuperscript{96} 42 U.S.C. § 1437f(f)(4) (1976). Because § 8 focuses on rent supplements and not on mortgage interest payments, the statute is primarily concerned with tenant eligibility requirements and not with allowable types of owners. Section 8 defines an owner as "any private person or entity, including a cooperative, or a public housing agency, having a legal right to lease or sublease newly constructed or substantially rehabilitated dwellings . . . ." Id.

\textsuperscript{97} Although the regulations are currently being revised, see note 54 supra, the latest regulations provide as follows:

\textsuperscript{98} Provision of decent, safe and sanitary housing at low and moderate rentals to persons and families of low and moderate income is generally stated as the goal of statutes creating HFAs. See, e.g., ILL. REV. STAT. ch. 67½, § 303 (1979).
bondholders that the mortgage secures. A foreclosure proceeding could cause the project to be sold free from restrictions designed to ensure its use for low and moderate income housing. Foreclosure actions might also create, or call attention to, financial difficulties within an HFA, thereby inhibiting the marketability of bond issues. Bond rating agencies probably would look favorably upon an aggressive campaign by an HFA to pursue financial delinquencies.

**Limited Partners**

Foreclosure of a project not only deprives limited partners of their ownership interests in the project, but also creates tax problems. The loss of ownership in a project for a limited partner eliminates a capital asset, an interest in the asset's appreciation, and possible dividends. These losses, however, are likely to be less costly to investors than the tax consequences accompanying foreclosure.

Foreclosure usually creates a tax liability for limited partners in two ways. First, foreclosure may be viewed as a sale of property, the amount due the mortgagee at foreclosure being the sale price. Limited partners' gain for tax purposes upon foreclosure will be the amount by which the pro rata share of the mortgage debt exceeds the limited partner's adjusted basis in the project. The nature of the tax treatment, however, is not clear in all cases.

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99. Protection of persons who have invested in HFA bonds is necessary for HFAs to remain viable. Statutes creating HFAs have various safeguards intended to assure that investments in HFA bonds will be secure. These include “moral obligations” undertaken by state legislatures to appropriate additional monies when HFA funds are insufficient to pay principal and interest on HFA bonds as well as provisions authorizing debt service and capital reserve funds. See, e.g., Ill. Rev. Stat. ch. 67½, §§ 314, 326.1, 323a (1979). See note 36 supra.

100. Under usual procedures for foreclosure sales, the project would be sold to the highest bidder regardless of whether it would subsequently be used for low and moderate income housing.

101. Investors in a project limited partnership are primarily motivated by the tax treatment accorded their investment. See notes 67-80 and accompanying text supra. Before foreclosure, a limited partner probably will have obtained tax benefits that will compensate for the foreclosure-caused loss of the capital contribution. The occurrence of a financial default suggests a current cash flow problem for the project. Moreover, the failure of the HFA and limited partnership to reach a workout agreement at least casts doubt on whether the project owner considers it viable. For a discussion of cash and tax benefits flowing from § 236 projects, see Note, The Multi-Faceted Needs of Low-Income Housing: Inadequacy of a Narrow-Focus on Capital Input, 21 St. Louis U. L.J. 693, 702 (1978).

102. See Woodsam Assocs., Inc., 16 T.C. 649 (1951), aff'd, 198 F.2d 357 (2d Cir. 1952). See generally I.R.C. § 1001. Proposed treasury regulation § 1.1001-2, set out at 44 Fed. Reg. 76,315 (1979), indicates that the full amount of the mortgage debt is treated as money received upon foreclosure, even if the property's fair market value is less than the amount of the debt. See Millar v. Commissioner, 577 F.2d 212 (3d Cir. 1978); John F. Tufts, 70 T.C. 756 (1978).

Note that I.R.C. § 1039 provides that gain from the sale or disposition of certain government assisted housing is not recognized when there is an approved disposition of the housing and the taxpayer reinvests in another qualified project.

103. As discussed at note 77 and accompanying text supra, a limited partner's basis includes a share of nonrecourse liabilities. The original basis is adjusted by prior deductions.
Secondly, the limited partner's tax liability also is likely to be affected by provisions for the recapture of accelerated depreciation as ordinary income. Generally, accelerated depreciation allowed for new housing is subject to recapture to the extent that there is gain on the disposition of the property. If, however, the project in default was funded under section 8 rather than section 236, then the recapture may be calculated more advantageously for the limited partners. The recapture provisions of the 1976 Tax Reform Act applicable to section 8 and certain other subsidized projects require a progressive reduction in the amount recaptured once a project has been owned 100 months. The reduction allowed is one percent per month. Thus, if the project has been owned longer than sixteen years and eight months, there would be no recapture. Because of these additional tax liabilities, limited partners will usually want to stave off foreclosure. Accordingly, any foreclosure proceedings are likely to be protracted, which, incidentally, is another reason foreclosure is unattractive to an HFA.

General Partners

To the extent that general partners have interests in the income and losses from projects comparable to those of limited partners and have obtained comparable tax benefits, foreclosure would affect general partners and lim-

104. The gain accruing upon foreclosure might be treated as ordinary income to the extent required by depreciation recapture provisions (see discussion at note 73 supra and notes 105-108 and accompanying text infra) and as capital gain as to the remainder. This result would be consistent with viewing foreclosure as equivalent to a sale of property. If such gain were considered solely to arise from the discharge of a liability, then it arguably should be considered ordinary income in its entirety. If the foreclosure is characterized as a discharge of liability, then the election provisions of I.R.C. §§ 108 and 1017 would apply. Such an election would permit the limited partner to reduce the basis of the partnership interest instead of recognizing income from the discharge of indebtedness. Cf. Estate of Jerrold Delman, 73 T.C. No. 3 (1979). Recent legislation provides that partners separately, and not the partnership, make such an election. I.R.C. § 703(b)(2). See generally Podolin, How to Handle the Burned Out Tax Shelter, 37th ANNUAL N.Y.U. INST. ON FED. TAX. ch. 16, 16-18 (pt. 1 1979).

105. I.R.C. §§ 56(a), 57(a)(2).

106. Excess depreciation is made a tax preference item under the code. See id.

107. Special recapture rules for § 8 projects are established by I.R.C. §§ 1250(a)(1)(B)(i), (b).

108. Id.

109. HUD's foreclosures generally take about two and one-half years to complete. Hearings on Multi-Family Properties, supra note 20, at 259.

110. Ironically, in some instances, foreclosure proceedings themselves have served as the ultimate tax shelter for limited partners by permitting tax deductions for expenses that are not paid. Hearings on Multi-Family Properties, supra note 20, at 260-61. Although precise figures on losses from this practice are unavailable, the IRS recognizes that deductions for accrued interest, other expenses, and depreciation are taken during periods of mortgage delinquency and foreclosure, even when the associated payments are not made. Id. Any such deductions should be recaptured once liability ends.
ited partners similarly. Foreclosure, however, could have other unique consequences for general partners.

General partners are likely to be involved in other similar projects and probably anticipate comparable future involvement. Accordingly, to the extent that foreclosure harms a general partner’s reputation, his or her chances of successfully developing projects in the future are diminished. Furthermore, actions of general partners leading to default and foreclosure, if sufficiently egregious, may result in debarment or suspension from contracting with HUD or particular HFAs. Persons and businesses seeking to obtain certain forms of federal assistance for proposed projects are required to disclose their involvement in other federally assisted projects, including any which have defaulted. Additional financial problems may be caused by the change in a project’s ownership following foreclosure. These include the general partner’s loss of entitlement to a share of the income generated by the project and loss of interest in the project’s residual value. Moreover, a change of ownership terminates any administrative or management fee that the general partner may derive either from the partnership or from the project itself.

Of course, the general partner must also face the possibility that limited partners will bring suit for damages suffered from the loss of their invest-

111. The regulations governing debarment, suspension and ineligibility of contractors, including those directly or indirectly receiving HUD funds, are set out at 24 C.F.R. §§ 24.0-.23 (1980). These regulations are currently being revised, primarily to strengthen the safeguards for HUD program participants. See 45 Fed. Reg. 46,012 (1980). For an instance of a sponsor-general partner being suspended from participation in HUD projects under the current regulations, see Sahni v. HUD, 478 F. Supp. 882 (D.D.C. 1979).

112. 24 C.F.R. §§ 200.210-.218 (1980). The regulations require that the principals of a proposed project, including the general partners of a limited partnership, list any HUD projects in which they have participated and state whether any such project has defaulted or has received mortgage relief. Id. §§ 200.211, .212.

113. Although limited partnership agreements differ in respect to the benefits accruing to general partners, it is common for them to provide the general partner with an interest in the project’s residual value that greatly exceeds his capital contribution. See text accompanying notes 65-66 supra.


114. The case law is replete with instances in which general partners provided services to projects for a fee or have interests in businesses that furnished such compensated services. See, e.g., Thompson v. United States, 408 F.2d 1075 (8th Cir. 1969); United States v. Gregory Park, Section II, Inc., 373 F. Supp. 317 (D.N.J. 1974).
ment and recapture. Although theories of recovery will, of course, depend upon particular factual circumstances, it should be recognized that the general partner is likely to have a wide range of duties to the limited partners. These duties might include contractual and statutory partnership obligations and attendant fiduciary responsibilities. Moreover, actions based on common law fraud or the torts of waste or mismanagement may be appropriate in some situations. Finally, a limited partnership interest is a security, and therefore purchasers of such interests are entitled to the protections of federal and state securities law. Accordingly, personal financial considerations, if not regard for the interests of the limited partners, will usually compel the general partner to contest vigorously a foreclosure action.

Defenses to Foreclosure

Because the effects of foreclosure can be so severe, mortgagors have raised a variety of defenses in actions brought to foreclose government assisted mortgages. Most such actions have been instituted by HUD, not HFAs, but principles established in these cases are germane to cases brought by HFAs. Some of the defenses are uniquely related to the government's role in financing subsidized housing. The pervasive role that HUD and HFAs play in supervising projects has afforded mortgagors opportunities to claim that these governmental participants should be blamed for financial defaults. Specifically, a common contention is that the failure of HUD or an HFA to grant requested rent increases or subsidies so limited a project's income that default was inevitable. Courts, however, have not agreed that gov-


116. See Uniform Limited Partnership Act § 9 (a general partner is "subject to all the restrictions and liabilities of a partner in a partnership without limited partners" with some exceptions). The Uniform Partnership Act sets forth certain obligations of partners to each other the violation of which may give rise to causes of action. Uniform Partnership Act §§ 18-24.


120. See Goodman v. Epstein, 582 F.2d 388, 406-09 (7th Cir. 1978). Note that the Supreme Court in United Hous. Foundation, Inc. v. Forman, 421 U.S. 837, 852 (1975), considering whether stock entitling one to lease a cooperative apartment was a security, identified the following as characteristics of a security: "[1] an investment in a common venture [2] premised on a reasonable expectation of profits [3] to be derived from the entrepreneurial or managerial efforts of others." Under Goodman, the anticipation of initial tax losses does not preclude the second criterion from being established. 582 F.2d at 407.

ernmental involvement has effectively shifted the risk of default from the owner to the financing agencies. In addition, the courts have rejected defenses based upon HUD’s financing nearby, competitive projects. Courts also have found that absent specific guidelines so requiring, HUD need not enter into workout agreements, such as modification of mortgage terms. Finally, one court rejected the argument raised by an assignee of a mortgage that HUD’s inadequate supervision of the original mortgagor-assignor caused the subject project’s default.

Mortgagors have also contended that a government agency should be barred from foreclosure because it was guilty of fraud or misrepresentations. Fraud allegations have commonly been asserted when the agency’s initial project appraisal was excessive, but the courts have rejected such contentions on the ground that the appraisal is conducted for the agency’s benefit and not to aid the owner. It should be noted, however, that in these cases there was no direct contractual relationship between the agency making the appraisal and the mortgagor. Finally, the Eighth Circuit has held that, although such alleged misrepresentations may constitute grounds for a counterclaim for damages, they are irrelevant in a foreclosure proceeding.

Equitable defenses to foreclosure have also been asserted. Mortgagors have claimed that HUD should be estopped to proceed with foreclosure because of representations made by agency officials that alternatives to foreclosure would be considered. The courts have decided in these cases that when the representations constituted unauthorized acts of government agents the agency is not bound thereby. Thus, the agency is not barred from proceeding with foreclosure.

122. See cases cited in note 121 supra.
126. The extent to which equitable defenses such as fraud are recognized in foreclosure actions may vary depending on the jurisdiction. Illinois, for example, allows the assertion of all equitable defenses that would be available in any other action. See ILL. REV. STAT. ch. 95, §§ 21, 22b, 23, 26 (1979). New York, on the other hand, severely limits the availability of equitable defenses in foreclosure actions on the ground that such actions are essentially in rem. See, e.g., Jo Ann Homes at Bellmore, Inc. v. Dworatz, 25 N.Y.2d 112, 302 N.Y.S.2d 799 (1969).
128. See cases cited in note 127 supra.
131. In United States v. Woodland Terrace, Inc., 293 F.2d 505 (4th Cir. 1961), the mortgagor contended that oral statements of FHA representatives to the effect that the FHA would, in the event of difficulty, assume management of the project, constituted a waiver of the right to foreclose, or estopped the exercise of that right. The court disagreed, stating that unauthorized statements do not work an estoppel, and even if the statements were authorized, the FHA had not waived its alternative contractual right to foreclose. Id. at 509. The parole evidence rule creates further problems for a mortgagor who would assert a contract modification or equitable estoppel defense.
Mortgagors have also invoked public policy as a defense to foreclosure, arguing that it would be inconsistent with housing policies underlying the federal subsidy programs to allow foreclosure because it would have a disruptive effect on the provision of low-cost housing. The authorities are in conflict, however, on whether such arguments constitute a valid defense to foreclosure. It seems fairly well established that where applicable statutes or regulations expressly provide for certain procedures to be followed before foreclosure a government agency's failure to follow such guidelines will bar foreclosure.

Mortgagors generally have not been successful in interposing defenses to preclude foreclosure, particularly in respect to multi-family projects. Indeed, when HUD decides to foreclose a housing project, the federal courts have accorded HUD broad discretion and substantial deference in this decision. Utilizing the standard of judicial review provided for in the federal Administrative Procedure Act, these courts will review a foreclosure decision to determine compliance with national housing policies, but will not reverse the administrative decision unless it is found to be "arbitrary or capricious." In order for this standard to be met, it must be shown


133. Whether the asserted public policy is a valid defense to foreclosure apparently depends upon whether the defendant has relied upon HUD regulations, which have the force of law, or upon statements contained in a HUD Handbook, which do not have such force. Compare Associated East Mortgage Co. v. Young, 163 N.J. Super. 315, 394 A.2d 899 (1978) (because Handbook provisions also appear in HUD regulations, defense is valid) and Federal Nat'l Mortgage Ass'n v. Ricks, 83 Misc. 2d 814, 372 N.Y.S.2d 485 (Sup. Ct. 1975) (although Handbook not binding, Handbook only restates policy of National Housing Act and HUD regulations—thus, defense is valid) with Encarnacion Hernandez v. Prudential Mortgage Co., 553 F.2d 241 (1st Cir. 1977) (because HUD memorandum made clear that Handbook not binding, no valid defense established by reliance on Handbook) and Government Nat'l Mortgage Ass'n v. Screen, 85 Misc. 2d 86, 379 N.Y.S.2d 327 (Sup. Ct. 1976) (language of HUD regulations themselves is permissive, not mandatory—no valid defense).

134. See cases cited in note 132 supra.


136. See generally K. Davis, ADMINISTRATIVE LAW AND GOVERNMENT 59-70 (2d ed. 1975). See also United States v. Winthrop Towers, 628 F.2d 1028, 1035-37 (7th Cir. 1980). In Winthrop Towers, HUD sought to foreclose a federally insured mortgage because the project was in default. The defendant mortgagor asserted in defense, inter alia, that inasmuch as HUD had imposed a moratorium on foreclosures of HUD-held mortgages on projects such as Winthrop Towers, it was arbitrary and capricious for HUD to seek to foreclose this mortgage. Id. at 1031. The court, holding that HUD's action was not arbitrary and capricious, id. at 1037, stated that although HUD's decisions to foreclose must be consistent with national housing objectives and are therefore reviewable, HUD has very wide discretion in making such decisions. Id. at 1035. This wide discretion, according to the court, results from the presumption that large commercial developers possess the sophistication to "make agreements they will be able to live with" and from the fact that the National Housing Act was intended to benefit poor individuals, not commercial developers. Id. at 1036.
that HUD has considered all relevant factors before deciding to foreclose.\footnote{137}

**Bankruptcy Proceedings**

When faced with the possibility of foreclosure, owners may consider another “defensive” measure: seeking relief under bankruptcy law.\footnote{138} Successful reorganization would prevent the HFA from realizing on its collateral\footnote{139} and the partnership would retain ownership of the project, avoiding, at least temporarily, the adverse tax consequences of foreclosure.\footnote{140} Recent substantive and procedural changes wrought by the Bankruptcy Reform Act of 1978\footnote{141} have affected the availability of this “defense” for typical HFA projects.\footnote{142}

During most of the time that the Bankruptcy Act\footnote{143} was in effect, the general interpretation of the Chapter XII cram down powers\footnote{144} precluded

\footnote{137} These factors include the feasibility of workout agreements, the use of further subsidization and the existence of a viable post-foreclosure plan for operation of the development. See United States v. American Nat'l Bank & Trust Co., 443 F. Supp. 167 (N.D. Ill. 1977); Kent Farm Co. v. Hills, 417 F. Supp. 297 (D.D.C. 1976). Kent Farm may be distinguishable from the ordinary situation in that a HUD moratorium on foreclosures was in effect at the time.

\footnote{138} Generally, the filing of a bankruptcy petition automatically stays actions against the debtor or the debtor’s property; however, filing does not stay HUD from foreclosing a mortgage insured under the National Housing Act. 11 U.S.C. § 362(b)(7) (1976). See In re Thornhill Way I, No. 80-1120 (7th Cir. Dec. 29, 1980) (decided under prior law). Nevertheless, this exemption generally does not apply to HFA projects because they are not usually insured.

\footnote{139} In an HFA financed housing project, the collateral would normally be the project itself, the land on which it is built, and, under the regulatory agreement, rents. See, e.g., IHDA Form No. LD-5(A), 17.

\footnote{140} See notes 101-110 and accompanying text supra. Bankruptcy Judge Roy Babbitt commented that “the Chapter XII’s filed these days smack more of preserving tax benefits than really rehabilitating a true, real estate entrepreneur.” In re KRO Assocs., 4 Bankr. Ct. Dec. 462, 468 (S.D.N.Y. 1978). HUD is considering reducing tax benefits during foreclosure to eliminate the incentive for owners to protract legal proceedings. Hearings on Multi-Family Properties, supra note 20, at 87.


\footnote{142} Two characteristics of typical HFA projects that are important in regard to the availability of bankruptcy relief are that (1) their mortgage loans are nonrecourse, i.e., the debtor or other parties are not liable for amounts owing in excess of what is realized on the collateral, and (2) their mortgages are uninsured. These characteristics will be assumed in the following discussion. A third characteristic of HFA projects in some states that has been important is that projects are generally “owned” by a land trust, in which a nonprofit corporation or a limited partnership owns the beneficial interest. See note 64 supra.

\footnote{143} Ch. 541, 30 Stat. 544 (1897-98) (as amended by the Chandler Act, ch. 595, 52 Stat. 840 (1938)) (repealed 1979).

\footnote{144} The Chapter XII authorization for cramming down a plan was provided by § 468(1) of the old bankruptcy act, formerly at 11 U.S.C. § 868(1), which indicated that as long as a class of creditors was being adequately protected, a plan could be confirmed even though a two-thirds majority in amount of that class did not accept the plan. A cram down has been aptly described
their application to affect the rights of secured creditors.\textsuperscript{145} such as HFAs. The cram down powers were ineffective against secured creditors because the courts would not confirm plans these creditors unanimously opposed.\textsuperscript{146} The possibility of a debtor cramming down a Chapter XII plan over the opposition of secured creditors, however, was greatly increased through an approach adopted in some later cases that focused on the court's evaluation of whether the plan adequately protected dissenting creditors, rather than focusing on the views of classes of creditors.\textsuperscript{147} Nevertheless, this newer approach had not, at the time the new bankruptcy code\textsuperscript{148} took effect, completely displaced the traditional, restrictive interpretations of cram down powers.\textsuperscript{149}

The new bankruptcy code includes a Chapter 11\textsuperscript{150} that consolidates the reorganization chapters of the old Act and abrogates the old Act's differences as to debtor qualifications for relief under particular chapters.\textsuperscript{151} This consolidation ends certain limitations on the availability of real estate reorganization arising from debtor qualifications.\textsuperscript{152}


\textsuperscript{145} See \textit{In re} Herweg, 119 F.2d 941 (7th Cir. 1941); Kyser v. MacAdam, 117 F.2d 232 (2d Cir. 1941).

\textsuperscript{146} See cases cited in note 145 supra.

\textsuperscript{147} See \textit{In re Pine Gate Assocs. Ltd., [1977-1978 Transfer Binder] BANKR. L.REP. (CCH) \textsection 66,324} (N.D. Ga. 1976) (holding that a plan adequately protected the senior creditors because they were to be paid the appraised value of the debt to their class); \textit{In re Marietta Cobb Apartments Co., 14 C.B.C. 503} (S.D.N.Y. 1977) (a plan was confirmed even though the only secured creditor—the mortgagee—opposed confirmation). Regarding this newer, more liberal approach to the availability of Chapter XII, see Note, \textit{From Debtor's Shield to Creditor's Sword: Cram Down Under the Chandler Act and the Bankruptcy Reform Act}, 55 CHI.-KENT L.REV. 713 (1979) [hereinafter cited as Debtor's Shield] and Gilbert & Massari, supra note 144, at 112-19.

\textsuperscript{148} See note 141 supra.

\textsuperscript{149} See, \textit{e.g.}, \textit{In re Georgetown Apartments}, 468 F. Supp. 844 (M.D. Fla. 1979); \textit{In re Schwab-Adams Co.}, 463 F. Supp. 8 (S.D.N.Y. 1978). See generally \textit{Debtor's Shield}, supra note 147, at 731-33.


\textsuperscript{152} Chapter XII relief could be obtained only by the "legal or equitable owner of real property or a chattel real." Old bankruptcy act, \textsection 406(b), formerly at 11 U.S.C. \textsection 806(6). An issue that arose in states, such as Illinois, where real property commonly was owned in land trusts, was whether the beneficiary of a land trust was a debtor qualified for Chapter XII relief. \textit{In re Romano}, 428 F. Supp. 1123 (N.D. Ill. 1977), the court found that a trust beneficiary was not a debtor qualified to proceed under Chapter XII. \textit{But see In re} Gladstone Glen, 628 F.2d 1015
The code lists ten prerequisites to a successful Chapter 11 cram down.\textsuperscript{153} Perhaps the most notable of these requirements is that at least one class of claims must have accepted the plan.\textsuperscript{154} Provided these requirements are satisfied, the terms of a plan are evaluated as they affect particular types of creditors. Three additional, reasonably precise guidelines are set forth for secured creditors that are of greatest significance to mortgagees.\textsuperscript{155} Yet, mortgagees will have to consider not only the status of secured claims, but also the status under the plan of unsecured claims and interests. Any mortgagee of a highly leveraged project subject to a proposed reorganization plan may be able to exert a significant influence as an unsecured creditor over the confirmation of a plan. The requirements for a cram down over the opposition of a class of unsecured creditors might prevent a plan's confirmation.\textsuperscript{156} Additionally, a mortgagee must consider the implications of the new bankruptcy code's provisions in respect to the allowed amount\textsuperscript{157} of its claim

\begin{itemize}
\item \textsuperscript{154} Id. § 1129(a)(10). Accordingly, confirmation of a plan over the opposition of a sole creditor will no longer be possible, as it once was. See In re Marietta Cobb Apartments Co., 14 C.B.C. 503 (S.D.N.Y. 1977).
\item \textsuperscript{155} 11 U.S.C. § 1129(b)(2)(A) (1979). These guidelines do not include all factors that a court should consider. The basic approach has been described as "a relaxed version of the traditional absolute priority rule." Klee, \textit{All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code}, 53 AM. BANKR. L.J. 133, 142-43 (1979) [hereinafter cited as Klee].
\item \textsuperscript{156} The statutory requirements are set forth at 11 U.S.C. § 1129(b)(2)(B) (1979). They would necessitate either a significant cash flow that could be allocated for the unsecured claims or a loss in equity in the property for the debtor limited partnership. See 5 \textsc{Collier on Bankruptcy} 1111-15, 1111-16 n.19 (15th ed. 1979).
\item \textsuperscript{157} 11 U.S.C. §§ 502, 506 (1979). Because the nonrecourse creditor's deficiency claim is unenforceable against the debtor and the debtor's property, the deficiency claim can be disallowed in liquidation cases under § 502(b)(1). See Klee, \textit{supra} note 155, at 140 n.61 & 152 n.117. In reorganization cases, the nonrecourse creditor's deficiency claim is affected by 11 U.S.C. § 1111(b) (1979). That subsection generally provides that the undersecured nonrecourse creditor has two claims allowed in reorganization cases—one secured claim and an unsecured claim for the deficiency. If the creditor's class elects § 1111(b)(2) treatment or the collateral is sold, however, this unsecured deficiency is lost. Although a creditor electing § 1111(b)(2) treatment loses an unsecured deficiency claim, its entire allowed claim is treated as though secured. This election prevents the secured claim from being cashed out for the collateral's value, with the creditor remaining unimpaired.
\end{itemize}
and the degree, if any, to which the plan impairs that claim.\textsuperscript{158} This calculation must be made because the new code's cram down provisions only protect the allowed amount of a claim that an impaired creditor has if the claim is in a class opposed to the plan.\textsuperscript{159} Thus, the bankruptcy "defense" could, in some circumstances, effectively interfere with an HFA's pursuit of its claims against the collateral or the insolvent owner.

\textbf{MISAPPLICATION OF FUNDS—VIOLATIONS OF THE REGULATORY AGREEMENT}

All subsidized multi-family projects are nonrecourse financed; that is, the developer of the project is not personally liable to repay the mortgage indebtedness.\textsuperscript{160} The developer does, however, have personal liability under the regulatory agreement. A standard clause in HUD regulatory agreements provides that developers are personally liable both for property that comes into their possession that they are not entitled to retain under the regulatory agreement and for their or their agents' acts in violation of the agreement.\textsuperscript{161} Similar language is usually contained in regulatory agreements used by HFAs.\textsuperscript{162} When an owner is a limited partnership, the general partner is personally liable to the same extent as is the limited partnership.\textsuperscript{163}

\textsuperscript{158} Three tests are established at 11 U.S.C. § 1124 (1979) to determine whether a class of claims or interests is unimpaired. Cashing out the allowed amount of a claim, which will be limited to the value of collateral in some circumstances, is recognized in § 1124(3)(A) as leaving a creditor unimpaired. Note that an unimpared class of creditors is deemed to have accepted the plan and a class that is not entitled to payment or compensation under the plan is deemed not to have accepted it. 11 U.S.C. §§ 1126 (f), (g) (1979).

\textsuperscript{159} An objecting creditor in a class of which a majority accepted the plan is protected by 11 U.S.C. § 1129(a)(7) (1979).

\textsuperscript{160} See United States v. Frank, 587 F.2d 924, 926 (8th Cir. 1978); Thompson v. United States, 408 F.2d 1075, 1078 (8th Cir. 1969).

\textsuperscript{161} See United States v. Frank, 587 F.2d 924, 926 n.2 (8th Cir. 1978). Paragraph 17 of the standard HUD regulatory agreement provides that owners do not assume personal liability for payments due under the note and mortgage, or for the payments to the reserve for replacements, or for matters not under their control, provided said Owners shall remain liable under this Agreement only with respect to the matters hereinafter stated, namely:

(a) for funds or property of the project coming into their hands which, by the provisions hereof, they are not entitled to retain; and

(b) for their own acts and deeds or acts and deeds of others which they have authorized in violation of the provisions hereof.

Id.

\textsuperscript{162} See, e.g., IHDA Form No. LD-5(A), ¶ 4(b).

\textsuperscript{163} Under the Uniform Limited Partnership Act a general partner of a limited partnership has the same liability as a partner in a general partnership. UNIFORM LIMITED PARTNERSHIP ACT § 9. A partner of a general partnership is jointly and severally liable for anything chargeable to the partnership. UNIFORM PARTNERSHIP ACT § 15. See United States v. Haddon Haciendas Co., 541 F.2d 777, 780-81 (9th Cir. 1976) (general partners of limited partnership held personally liable for waste for failure to repair and maintain project premises).
an owner is a corporation, a corporate officer or director may likewise be liable for regulatory agreement violations.\textsuperscript{164}

**HFA's Rights Under Regulatory Agreement Against Owner**

When funds have been diverted in violation of the regulatory agreement, an HFA typically has several avenues of recourse. Most regulatory agreements require an annual audit of the project by a certified public accountant.\textsuperscript{165} If the financial audit has not been conducted, one should be ordered. In addition, the accountants should be required to prepare a "compliance audit." In a compliance audit, the auditor determines whether the funds of the project have been properly expended under the mortgage, mortgage note, and regulatory agreement. A well prepared compliance audit may serve as the basis for future action against the owner. It may also provide facts to negate a project owner's charge of irresponsibility against an HFA. Relevant facts may also be uncovered by an examination of monthly operating statements.

After the HFA receives the compliance audit, its next step is to prepare a detailed default letter. The default letter should detail the history of the loan, quote verbatim the violated provisions of the mortgage, mortgage note and regulatory agreement, list the amounts of the diverted funds, declare the entire mortgage indebtedness due, and request the owner's view as to the facts. The default letter should be sent to the general and limited partners of a limited partnership.

Seven states provide their HFAs with an alternative to either immediate foreclosure or suit pursuant to a regulatory agreement in the event of a financial default or an improper diversion of development funds. In these states, the HFA is authorized by statute to obtain control of the owner entity by appointing a sufficient number of additional members to constitute a vot-


\textsuperscript{165} See, e.g., IHDA Form No. LD-5(A), ¶ 13(e).
ing majority. In the case of a limited partnership, the HFA may appoint a partner having sole power to manage the partnership affairs. Similarly, the HFA may retain the power to cancel any contracts entered into by the developer and a management agent. To satisfy due process requirements, however, a written charge with an opportunity to respond may be necessary.

After the default letter has been sent, the HFA can negotiate with the management of the partnership. Assuming that efforts to resolve problems fail, the HFA can foreclose (if the mortgage delinquency is substantial) or assert other claims. For instance, a lack of records could produce a claim for an accounting. The mishandling of funds might furnish a basis for a constructive trust claim or an express trust created by the regulatory agreement.

A likely suit would be an action at law by the HFA seeking judgment against the owner of the project for misapplication of funds. To understand the basis for such a suit, an analysis of the concept of “surplus cash” as defined by the regulatory agreement is necessary. The funds generated by a project are subject to a mortgage lien. In addition, the regulatory agreement creates a lien and provides for a series of priorities as to how rental income is to be spent. The leading case discussing surplus cash is Thompson v. United States, where the court extensively quoted the regulatory agreement. Surplus cash, in the context of that case, was what remained after payments for reasonable operating expenses and repairs. Operating expenses were defined by the court as “limited to expenses paid or incurred in con-


167. See, e.g., Ill. Rev. Stat. ch. 67½, §§ 302(k)(2), 307.8 (1979) (providing that eligibility for an HFA loan requires a limited partnership to include in its agreement a provision granting the HFA authority to appoint a partner having sole managerial powers in the event of a financial default). See note 19 supra.

168. See T.A. Moynahan Properties, Inc. v. Lancaster Village Coop., Inc., 496 F.2d 1114 (7th Cir. 1974).


172. See, e.g., IHDA Form No. LD-5(A), ¶¶ 13(g), 17.

connection with the actual operation of the [project] as a going concern." 174 Without surplus cash there can be no distribution from project income. Even with surplus cash, distributions can be at most for the amount of the dividend prescribed by statute. Thus, any claim by an HFA against an owner starts with an analysis of whether the expenditures in question were operating expenses of the project and ends with a computation of surplus cash.

The only reported decisions involving claims against an owner under a regulatory agreement have been prosecuted by HUD. The Thompson case discussed the owner's repayment of loans with project income, payment of attorneys' fees, and capital expenditures. The court there recognized the right of the government to a judgment for these unauthorized withdrawals of development funds. 175 Other unauthorized withdrawals of development funds have similarly been invalidated by the courts. 176 Furthermore, the defendants in regulatory agreement actions have not been successful in contending that they are entitled to a profit. Therefore, HUD or an HFA will not be barred from foreclosure or suit on the regulatory agreement because the project proved unprofitable. 177 Defenses based on estoppel or waiver also have been unsuccessful. 178

Three practical problems can arise in suits by HFAs against owners under regulatory agreements. The first involves accounting information. Since ac-

174. Id. at 1080 (quoting 272 F. Supp. at 787).
175. Id. at 1080-81.
176. See, e.g., United States v. Frank, 587 F.2d 924, 926-28 (8th Cir. 1978), aff'd 447 F. Supp. 951 (E.D. Mo. 1978) (payment of fees to management company after its contract had been terminated by HUD is not an operating expense); United States v. Mansion House Center N. Redevelopment Co., 447 F. Supp. 951, 957 (E.D. Mo. 1978) (payment of legal fees other than those incurred in day to day operation of project is not operating expense); United States v. Mansion House Center N. Redevelopment Co., 419 F. Supp. 85, 86-87 (E.D. Mo. 1976) (amount expended to convert apartment building into motor hotel is not operating expense); United States v. Gilman, 360 F. Supp. 828, 836-37 (D. Md. 1973) (no surplus cash exists where project is in default of regulatory agreement).
177. The court in Thompson v. United States, 408 F.2d 1075, 1080 (8th Cir. 1969), for example, stated:
The trial court further correctly noted that: "While the partnership was not required to advance funds to the project, it is clear that in the absence of such advances the project would never have been able to get off the ground. The advances were made by the partnership not to protect the insurance company or the Government or to enhance the security but to promote the interests and expectations of the partners. The Government never guaranteed the partnership that the Summit House operation would be successful or profitable, and the Government never assumed the risk of loss should the project fail, except that the Government was willing to insure a loan which has for its security only the property itself, there being no personal recourse against the borrower."
counting information is the key to determining what funds are the project’s and whether they have been properly expended, the existence of an accountant privilege statute could forestall the acquisition of accounting information. If the privilege is the client’s, then the HFA could argue that it is waived by the regulatory agreement requirement that financial information be furnished. A second problem is obtaining tax returns. The Tax Reform Act of 1976 provides that tax returns and information are confidential. The taxpayer must consent to their release. The final problem is that of diversity of citizenship when suit is filed in the federal court. Some courts take the position that only the citizenship of the general partners is relevant; other courts have considered the citizenship of both the limited and general partners.

**HFA’s Rights Against Third Parties**

An HFA might also consider claims against recipients of funds paid in violation of a regulatory agreement. Often such recipients are solvent, whereas the owner is insolvent, his whereabouts unknown, or he is otherwise judgment proof. A common fact pattern involves loans made by banks to project owners. The loan is expended for items that are not operating expenses of the project, and to some extent the loan is repaid. The HFA may be able to proceed against the bank on three independent legal theories: improper interference with contractual relations, conversion, and express or constructive trust.

An HFA might claim improper interference with the contractual relations of the HFA and the project owner. The claim would arise from the owner’s

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179. See, e.g., ILL. REV. STAT. ch. 111, § 5533 (1979); MO. ANN. STAT. § 326.151 (Vernon 1979); FED. R. EVID. 501. See also Dorfman v. Rombs, 218 F. Supp. 905 (N.D. Ill. 1963) (the accountant’s privilege); Weck v. District Court, 158 Colo. 521, 408 P.2d 987 (1965) (the client’s privilege); Savino v. Lucianao, 92 So. 2d 817 (Fla. 1957) (the client’s privilege); Ash v. Reiter, 78 N.M. 194, 429 P.2d 653 (1967) (the accountant’s privilege).


distribution of funds in violation of regulatory agreement provisions. The tort of interference with contracts is based upon one person's intentional and improper disruption of the performance of a contract between two other parties by causing one of the parties not to perform. Intentional interference with a contract presupposes knowledge of the contract. Proof of the essential element of knowledge might be based on the bank's actual knowledge of the agreement. Proof of actual knowledge, of course, would put the HFA in the best position. Possibly, the involvement of the HFA in financing the project puts the bank on notice sufficient to cause it to make an investigation and to make it chargeable with knowledge of the regulatory agreement. Assuming the bank did not know that the project was government financed, the filing of the regulatory agreement in the chain of title

184. Regulatory agreements commonly have numerous provisions limiting an owner's right to disburse funds. See, e.g., IHDA Form No. LD-5(A), ¶¶ 6, 10, 13, 18. Borrowing money from a bank and later repaying the indebtedness in whole or in part would violate specifically ¶ 10(a), (b) and (h) of the Illinois Housing Development Authority's regulatory agreement. These paragraphs prohibit use of funds for other than reasonable operating expenses and incurring any liability for other than operating expenses unless the Authority agrees. *Id.*

185. The *Restatement (Second) of Torts* § 766 (1965) provides:

One who intentionally and improperly interferes with the performance of a contract . . . between another and a third person by inducing or otherwise causing the third person not to perform the contract, is subject to liability to the other for the pecuniary loss resulting to the other from the failure of the third person to perform the contract.


186. *Restatement (Second) of Torts* § 766, Comment i (1965) states:

To be subject to liability under the rule stated in this Section, the actor must have knowledge of the contract with which he is interfering and of the fact that he is interfering with the performance of the contract. Although the actor's conduct is in fact the cause of another's failure to perform a contract, the actor does not induce or otherwise intentionally cause that failure if he has no knowledge of the contract.


188. "Knowledge" does not necessarily mean actual knowledge. It is sufficient that the parties who allegedly interfered with a contract "have reason to know" of the existence of the contract. Mid Continent Tel. Corp. v. Home Tel. Corp., 319 F. Supp. 1176, 1200 (N.D. Miss. 1970). In Continental Research, Inc. v. Cruttenden, Podesto & Miller, 222 F. Supp. 190 (D. Minn. 1963), the court found that the defendant partnership had knowledge of the existence of a contract with which it allegedly interfered from the circumstance that memos reflecting the existence of the contract had been circulated through defendant's office. *Id.* at 196. The court quoted a Minnesota case which had stated that "[i]t is enough to show that defendant had knowledge of facts which, if followed by reasonable inquiry, would have led to a complete disclosure of the contractual relations and rights of the parties." *Id.* at 199 (quoting Swaney v. Crawley, 154 Minn. 263, 265, 191 N.W. 583, 584 (1923)). *Accord.* Farley v. Kissel Co., 18 Ill. App. 3d 133, 146, 310 N.E.2d 385, 389 (5th Dist. 1974); Harper, *Interference with Contractual Relations*, 47 *Harv. L. Rev.* 873, 880-81 (1953). *Cf.* Kerr v. DuPree, 35 Ga. App. 122, 123, 132 S.E. 393, 395 (1926) (husband's knowledge of existence of contract not imputed to wife).
Another possible barrier to sustaining a cause of action against the bank based on interference with contractual relations is establishing that the bank’s interference was improper. Numerous factors have been suggested as bearing on whether interference is improper, including the nature of the alleged interferer’s conduct, his or her motive and interest, and the nexus between the conduct and the interference. Some courts have rejected claims that the making of a loan constituted improper interference with the performance of a contract. Nevertheless, it can be argued that these cases are distinguishable—for example, none of them involved a secured lender as the aggrieved party.

If an action were maintained by an HFA against a bank, damages would likely include the amount that the developer had repaid on the loan. It is also likely, however, that these damages would be reduced by the amount of any damages recoverable from the developer for breach of the regulatory agreement.
agreement.\textsuperscript{194} Damages recoverable from the bank may also include consequential and punitive damages.\textsuperscript{195}

The second theory on which a suit against a bank may be based is conversion.\textsuperscript{196} An action will lie for the conversion of money if it is a specific sum capable of identification.\textsuperscript{197} The specific funds established by regulatory agreements and the provisions describing the permissible uses of those funds should suffice to meet the foregoing requirement.\textsuperscript{198} But, for an HFA to prevail on a conversion theory, it must establish that it had a present right to control or possess the funds.\textsuperscript{199} The provisions of the mortgage and regulatory agreement must be examined to determine when the HFA obtains rights to control or possess the funds claimed to have been converted. These rights could conceivably come into being at three different times depending upon the agreement between the parties and its interpretation. The first is when the mortgage is executed—the HFA's right to rents becoming effective upon recording.\textsuperscript{200} Such an assignment is called an absolute assignment \textit{in praesentii}. The second is when the HFA's right to possession of rents vests only upon the occurrence of an event, commonly upon default under a mortgage or mortgage note.\textsuperscript{201} This type of assignment is called a conditionally absolute assignment. The third is when an HFA must either declare a default and take actual possession of the project or have a receiver appointed to collect rents for the HFA's benefit in order to perfect its right to possession of rents.\textsuperscript{202}

In the first case, an HFA might maintain a conversion action at any time after the mortgage is executed and recorded, the bank's possession of any
funds derived from rental payments being wrongful from the time the bank exercises control over those funds. In the second case, conversion might lie for any funds received by the bank after occurrence of the specified condition. In the third case, a bank might be liable for conversion only for funds paid to it after an HFA perfects its right to the rents.

In order to maintain a conversion action against a bank, an HFA need not prove that the bank intended to interfere with the HFA's right to possession or control of the funds, but only that the bank intended to exercise dominion over those funds. It is helpful in establishing the latter if the aggrieved party, the HFA, has made a demand for return of the funds before filing suit. Without having made such a demand it would be more difficult, although not impossible, to prove that the bank intended to exercise dominion over the funds.

The third theory upon which suit might be brought against a bank for money received from a project's income is that the bank held the funds in trust for the HFA. This theory includes two distinct legal grounds. First, that the HFA is entitled to an express trust over any funds that the owner improperly diverted from the project, and, second, that the HFA is entitled to a constructive trust over any such funds. Under either variation, the HFA would seek imposition of a constructive trust over the funds received by the bank.

Regulatory agreements commonly used by HFAs include a provision that arguably creates an express trust—that project funds not deposited in the project bank accounts or disbursed in accordance with the regulatory agreement shall be held in trust. Inasmuch as use of the word "trust" is not necessarily sufficient to demonstrate the intent necessary to establish an express trust, an HFA arguing that an express trust was created would have to show that the transaction as a whole indicates intent to create such a trust. To accomplish this, an HFA would have to distinguish the relation-

204. See, e.g., Quaker Oats Co. v. McKibben, 230 F.2d 652, 654 (9th Cir. 1956). See also RESTATEMENT (SECOND) OF TORTS §§ 222A, 224, 224, Comment c (1965).
205. The Restatement states that conversion may be committed by, inter alia, "refusing to surrender a chattel . . . ." RESTATEMENT (SECOND) OF TORTS § 223(g) (1965). See also id. §§ 237-241.
206. See, e.g., IHDA Form No. LD-5(A), § 10(3) ("Any distribution of funds of the Development, which the party receiving such funds is not entitled to retain hereunder, shall be held in trust separate and apart from any other funds.").
ship created by the regulatory agreement from a simple debtor-creditor relationship.\textsuperscript{209} The mortgagor-mortgagee relationship is itself a debtor-creditor and not a trust relationship.\textsuperscript{210} The two requirements in regulatory agreements that project funds are to be kept in segregated accounts and are subject to numerous other restrictions furnish reasons for distinguishing the HFA-owner relationship from the usual mortgagor-mortgagee relationship.\textsuperscript{211} A further potential impediment to establishing an express trust is that the corpus of the trust does not exist when the HFA and the owner enter into the regulatory agreement.\textsuperscript{212}

Establishing that a court should impose a constructive trust over funds that the owner diverted is also not free from difficulty. A constructive trust can be imposed when the property at issue was acquired by fraud or breach of a fiduciary relationship.\textsuperscript{213} Establishing fraud would be difficult because the HFA would probably have to show that the owner committed a fraud when acquiring the funds or that its activities in respect to the project in general were fraudulent.\textsuperscript{214} The mortgagor-mortgagee relationship itself is generally not considered fiduciary in nature.\textsuperscript{215} A fiduciary relationship may be established, however, where a mortgage agreement contains definite restrictions on the mortgagor's use of particular funds.\textsuperscript{216}

Provided that the HFA successfully contends that the project funds diverted by the owner were subject to either an express or constructive trust, it can seek imposition of a constructive trust over the funds transferred to

\textsuperscript{209} See generally SCOTT ON TRUSTS §§ 12 to 12.12 (3d ed. 1967). See also Carlson, Inc. v. Commercial Discount Corp., 382 F.2d 903 (10th Cir. 1967); Lords, Inc. v. Malex, 356 F.2d 456 (7th Cir. 1965).

\textsuperscript{210} Courts have considered these relationships when mortgagors asserted that their advance payments to mortgagees of such items as taxes and insurance premiums were trust funds on which interest should be paid. These courts generally have rejected these assertions, even when the mortgage expressly provided that such funds were to be held in trust. See, e.g., La Throp v. Bell Fed. Sav. & Loan Ass'n, 68 Ill. 2d 375, 370 N.E.2d 188 (1977); Sears v. First Fed. Sav. & Loan Ass'n, 1 Ill. App. 3d 621, 275 N.E.2d 300 (1st Dist. 1971).

\textsuperscript{211} Cf. Elliott v. Bumb, 356 F.2d 749 (9th Cir. 1966) (where seller of money orders held funds received in separate account pursuant to agreement that such funds should be held in trust for the issuer of the money orders, court held a valid trust created); Janes v. First Fed. Sav. & Loan Ass'n, 57 Ill. 2d 398, 312 N.E.2d 605 (1974) (where defendant savings and loan association loaned plaintiff's money to purchase real estate and defendant later received a 10% rebate from a title insurance company, defendant held rebate upon a constructive trust for plaintiffs).

\textsuperscript{212} Courts are divided on whether a trust will automatically arise when trust property is later acquired. Annot., 3 A.L.R.3d 1416 (1965). Although an existing contract right can be the subject of an express trust, it is questionable whether an owner has a contract right to rents before leasing dwelling units.

\textsuperscript{213} G. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 471 (2d ed. 1978).


\textsuperscript{216} See Janes v. First Fed. Sav. & Loan Ass’n, 57 Ill. 2d 398, 312 N.E.2d 605 (1974). Regulatory agreement restrictions on the owner's disbursement of funds arguably support a finding of a fiduciary relationship between an HFA and an owner.
the bank. Only if the bank qualifies as a bona fide purchaser can it take the property free of the trust.\textsuperscript{217} Whether the bank so qualifies will depend upon a variety of circumstances. These include information known by, or possibly available to, the bank that the funds were subject to an express or constructive trust when held by the owner\textsuperscript{218} and whether the creditor bank was also the depository of project accounts.\textsuperscript{219}

CONCLUSION

The multi-family rental subsidized housing industry is a creature of federal subsidies. These subsidies can take the form of mortgage interest payments, rent supplements or rent subsidies. To entice investors to invest in subsidized housing projects, federal income tax deductions, which are indirect subsidies, are also provided. Another significant indirect subsidy is the tax-exempt status of HFA bonds.

There is, however, another hidden subsidy. It is the use of taxpayer dollars to rescue defaulted projects. According to one official report, seventy-one percent of all projects with insured mortgages assigned to HUD are in financial default.\textsuperscript{220} This figure is astounding. The loss of principal and interest due to nonpayment or deferral and repayment in cheaper, inflated dollars is yet another burden on the American taxpayer. HFAs are not, by contrast, plagued with a delinquency rate that approaches what HUD has experienced under some programs, possibly because they have only been in existence since 1960. Alternatively, HFA underwriting and management standards could be more financially responsible than HUD's.

In any case, when faced with a defaulting project, an HFA's priority will be to cure the default by procuring funds from the general and limited partners of the project and from third parties. The general partner obtained a highly leveraged, subsidized loan, advancing only one to two percent cash equity, and usually made a handsome profit from fees paid by the partnership for building the project and selling interests in it to limited partners. In a default, the general partner should be required to repay all project funds

\textsuperscript{217} See A. Scott, The Law of Trusts §§ 283, 284, 474 (1967). A bona fide purchaser is one taking property for value and without notice of the breach of trust or of other fiduciary relationship. Id. § 474.

\textsuperscript{218} Depending on the mode of payment to the bank, negotiable instrument law may govern the bank's liability for receipt of trust funds. Generally, a bank will be charged with notice of funds being impressed with a trust only if it had actual knowledge of that fact or acted in bad faith. Yoakum County Water Control & Improvement Dist. No. 2 v. First State Bank, 433 S.W.2d 200, 212 (Tex. Civ. App. 1968); Restatement of Restitution § 174 (1935). A bank may, however, have a duty of inquiry regarding "suspicious circumstances." Oscar Gruss & Son v. First State Bank, 582 F.2d 424, 431 (7th Cir. 1978).

\textsuperscript{219} A bank receiving repayments of loans when it is the depository of project accounts is more likely to be charged with notice than is a bank that does not also hold project accounts. Bonhiver v. State Bank, 29 Ill. App. 3d 794, 805-06, 331 N.E.2d 390, 399-400 (1st Dist. 1975); Westerly Community Credit Union v. Industrial Nat'l Bank, 103 R.I. 662, 671-72, 240 A.2d 586, 591-92 (1968).

\textsuperscript{220} Hearings on Multi-Family Properties, supra note 20, at 17, 257.
used in violation of the regulatory agreement. Even if there were no violations of the regulatory agreement, the general partner might provide additional funds to prevent a mortgage foreclosure that could cause such adverse consequences for the general partner as loss of investment, loss of reputation as a syndicator, debarment by the HFA or HUD, removal as general partner pursuant to statute, possible suits by limited partners for securities law violations, and income tax liabilities.

Limited partners faced with a mortgage foreclosure will usually find it desirable to provide additional funds as well. A foreclosure causes an involuntary sale of the project and a recapture of accelerated depreciation. Both results will usually give rise to substantial federal income tax liabilities. This tax consideration is far more important than the loss of a limited partner's investment in the project. To obviate federal tax liabilities, a limited partner should make an additional capital contribution or allow a resyndication of the partnership to generate additional funds for investment.

An HFA should explore all means of raising additional funds before bringing suit under the regulatory agreement or initiating foreclosure, including pursuit of third parties who received project funds. This procedure protects its assets and reserves, and also prevents unnecessary requests to the state legislature for taxpayer monies. HUD, too, could adopt a similar, more aggressive policy of requiring owners of projects to cure defaults, rather than having the taxpayers bear the burden of default. In these ways, federally subsidized multi-family housing can retain both its financial integrity and its significant position in today's housing market.
## APPENDIX A

### State Statute and Size Chart

<table>
<thead>
<tr>
<th>State</th>
<th>Statute</th>
<th>Units</th>
<th>Outstanding Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>Cal. Health &amp; Safety Code §§ 50900-51375 (West 1979)</td>
<td>3,200</td>
<td>$135,000,000</td>
</tr>
<tr>
<td>Colorado</td>
<td>Colo. Rev. Stat. §§ 29-4-701 to -732 (1977)</td>
<td>3,200</td>
<td>$71,000,000</td>
</tr>
<tr>
<td>Delaware</td>
<td>Del. Code Ann. tit. 31, §§ 4050-4079 (Supp. 1980)</td>
<td>1,064</td>
<td>37,995,000</td>
</tr>
<tr>
<td>Idaho</td>
<td>Idaho Code §§ 67-6201 to -6225 (1980)</td>
<td>2,011</td>
<td>63,665,000</td>
</tr>
<tr>
<td>Iowa</td>
<td>Iowa Code §§ 220.1-36 (Supp. 1980)</td>
<td>1,080</td>
<td>$28,130,000</td>
</tr>
<tr>
<td>Kentucky</td>
<td>Ky. Rev. Stat. §§ 198A.010-250 (1977)</td>
<td>6,528</td>
<td>115,000,000</td>
</tr>
<tr>
<td>Maryland</td>
<td>Md. Ann. Code art. 41, §§ 266DD-1 to -8 (1978 &amp; Supp. 1980)</td>
<td>6,800</td>
<td>224,000,000</td>
</tr>
<tr>
<td>(Appendix)</td>
<td>(Supp. 1980)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minnesota</td>
<td>Minn. Stat. §§ 462A.01-24 (Supp. 1979)</td>
<td>13,042</td>
<td>461,845,000</td>
</tr>
<tr>
<td>Nevada</td>
<td>Nev. Rev. Stat. §§ 319.010-390 (1975)</td>
<td>1,610</td>
<td>38,856,600</td>
</tr>
</tbody>
</table>

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1. 3 Hous. & Dev. Rep. (BNA) 50:5304 (information current as of July 1, 1980).
2. Id. at 50:5303.
3. Id. at 50:5424.
4. Id. at 50:5423.
<table>
<thead>
<tr>
<th>State</th>
<th>Statute</th>
<th>Units</th>
<th>Outstanding Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Puerto Rico</td>
<td>P.R. Laws Ann. tit. 17, §§ 31-76 (1972)</td>
<td>1,713</td>
<td>62,595,000</td>
</tr>
<tr>
<td>Rhode Island</td>
<td>R.I. Gen. Laws §§ 42-55-1 to -27 (1977)</td>
<td>6,466</td>
<td>255,955,000</td>
</tr>
<tr>
<td>South Dakota</td>
<td>S.D. Codified Laws Ann. §§ 28-19-1 to -162 (1977)</td>
<td>1,547</td>
<td>63,845,000</td>
</tr>
<tr>
<td>Utah</td>
<td>Utah Code Ann. §§ 63-44a-1 to -20 (1978)</td>
<td>418</td>
<td>11,019,635</td>
</tr>
<tr>
<td>Virginia</td>
<td>Va. Code §§ 36-55.24 to .52 (1976)</td>
<td>29,700</td>
<td>966,445,000</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>Wis. Stat. §§ 234.01-.55 (Supp. 1980)</td>
<td>11,302</td>
<td>257,631,289</td>
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<tr>
<td></td>
<td></td>
<td>292,112</td>
<td>8,981,253,699</td>
</tr>
</tbody>
</table>

Information based on letters received from HFAs by Alan S. Ganz. Note that in some instances HFAs included data for both single-family and multi-family housing in their responses. The information, which should be considered an approximation of actual HFA multi-family housing activity, generally is current as of September 30, 1980. Fourteen states in addition to those listed above have established HFAs. These states, however, are currently not financing multi-family housing. For information about particular HFAs, see 3 Hous. & Dev. Rep. (BNA) 50:5107-,5963.

**APPENDIX B**

**SUIT FORECLOSURE CHART**

<table>
<thead>
<tr>
<th>State</th>
<th>Number of Foreclosure Suits Filed</th>
<th>Number of Foreclosure Suits to Judgment</th>
<th>Number of UnitsInvolved</th>
<th>Number of Suits Involving Regulatory Agreement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Connecticut</td>
<td>0</td>
<td>N/A</td>
<td>N/A</td>
<td>1</td>
</tr>
<tr>
<td>Illinois</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>4</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>6</td>
<td>1</td>
<td>72</td>
<td>1</td>
</tr>
<tr>
<td>Michigan</td>
<td>3</td>
<td>0</td>
<td>192</td>
<td>0</td>
</tr>
<tr>
<td>New Jersey</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>New York</td>
<td>4</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Virginia</td>
<td>3*</td>
<td>2**</td>
<td>3</td>
<td>0</td>
</tr>
</tbody>
</table>

Information based on letters received from HFAs by Alan S. Ganz. The information generally is current as of September 30, 1980.

* Foreclosure proceedings brought without suit being filed.
** Suits for deficiency judgments.