INSTITUTE FOR LOCAL GOVERNMENT

FOUNDED 1955

LAND USE AND ENVIRONMENT

Ensuring Continued Affordability in Homeownership Programs

May 1, 2006

Polly V. Marshall & Barbara E. Kautz
Goldfarb & Lipman LLP

Edited by:
Bill Higgins
Institute for Local Government

Generous Support for this Publication Provided by:

Fannie Mae Foundation

The Non-Profit Housing Association of Northern California

GOLDFARB & LIPMAN LLP
1300 Clay Street, 9th Floor
Oakland, CA 94612
(510) 836-6336
www.goldfarblipman.com

Ensuring Continued Affordability in Homeownership Programs

The initial creation of affordable housing for homeowners requires a major effort by local government, developers, housing organizations, and citizens alike. When communities decide to design and implement an inclusionary or other homeownership program, they typically spend a great deal of energy achieving a political consensus on the policy aspects of their programs, such as the income level to be served, the length of affordability, and whether affordability is to be ensured by limiting the price at which homes can be sold (a resale restriction) or by requiring homeowners to share increases in the value of their home with the community (equity-sharing). Drafting an ordinance, issuing government approvals, providing subsidies and designing appropriate deed restrictions is often time and resource intensive.

With such a large investment of time and money in their homebuyer programs, communities have a large stake in assuring that the housing remains affordable over the long term. Communities have been shocked to find that they are threatened with losing—or have lost—their affordable units due to problems ranging from a developer's failure to build the units, to foreclosures and bankruptcies, to sales by homeowners in violation of deed restrictions, or to delays in enforcing the restrictions.

Agencies may encounter a variety of pitfalls that, if handled incorrectly, may prevent an ownership unit from remaining affordable. For example, if documents are not properly drafted and recorded, and if the local agency does not have the staff and time to monitor and enforce those restrictions, the very first homeowner who purchased an affordable home can walk away with a windfall profit, and the affordable housing that the community worked so hard to create will be gone forever. Once the first homeowner walks away with a huge profit, other homeowners will try to follow.

These problems arise because the affordable units are often worth hundreds of thousands of dollars more on the open market than if sold at a restricted resale price. Homeowners who were thrilled to buy a home at a price substantially below the market are often angry when they propose to sell their homes and find that the resale restrictions or equity sharing provisions substantially limit their profit. Homeowners often desire to take out second mortgages to pay their bills or to send their children to college and are distressed to find that they have little equity in their home. Homeowners are sometimes able to convince a City Council that the resale restrictions are unfair, despite the significant subsidies that enabled the homeowners to purchase the units in the first place.

The good news is that most of the pitfalls are avoidable. Assuring long-term affordability requires four elements, each of which is explored further in this paper. First, the agency must ensure that the developer actually constructs the required affordable units. Second, the deed restrictions and other documents guaranteeing affordability must be recorded in ways that are recognizable by lenders and title companies. Third, decision-makers and homeowners must clearly understand the restrictions so that they are not surprised at the time of resale. Last, the agency must have adequate staff or make other

provisions to monitor the units, to identify problems at an early date, and to take legal action when needed.

I. Making Sure the Developer Builds the Housing

Case Study: "Illusionary" Units

A California developer proposed to cluster his affordable units on a separate parcel. The city allowed him to build the market rate units before the affordable units. Three years later, all of the market-rate homes have been sold, but the lot intended for the affordable housing sits vacant, and no affordable units have been built.

The City will now find enforcement to be problematic. Builders often create a separate corporation or other business entity for each project; the entity that constructed the rest of the project might have liquidated all of its assets, or its assets may be limited to the vacant lot. The City will find it politically and legally difficult to hold up occupancy of the market-rate homes, which have been purchased by homeowners who have no knowledge of—or responsibility for—the affordable units. The vacant lot may have been sold to another owner, who may have received no constructive notice of the conditions of approval. Even if the City succeeds in gaining control of the lot, it may be forced to provide extensive subsidies to create the affordable housing that was the developer's responsibility.

Inclusionary units by themselves may not result in a profit for the developer. The developer may, in fact, lose money on them and so may have a powerful incentive to avoid building them.

Communities need to use points of leverage in the development process—such as issuance of a building permit—to ensure that the affordable units are actually built as contemplated. Successful techniques include concurrency requirements, which require that the affordable units be built at the same time as the market-rate units; and master development agreements, which secure the developer's promise to build the units and are recorded against the property.

Local governments have their greatest control over a project when the developer is seeking "discretionary" approvals: those that can be approved or denied—like rezonings, use permits, and planned development permits—based on the judgment of local decision-makers (as opposed to ministerial approvals such as a building permit, where a decision is made based on fixed standards). Local control is not unlimited; governments cannot, for instance, require "extortionate" conditions that are unrelated to the impacts of a project.[1]

However, conditions that are designed to ensure that projects comply with adopted inclusionary ordinances,[2] and to ensure that the promised affordable units are actually built, are certainly appropriate.[3] To make enforcement easier, conditions imposed during the planning application process need to be drafted so that they are clearly tied to the points at which local government has maximum leverage in the development process: issuance of a building permit or prior to final inspection; issuance of an occupancy permit; or before recordation of a final or parcel map. Some of the key conditions that should be imposed to ensure long-term affordability are discussed here.

During review of the planning application, the agency will also consider issues such as unit location and design and verify that the project conforms with the inclusionary ordinance's requirements for items such as level and length of affordability.

A. CONCURRENCY: USING POINTS OF LEVERAGE IN THE DEVELOPMENT PROCESS

The affordable units are most likely to be built if the developer needs to do so in order to construct and occupy the market-rate units in the project. A typical concurrency condition requires that the affordable units be constructed and made ready for occupancy at the same rate as the market-rate units. If 10% of the units in the project are affordable, then a building permit must be issued for one affordable unit for every nine market-rate units. Similarly, an occupancy permit must be issued, or final inspection completed, for one affordable unit for every nine occupancy permits approved for market-rate units. If the affordable percentage is 15%, then the ratio would be approximately one in seven.

Agencies should require applicants to propose a schedule for construction of the affordable units during project approval, and the agreed-upon schedule should be made a condition of approval. This allows the developer and the local agency to make alternative provisions to guarantee construction of the affordable units when there are unusual conditions, such as the clustering of all the affordable homes in a separately built complex.

Requiring concurrency at occupancy only rather than at both the building and occupancy permit stage is often not a successful strategy. This practice may allow a developer to finish building all of the project's market-rate units before even starting construction of the affordable units.

Compliance with the conditions would then mean that the market-rate units would sit vacant until the affordable units were completed. This result is fraught with problems. Localities are usually loath to require a developer to leave completed housing vacant for months. The finished homes may have been sold to buyers who will have nowhere to live if they cannot move into their new homes. Few local officials will be able to resist the homeowners' pleas that they should be allowed to move into their homes, even if that removes the agency’s leverage to force the construction of the affordable units. If public

agencies want the affordable housing to be built, the best way is to ensure that construction of all housing types starts at the same time.

Of course, issuance of a building permit does not guarantee that an affordable unit will actually be built. However, once the developer has gone to the expense of completing construction plans and paying for a building permit, it is more likely that the construction will start. Staff can also check the site at intervals and may be able to take proactive steps if the affordable units are not being built.

B. AFFORDABLE UNITS TO BE CONSTRUCTED BY OTHERS

If the affordable units are to be located on a parcel donated to another party, or will be constructed by others off-site, there is a risk that the units may not actually be built. It is harder to require concurrency under these conditions because the builder of the affordable housing may not want to be tied to the developer's schedule, and vice-versa. To gain some assurances, agencies usually require that a planning application be made for the development on the donated site at the same time as the application is made to construct the market-rate units, and that the off-site project be approved at the same time. Localities may also require evidence that the affordable housing developer has been identified and that financing is in place to build the affordable units. Communities may require that construction loans be closed for the affordable housing before some portion of the market-rate housing is built.

If the developer's only obligation is to donate the property to the affordable housing developer, possibly in conjunction with payment of in-lieu fees, then the land donation and payment of fees should be completed before issuance of a building permit or recordation of a final map.

C. MASTER AFFORDABLE HOUSING AGREEMENTS

A master affordable housing agreement is a contract between the developer and the local agency that lists the developer’s affordable housing obligations and is subsequently recorded against the project property. A recorded agreement will continue to apply to all parts of the original property even if it is later subdivided, and pieces are sold off to different developers. The master affordable housing agreement ensures that affordable units are built as required. In addition, it:

- ***Lists all the Obligations in One Place***. Focuses the developer's attention on implementation details—and on the need for implementation—before construction starts and before any property is sold to another party.

- ***Allows Staff to Work Out the Details***. Enables implementation details to be worked out between the staff and developer rather than necessitating planning commission or legislative body approval of minor changes.

- ***Creates a Mechanism for Enforcement***. Requires the developer to enter into a contract with the local agency. It may be easier for the agency to enforce a contractual obligation than a condition of approval.

- ***Provides Notice to Successors in Interest***. Provide notice to successors in interest—future buyers and lenders—so that the affordability requirements can be enforced against those parties. Any future owner or lender is considered to have "constructive notice" of any document recorded against the property.[4] It is possible that the affordability requirements could not be enforced against a buyer who had no actual or constructive notice of the conditions of approval.

Agencies should impose a condition of approval requiring that a master affordable housing agreement be recorded against the property before any final or parcel map can be recorded and before any building permit can be issued. The developer cannot sell off pieces of the property until a final or parcel map is recorded. Requiring recordation of the master agreement before this occurs ensures that future buyers are legally notified of the inclusionary requirements and will be bound by them.[5]

Affordable Housing Agreement Checklist

- Legal description of the entire property
- Location of the affordable units, possibly including a legal description of specific sites
- Development schedule in relation to the market-rate units; implementation of concurrency requirements
- Type of units (single family, condominium, townhouse, etc.)
- Number of bedrooms and square footage
- Unit design and appearance; colors and materials
- Level of affordability and length of affordability
- Controls on resale prices and/or equity-sharing provisions, and provisions for recording restrictions against individual homebuyers as the affordable units are sold
- Procedures for setting initial affordable sales prices when units are ready for occupancy
- Procedures for selecting initial buyers and verifying incomes; if applicable, preferences for certain buyers (e.g., local residents and employees)
- If applicable, procedures for payment of in-lieu fees, dedication of land, or contribution to offsite construction
- Provisions for minor and substantive amendments

- Provisions for ongoing monitoring
- Remedies in the event of default, like payment of attorneys' fees, civil penalties, and other remedies that may not be typical. For instance, the local agency can include a provision stating that residents of the development are third party beneficiaries of the contract, allowing them to bring suit against the developer should they be harmed by the developers' failure to comply with the conditions of approval.
- Mechanism for terminating the master developer agreement once homebuyer restrictions are recorded against title.

The specific terms will depend on the content of the local inclusionary ordinance, the design of the project, and local administrative practices.

II. Proper Documents to Ensure Long-Term Affordability

Effectively managing homeowner programs requires a good understanding the typical structure of homeowner financing, recording of property interests, and the contents of a title report. Title companies, lenders, and realtors are accustomed to dealing with a few readily recognizable documents and often do not read the other documents listed in a title report. But the requirements associated with affordable inclusionary housing—which has only taken hold in a small percentage of communities outside of California—are not always well recognized by national firms. Consequently, if local agencies are not monitoring the units closely, banks and other organizations may fail to notice the restrictions and let unauthorized transactions proceed.

A. TYPICAL STRUCTURE OF HOMEOWNER FINANCING

Almost every person who buys a home borrows at least some of the money from a bank or other lending institution. The lender requires the buyer to sign two documents which together provide security for the loan: *a promissory note and a deed of trust*.

A *promissory note* is simply a written promise to repay a debt. It can be as simple as "IOU $100, payable on Tuesday." In the case of a home loan, the promissory note will include all of the lender's terms and conditions in addition to the promise to repay the loan. Promissory notes typically include the rate of interest, monthly payments, term of the loan, penalties for late payments, and numerous other provisions.

The lender obtains security for the loan by requiring the borrower to sign a deed of trust. The deed of trust allows the home to be foreclosed on if the homeowner is in default on the loan.[6]

While the note is not recorded against the property, commercial lenders always record their deeds of trust. When a property is sold, all holders of recorded deeds of trust will be notified by the title company.[7] (A "deed of trust," which provides security for a loan, should be distinguished from a "grant deed," which transfers the ownership in a property.)

B. RECORDING AND TITLE REPORTS

Documents like deeds of trust are "recorded" (listed by date and time received) by the County Recorder in specialized records so that prospective buyers and lenders will have knowledge of any party that may have an interest in real property. The recording system protects interests in real property and helps to protect buyers from purchasing properties with undisclosed problems. If a document showing an interest in property is not recorded, the holder of the interest in the property may not be able to enforce the interest. Recorded documents may include deeds of trust, memoranda of leases, a notice that a lawsuit is pending (a "lis pendens"), mechanics' liens, IRS liens, a notice that property is located within a redevelopment area, easements, and many other property interests.

Any documents recorded against a property are shown as "exceptions" on a "title report" prepared by a title company. The documents are listed in the order in which they were recorded. Any buyer or lender is considered to have "constructive notice" of the contents of all documents listed in the title report—in other words, courts will presume that the buyer has read every document listed in the title report, whether or not the buyer has *actually* read the document.

The order in which documents are recorded generally determines which ones are honored first in the event of a default, with certain exceptions such as liens for failure to pay property taxes, which almost always have first priority. When more than one deed of trust has been recorded, the deed of trust recorded first gets paid off first in the event of a default. The "first mortgage," which is usually the largest loan against the property, is secured by the first deed of trust to be recorded. Additional loans—called subordinate loans—are recorded later in second, third, or even fourth or fifth position. (There is no limit on the number of deeds of trust that may be recorded.) The "first lender" is the one who provides the first mortgage. In return for having the loan in first position, the first lender will usually loan funds at a lower rate of interest than a subordinate lender. In the private market, second deeds of trust are often referred to as home equity loans, second mortgages, or junior mortgages or financing.

The order of recording documents is very important. If there is a foreclosure, the foreclosing lender will "wipe out" anything that was recorded after his deed of trust—every document that is "subordinate" to his deed of trust—and will take title to the property "subject to" any document that was recorded prior. Holders of subordinate interests must be able to pay off loans in superior positions, or otherwise cure a default, or they will lose all of their interest in the property if the first lender forecloses on it.

Financing, Recording, and Title Report on a Typical Home

Assume that a house sells for $250,000 in 2001. The homeowner makes a $50,000 down payment and receives a $200,000 loan at 5.5% interest from American Bank. A year later, after the house has increased in value to $350,000, the homeowner borrows another $20,000 at 8% interest from California Bank.

Assuming that both of the loans are secured by the value of the house, the owner's title report will show that:

- American Bank recorded a deed of trust in the amount of $200,000 in 2001.
- California Bank recorded a deed of trust in the amount of $20,000 in 2002.

If the homeowner defaults, and either of the banks forecloses, the home will be sold at a trustee's sale. Because American Bank recorded its deed of trust first, and is in first position, it will receive the first $200,000 in proceeds from the sale, with California Bank receiving the next $20,000.

If the house sells for more than $220,000 plus foreclosure costs at the trustee's sale, both American and California will be made whole. However, if American forecloses, it will "wipe out" the California Bank's loan unless a buyer is willing to pay at least $220,000. Consequently, California Bank must be able to come up with $200,000 cash to pay off American's loan to protect its investment.

C. TYPICAL FINANCING USED IN AFFORDABLE HOUSING PROGRAMS

Financing affordable housing units is generally more complex than a typical market rate transaction. More entities are involved in the transaction and all want some assurances that their investment or loan in the unit will be protected. However, only one loan or financing tool can be recorded "first" and secure for itself senior priority in case of a default.

Primary Financing

Under most affordable housing homeownership programs, the primary financing is provided by a bank, which makes a loan to the homebuyers for the maximum that they can afford. This loan is almost always in first position and not subordinate to any other loan. In addition, lenders are often reluctant to permit these loans to be subordinate to any restrictions on affordability or resale price; if they foreclose, the first lenders ideally want to be able to sell the property free and clear of any restrictions on price. Commercial

lenders usually package their loans and sell to various institutions in the secondary mortgage market, often to the Federal National Mortgage Association (FNMA, fondly known as "Fannie Mae"). Other commercial loans may be insured by the Federal Housing Administration ("FHA"). The California Housing Finance Agency ("CalHFA") also provides first mortgages at low interest rates to low and moderate-income first-time homebuyers.

All three agencies have very strict standards for their loans and for loans that they will purchase or insure. All of these agencies also establish standards for any subsidized secondary financing provided by public agencies or nonprofit organizations or guaranteed by an employer, which may limit the terms, such as in regard to equity-sharing, that cities can include in their own loans if they are to be eligible for the three programs. FHA and CalHFA require that restrictions on resale price be subordinate to their first loan, so that they can foreclose on the property and resell it free and clear of all other interests.[8] This requirement means that the local agency can lose the affordable unit if it cannot cure a default on the first mortgage or take other action to prevent a foreclosure.

In March 2006, FNMA announced a new program to allow resale restrictions to be recorded ahead of loans that FNMA will purchase. The program will allow communities to retain their resale restrictions in the event of a foreclosure by the first lender. This should encourage more lenders to allow resale restrictions to be recorded ahead of their deeds of trust and enhance the ability of cities to enforce their resale restrictions even after a foreclosure has taken place.[9] It is not yet known how many lenders will be interested in this new program.

Secondary Financing

Local government's assistance to a homebuyer is often provided in the form of subordinate financing. CalHFA and certain federal programs may also provide subordinate financing. These second loans (or even third loans) typically provide one or more of the following:

- Closing costs
- Down payment assistance
- Gap financing between the fair market value and the maximum sales price that the owner can afford

Loans for all three of these purposes may accumulate interest and most often are repaid either at the time of sale or following a regular repayment schedule.

Another form of subordinate financing is equal to the difference between the fair market value of the home and the affordable sales price but does not involve a cash loan. The developer receives the affordable price for the unit. The homebuyer then signs a

promissory note to the public agency for the difference between the affordable price and fair market value, and the public agency records a deed of trust for this amount. For instance, if a home worth $350,000 is sold to a moderate-income buyer for $250,000, the homebuyer would sign a note, and the agency would record a deed of trust for the $100,000 difference between the fair market value and the affordable price. This deed of trust would be subordinate to the normal bank loan made to finance the $250,000 purchase price. These notes are sometimes called "soft seconds" because the homebuyer is not usually required to pay any interest or principal until the home is sold, or possibly not at all.

Many agencies choose to maintain affordability primarily by controlling the resale price rather than by recording a deed of trust for the difference between the affordable price and the market rate price. In this case, the developer would simply sell the unit to the homebuyer at the affordable price; there would be no need to have a note and deed of trust for the difference between the affordable price and fair market value. Nonetheless, as will be discussed in the next section, it is still desirable to record a deed of trust to provide security for the restrictions on the resale price.

Each government agency that provides assistance to a homeowner may have specific requirements for its note and deed of trust, and the documents to be signed by the homebuyers tend to be more complex than those used in typical single-family home transactions. Consequently, the local agency needs to take care to ensure that the borrower understands the terms of the loan.

III. THE FIVE DOCUMENTS NEEDED FOR ANY HOME OWNERSHIP PROGRAM

Case Study: The Invisible Deed Restriction

A town had had a 20-year inclusionary program that had never experienced any problems. The resale controls were all attached to the grant deed and not recorded separately. The grant deed required the homeowner to record, on behalf of the town, a request for notice of default; the homeowners never did so.

When the homeowners over-encumbered the property and declared bankruptcy, the bank foreclosed and purchased the property at a trustee sale—having no knowledge of the resale controls, which were not recorded separately and so were not listed in the title report. The town learned what had happened only when the neighbors saw the bank's "for sale" sign.

Eventually the town was able to regain title to the property and sell it to an eligible buyer, However, the property was vacant for a year, back taxes and homeowners' dues accumulated, and the town incurred substantial attorneys fees and costs to regain the property.

Given the typical structure of first-time homeowner financing, agencies need to prepare five documents to ensure that their controls on ownership units are enforced:

1. Option to Purchase Agreement (recorded), which may or may not include restrictions on the resale price. Agreements that include a resale restriction should have the resale restriction in the title (for instance, "Option to Purchase at Restricted Price").

2. Promissory Note (not recorded)

3. Deed of Trust (recorded)

4. Request for Notice of Default or Sale (recorded)

5. Disclosure to Buyers (not recorded).

A. OPTION TO PURCHASE AND RESALE RESTRICTION AGREEMENT

The option to purchase agreement, often coupled with a resale restriction agreement, allows the public agency to purchase the affordable home when the owner is ready to sell it, sets the restricted resale price (when applicable), and also includes all of the

substantive provisions to be applied to the property as a condition of any governmental subsidy or purchase at below fair market value. Usually the public agency can assign its option to purchase to another income eligible homebuyer, so that the agency never actually takes title to the home.

The agency can also exercise its option to purchase if there is a default by the homeowner. This allows both the homeowner and the agency to avoid foreclosure proceedings. However, it does require that the agency have funds available to be used to purchase a home in the event that foreclosure is threatened.

Checklist of terms to be included in the option to purchase and resale restriction agreements

When the Resale Price Is Restricted

1. Required length of affordability and affordability level (very low, low, or moderate-income)
2. Means of calculating the resale price
3. Entity (usually the public agency) entitled to the difference between the sales price and the restricted resale price if a qualified buyer cannot be found

When the Resale Price Is Not Restricted:

1. Provisions for repayment of the initial subsidy (or for rolling over the subsidy to a new buyer at resale)
2. Provisions for sharing of equity or appreciation
3. Term (in years) of the required repayment

For All Agreements

1. Protections for buyer if price of home declines (often included because homebuyer's potential for appreciation is limited)[10]
2. Treatment of capital improvements at resale
3. Treatment of deferred maintenance at resale
4. Provisions for repayment of any secondary financing benefiting a public agency

5. Requirements for owner-occupancy and/or restrictions on rentals

6. Procedures for property transfer. Usually the agency has an option to purchase at an agreed-upon price within a set period of time when the owner decides to sell. Depending on the terms of the agreement, this may be at either the restricted resale price or at fair market value.

7. Treatment of involuntary sale or transfer: inheritance, divorce, etc.

8. Addition of parties to title by marriage or domestic partnership

9. Requirements for hazard insurance and payment of property taxes

10. Provisions for subordination of the agreement, refinancing, and home equity loans

11. Buyer's consent to the option to purchase

12. Default events that trigger the Option to Purchase or foreclosure. These typically include the first lender's declaration of default, failure to make payments on any secondary financing provided by the agency, the owner's failure to occupy the home as its principal residence, failure to pay property taxes, and a sale or transfer in violation of the restrictions.

Drafting of options to purchase and resale restriction agreements should always be done by an attorney competent in affordable housing and real estate transactions.

When inclusionary housing ordinances were first adopted 20 and even 30 years ago, most agencies did not record separate documents regarding the resale restrictions or the community's right to purchase the unit. Instead, they merely attached the conditions to a grant deed. When recorded in this way, however, the restrictions often do not show up in a title report, even by title of the document, and allow an argument to be made, especially by an unsophisticated buyer, that the restrictions were not disclosed before they purchased the property.

In response, local agencies now record their resale restrictions as separate documents and carefully title the agreements, since the title of the document is usually the only part of the document that will show up in a title report. Typical titles are, "Option to Purchase at Restricted Price" or "Restricted Resale Price and Option to Purchase." However, experience has shown, that buyers, lenders, and realtors may also ignore clearly labeled resale restrictions. The parties to a transaction rarely read the documents listed as exceptions in a title report. Loans may be processed in banking centers located in other

states or even offshore; employees processing the loan may have never heard of an inclusionary housing program, and "resale restrictions" may be incorrectly assumed to be illegal restrictive covenants (a provision requiring sale of property to persons of a particular race).

Most importantly, when the property is sold, either through a market transaction or at a trustee's sale because of default, no law or practice requires notice to the City, County, or Redevelopment Agency that recorded a resale restriction. Consequently, if an agency only records a resale restriction, it may not be notified by a title company when the property is sold or title is transferred. The agency, however, will receive notice if it records a deed of trust and a request for notice of default.

Case Study: "Catch Me If You Can"

A city had operated its inclusionary program for several years and recorded a separate document labeled "Resale Restriction." The owners, who had purchased at an affordable price, saw their neighbors in market-rate homes selling comparable homes at large profits and decided to sell without notifying the city. They retained a realtor (who also ignored the restrictions), listed the home on the Multiple Listing Service, pocketed $100,000, and moved to Nebraska. The buyers and their realtor also failed to appreciate the meaning of the "Resale Restriction" listed on the title report. The city learned of the sale only when other first-time homebuyers complained that they wanted to sell at market rate, too!

The town sued the sellers, buyers, and realtors for fraud and conspiracy. Eventually the lawsuit was settled. The buyers were found to be income-eligible to participate in the homeownership program. The realtors and sellers paid the buyers the difference between the market price and the affordable price. But the city incurred substantial attorney’s fees and costs and significant negative publicity before it regained the property.

B. PROMISSORY NOTES AND DEEDS OF TRUST

Because deeds of trust are so familiar to lenders, title companies, and realtors, the agency's inclusionary requirements can best be enforced if they are incorporated into a deed of trust. While a deed of trust is most commonly used to provide security for a loan, it can also be used to provide security for any obligation.[11] The advantage for a local agency is that state law requires all holders of subordinate deeds of trust to be notified if the owner defaults, prior to the sale of the property at a trustee's sale.[12] This gives the agency time to cure the default, or to exercise its option to purchase.

In addition, normally all holders of deeds of trust will be notified by a title company when property is sold through a purchase agreement, with a request for a "payoff

demand" (how much is needed to pay off the loan). This is because the new buyer, or the buyer's lender, typically requires as a condition of sale that all deeds of trust be removed ("reconveyed") before the new owner will take title and because title companies understand that most loans are not assumable by the new buyer. Consequently, the title company will send a notice to the public agency as the deed of trust holder when a sale is pending, and secret sales, as in the second case study, will be avoided.

Case Study: The Effect of Cure Right

Assume that American Bank is in first position with a $200,000 loan and California Bank is in second position with a $20,000 loan. If the homeowner defaulted and American Bank foreclosed, California would need to be able to pay $200,000 at a trustee's sale to ensure that its loan was protected.

However, if California has cure rights, it will be notified by American once American has determined that the borrower was in default. Typically the homeowner might owe three months' loan payments plus penalties. Assuming that American's loan was made at 6% interest, the homeowner's monthly payments would total $1,124, and three months' payments with penalties might total $3,600. Rather than having to pay $200,000, California Bank can cure the default for $3,600. In the case of a public agency with an option to purchase, this gives the agency time to exercise its purchase option or assign its rights to another buyer.

Since the local agency's deed of trust is almost always recorded in a position subordinate to the first mortgage, the agency needs to be able to "cure" any default on the first mortgage in the event that the homebuyer defaults on it. State law gives cure rights to the holders of all subordinate deeds of trust.[13] Cure rights allow the agency to pay off the amounts owed on the first mortgage in the event that the homeowner is in arrears. The agency can then either declare a default on its own deed of trust or can exercise its option to purchase the home to avoid foreclosure.

Local governments typically prepare the following documents to provide security and ensure that the housing remains affordable:[14]

- For all subordinate financing, a *promissory note* specifies the loan terms, including interest rate, repayment schedule, whether the interest is compounded or simple, etc. The financing is secured by a *deed of trust*, which is recorded.

- If the public agency is to receive a share of the appreciation in the home's value at resale, the *promissory note* explains how the shared appreciation is to be calculated. This note is also secured by a *deed of trust*.

- If the home was originally sold at an affordable price, and if the resale price is controlled so that the home always remains affordable, then the promissory note is an *"excess proceeds" note*. An excess proceeds note is a mechanism to enforce a resale restriction. The "excess proceeds" are the difference between the restricted resale price and the home's actual sales price at resale. The excess proceeds note is the homebuyer's promise to pay the local agency all proceeds above the restricted resale price.

  If the home is sold at the restricted price, the homeowner keeps all the proceeds, but if a qualified buyer cannot be found and the home is sold for fair market value, or if the owner ignores the restrictions and sells the home on the open market, the agency will capture the excess proceeds. The excess proceeds note is secured by a recorded *deed of trust.*

- All of the other obligations in the resale restrictions—the requirement that the home be owner-occupied, requirements for payment of property taxes and hazard insurance—are also incorporated into the deed of trust to ensure that these obligations are complied with. If a deed of trust secures only the performance of contractual obligations, and not repayment of a loan, it is called a *"performance" deed of trust*.

Performance deeds of trust are authorized by California law.[15] The enforceability of a performance deed of trust in the context of a first-time homebuyer program was upheld by the California Court of Appeal in 2005 in *Dieckmeyer v. Redevelopment Agency*.[16] Dieckmeyer had purchased a home under a first-time homebuyers program. She received a $23,000 loan from the Huntington Beach Redevelopment Agency for closing costs, loan fees, and the down payment. The loan was to be repaid with interest and with a share of her equity in the home upon resale. In addition, Dieckmeyer agreed to covenants, conditions, and restrictions (CC&Rs) recorded by the developer, which required her to sell the property to another moderate-income household.

Dieckmeyer paid off the loan with interest and demanded that the redevelopment agency reconvey the deed of trust to her, allowing her to sell at fair market value with no obligation to sell to another qualified homebuyer or to share her equity with the agency. The court of appeal agreed that the agency's deed of trust could remain on the title to the home to secure eventual payment of the shared equity, even though she had paid off the $23,000 loan. The court noted that Dieckmeyer would not have been able to buy her home without the city's assistance and was now trying to avoid a deal that she had agreed to. This decision supports local governments' use of deeds of trust to enforce the contractual obligations of first-time homebuyers.

C. REQUEST FOR NOTICE OF DEFAULT OR SALE

A request for a notice of default or sale is a recorded document that requires notice to be provided whenever the holder of a deed of trust declares a default or whenever the property is to be sold due to a default. Normally it is recorded at the time of initial sale along with the deed of trust and other documents. The advantage of recording a request for notice is that the agency will be notified sooner if the homeowner defaults, within ten business days of the date that a notice of default is recorded.[17] Holders of deeds of trust need only be notified within 30 days.[18] In addition, the agency will receive specific notice of any foreclosure sale.

A request for notice of default is applicable only to a specific loan and must be recorded for each lender known to the public agency. The requirements for this notice are listed in Civil Code section 2924b. They are somewhat complex. In the past some public agencies have required the *homeowner* to record the notice. This is unrealistic; a low-or moderate-income homeowner is unlikely to understand either how to draft the notice or how to record it. The notice should be drafted by the agency's counsel and recorded at the time of initial sale to the homebuyer.

If the homeowner later receives a home equity loan, the agency may not be notified and will not be able to record a request for notice of default against that lender. In the event of a default on that financing, the agency may not receive any notice, since the person purchasing the home at a foreclosure sale would take "subject to" the agency's deed of trust and resale restrictions, which would remain in place. (Issues regarding home equity loans and other financing subordinate to the public agency's are considered below.)

D. DISCLOSURE TO BUYERS OF AFFORDABLE HOMES

Case 3 Reprised: "I Didn't Know What I Was Signing"

Owners sold their income restricted home at market price and moved out of state (where land values were much cheaper). When they were ultimately tracked down, they claimed that they didn't know that there were resale restrictions, even after they were shown the copies they had signed. They also asserted that they were primarily Spanish-speaking and didn't understand. Lastly, they said that their realtor told them the restrictions didn't apply to them.

When caught violating resale restrictions, homeowners often allege that the restrictions were inadequately disclosed. This is understandable because the resale restrictions, promissory note, and deed of trust combined may total well over fifty pages and are not written in simple English.

To guard against these claims, local agencies should prepare a separate disclosure that explains the terms of the resale restriction, promissory note, and deed of trust in plain language. (This document *must* be reviewed by counsel to ensure that it accurately reflects what is in the agreements). Typically the disclosure will include calculations showing the homebuyers how much equity they will receive in various situations and/or the resale price of their home given certain assumptions. The disclosure will also explain the other terms: requirements for hazard insurance, the term of affordability, the option to purchase, and provisions in the event of default. Some communities have prepared videos explaining the loan terms to new homebuyers.

The buyer acknowledges reading and understanding the documents by signing the disclosure. Many communities also require first-time homebuyers to participate in homeowner education programs that explain maintenance requirements, homeowner responsibilities, predatory lending, and other issues that homeowners may encounter.

Disclosure issues may also arise when the homebuyer is not fluent in English. For certain consumer contracts, the California Civil Code provides that if negotiations have been conducted primarily in Spanish, Chinese, Tagalog, Vietnamese, or Korean, then a translation of the contract must be provided in the relevant language.[19] However, loans secured by real property are exempt from this provision, unless the proceeds are to be used for "personal or household expenses" (such as may be the case with home equity loans).[20] Agencies rarely make the types of loans that are subject to these provisions.

Nonetheless, to avoid assertions of misrepresentation, it is good practice to translate at least the disclosures into the applicant's language. Many agencies offer plain English and plain Spanish explanations of the process. At least one agency videotapes the explanation and signing of the acknowledgement. Where loans are frequently made to speakers of other languages, it is also desirable to have all of the documents translated into those languages.

IV. ISSUES INVOLVING REFINANCING AND HOME EQUITY LOANS

With radio and television ads encouraging homeowners to refinance their homes and take out equity, public agencies have encountered repeated problems with homebuyers refinancing their first mortgage or obtaining home equity loans in excess of the restricted resale price or without regard to the agency's right to a share of appreciation. If the homeowner cannot make the monthly payments, the lender will try to foreclose and take title to the home, in some cases forcing the agency to go to court to retain its interest in the property. Many loans have predatory terms, including some adjustable rate mortgages that permit large monthly interest rate increases; so-called "Option ARMs," which allow interest to accumulate and be added to principal ("negative amortization"); and loans requiring the homeowner to pay off the entire loan within a few years ("balloon payments").

Lenders are willing to make these loans because they often do not read the recorded documents and are unaware of the restrictions imposed on the sale of the home, and the lenders believe that there is sufficient equity in the home to pay off the loan even if the homeowner defaults. Some lenders are primarily interested in the fair market value of the home and are not concerned about the homeowner's credit history and ability to pay. Some lending is predatory: the lender knows that the owner's income is inadequate to repay the loan and doesn't expect to be repaid. Instead, the lender assumes that the homeowner will default, and the lender will acquire title at a below market cost.

The homeowner usually desires to refinance or to obtain a home equity loan for perfectly legitimate reasons: to finance a child's college education; to obtain a lower interest rate; to construct home improvements. With high-priced homes nearby, the homeowner may be surprised to find that she has little equity in her home in comparison with the appreciation of market-rate homes.

If agencies record deeds of trust, they should have some control over refinancing of first mortgages. However, limits on subordinate financing are more difficult to enforce because there is no statutory requirement to notify the agency when the loan is recorded.

A. REFINANCING

If the homeowner seeks to *refinance* the first mortgage, the public agency will more than likely receive notice *if* it has recorded a deed of trust. That is because the new first lender will usually demand that the agency subordinate its deed of trust to the new loan so that the new first mortgage will have priority over the agency's deed of trust.[21] Since the homeowner ordinarily cannot refinance unless the agency agrees to subordinate, most agencies agree to do so.

The option to purchase and resale agreement should include conditions for the subordination of the agency's loan. Local policies regarding refinance vary widely. Some of the terms imposed by local agencies as conditions to subordination include the following:

- ***Limits on total debt***. The total debt on the property, including the refinanced loan, any secondary financing, and the local agency's share of appreciation, if any, cannot exceed some percentage (usually 90% or 95%) of either the restricted resale price, if the resale price is restricted, or fair market value.

  An alternative followed by some agencies is to limit the amount that can be borrowed to the balance of the original purchase money loan. In other words, if the homeowner originally received a $150,000 loan that has a balance of $120,000, the homeowner will not be able to refinance for more than $120,000, even if the restricted resale price is now $180,000. This prevents the homeowner from taking out any cash from the refinancing, even if they have additional equity

in the home and the ability to pay. The owners may then seek riskier subordinate loans at higher interest rates to utilize the equity in their home.

- ***Limits on loan form***. Only certain types of loans are acceptable, allowing rejection of loans under which the borrower is more likely to default, such as those that require large balloon payments, permit big jumps in the interest rate, exceed a market rate of interest, or are not amortized.

- ***Limits by ability to pay***. Monthly housing costs after the refinancing will not exceed the owner's ability to pay.

- ***Limits on use of funds.*** Any cash taken from the refinancing will be used only for certain expenses, such as necessary capital improvements.

- ***Requirements for partial paydown of the agency's note.*** Part of the agency's note must be repaid if any cash if taken from the refinancing.

The local agency should also require that a request for notice of default or sale be recorded as part of its agreement to subordinate. These controls should protect the local agency's interest in the event of a refinancing.

B. PAYOFF DEMANDS AND REQUESTS FOR RECONVEYANCE

When a homeowner wishes to refinance, the local agency will typically receive from a title company a *payoff demand* and a *request for reconveyance.* The *payoff demand* asks the agency how much money the homebuyer owes the agency, so that all of the homeowner's debt can be included in one new loan.[22] The *request for reconveyance* asks the agency to reconvey its deed of trust—essentially, to eliminate its deed of trust from the title to the property. Usually a homeowner is entitled to have a lender reconvey its deed of trust once the homeowner pays off the loan. However, the local agency's deed of trust is usually in part a *performance* deed of trust securing the homeowner's obligations to the agency (such as the homeowner's promise to occupy the unit as the principal residence). If the agency mistakenly agrees to reconvey its deed of trust, it may lose most of its control over the property.

Agencies face three typical scenarios:

- ***Refinance of a deferred or low-interest loan.*** In most cases, it is not in the homeowner's interest to refinance this loan because the deferred, low-interest agency loan is replaced with a higher interest loan on which monthly payments need to be made. When local agencies receive a payoff demand for such a loan, they should contact the homeowner and explain the benefits of keeping the agency's loan in place. If the agency intends to control the resale price or to sell

the property to another eligible buyer or to have other controls on the property, it should not agree to reconvey its deed of trust even after the loan is repaid.

- ***Refinance of an equity-sharing note***. A homeowner may decide to prepay a local agency's equity-sharing note based on the home's present value rather than be forced to share future increases in value with the agency. Depending on past and expected future increases in price, this may or may not be in the homeowner's interest. If the homeowner pays off the entire loan, the agency may want to reconvey its deed of trust to the owner, unless it is interested in requiring owner-occupancy or exercising other controls over the home.

- ***Refinance of an excess proceeds note.*** No amount is due on an excess proceeds note unless the owner sells at a price higher than the restricted resale price. If the owner simply wants to refinance but is not selling the home, no money will be due on the excess proceeds note. The agency should tell the title company that no money is due but that its deed of trust will remain in place to secure performance. If the title company requests subordination, the agency can decide whether or not to subordinate based on its criteria.

Case Study: As Much Money As You Want

A city sold a home to a first-time homebuyer and recorded a separate document labeled a "Resale Restriction and Option to Purchase." The city's restrictions limited the price at resale to $150,000, but unrestricted homes in the neighborhood sold for $500,000. The homeowner refinanced the house for $250,000 and then was loaned another $100,000! Although the loans on the house, totaling $350,000, were much less than its fair market value, they exceeded the permitted resale price by $200,000.

The homeowner could not repay the loans and eventually defaulted. The city learned of the trustee's sale two days before its scheduled date and enjoined the sale. While the litigation proceeded, the homeowner moved out and squatters moved in. Eventually the city spent over $100,000 to repair the damage caused by the squatters plus significant attorneys fees, unpaid taxes, and homeowners dues. The lender lost the excess $200,000 in loans, which the homeowner had already spent on consumer goods.

C. SUBORDINATE FINANCING

As in the case study, agencies have often encountered their biggest problems when a lender is willing to make a loan subordinate to the existing agency deed of trust and never asks the agency to subordinate its loan or resale restrictions. The new lender is not required to notify the holder of an existing deed of trust before making a subordinate loan

on the property. Ultimately, local agencies may discover home equity loans and other subordinate financing only by reviewing public records showing the documents recorded against a home.

The problem for local agencies is that subordinate lenders are not required to notify the holder of a deed of trust senior to their loan before holding a foreclosure sale,[23] unless a request for notice of default has been recorded. If the agency doesn't know about the loan, it will not have recorded a request for notice of default. When someone buys a home due to the foreclosure of a subordinate loan, he buys the home "subject to" any deeds of trust and any resale restrictions recorded before the subordinate loan. However, if the agency never hears about the foreclosure sale, it is possible that a person who does not qualify as a low or moderate-income household could purchase the property at auction for an amount in excess of the restricted resale price.

The locality could then be faced with undertaking an action for specific performance and declaratory relief to exercise its option and obtain title, or an action to collect the amount due under its "excess proceeds" note (if the funds are available), or an action to declare a default and to foreclose for violation of the deed of trust.[24] Some lenders have argued that the resale restrictions violate state laws requiring sale at foreclosure to the highest bidder, although there is no case law supporting the invalidity of a resale restriction in the event of foreclosure.[25] In addition, the lower moderate-income homeowner will have lost the home.

To discourage homeowners from taking out loans in excess of the restricted price or in excess of their ability to pay, public agencies have included the following restrictions in their documents:

- ***Require payment***. Requiring payment on an existing public agency note if subordinate financing is obtained. For instance, the agency may require that monthly payments be made on a loan where payment would ordinarily not be required until resale. Agencies sometimes provide that the required payments, when added to those due under the first and subordinate mortgages, may not exceed some percentage (say, 35%) of the owner's income. The hope is that the homebuyer will not qualify for additional excessive loans or will qualify only for a lesser amount.

- ***Approve subordinate financing***. Requiring homebuyers to obtain approval from the agency before taking out subordinate financing, with restrictions on the loan terms and total debt similar to those imposed on the refinancing of a first mortgage.

- ***Automatic default***. Stating that obtaining subordinate financing without permission is a default, and the public agency may either exercise its option to purchase or record a notice of default and foreclose on the property.

- ***Homebuyer education***. Requiring prospective homebuyers to attend mandatory education sessions that describe predatory lending practices and the risk of foreclosure due to subordinate loans.

However, it is important to note that both federal and state law prohibit any lender from calling a loan due on an owner-occupied single-family home merely because the homebuyer records subordinate financing against the home. The federal Garn-St. Germain Act preempts all state laws regarding "acceleration" of loans (declaring them due and payable) and expressly forbids acceleration due to the recordation of another subordinate loan on an owner-occupied single-family home.[26] Of the first three options listed, requiring payment on the agency's loan is the one most likely to be considered consistent with federal law.

California also has a state law that is largely consistent with the Garn-St. Germain Act.[27] It somewhat expands the protections of federal law by stating that the lender also cannot declare the loan in *default* solely by reason of the owner's encumbering the real property with a junior deed of trust. Therefore, a local agency can neither accelerate the loan, nor declare the homebuyer in default and seek to foreclose on the property, *solely* because the homebuyer has recorded another loan against the property. However, it could be argued that, in the affordable housing context, the reason for declaring a default is not merely because the junior loan has been recorded, but because the additional loan has made the home unaffordable by creating debt that exceeds the affordable price. In other words, the default is not due *solely* to the recordation of the other loan.

There is no case law on this point. It could also be argued that the federal Garn-St. Germain Act preempts *all* remedies against homebuyers when they merely enter into a subordinate loan. Consequently, agencies cannot be sure that any remedies against the mere recordation of subordinate loans are enforceable.

There is also a practical problem with most of the remedies available to the local agency. Requiring homeowners to increase their payments to the agency after taking out another loan will raise the odds that the homeowners will default on the subordinate loan. Agencies may well be very hesitant—with the potential for significant negative publicity—to force the owners out of their home by exercising an option to purchase merely because the owner has obtained subordinate financing.

Ultimately, the effect of these provisions may be primarily to discourage homebuyers from obtaining subordinate financing, and to have them consult with the local agency if they do so. Many agencies choose to restrict subordinate financing for this purpose—to discourage homeowners from overburdening themselves with debt—even though the agency has been counseled about the legal difficulty of enforcing the restrictions. In some cases, subordinate lenders who discover the resale restrictions have been willing to unwind their loans after these provisions are brought to their attention.

IV. MONITORING HOMEBUYER PROGRAMS

Getting the units planned and built, and then protecting the investment by properly recording the agency's interest in the property is about two-thirds of the battle. Implementing affordable homeownership programs also requires a commitment of time and resources to monitor and implement the program over the life of the affordable unit. There are a variety of considerations, including developing a system for monitoring the units, making sure the units are adequately maintained, and tracking subsequent transactions to assure that they accord with the purposes of the ordinance.

Case 5: Limited by the Condition Imposed

A redevelopment agency worked for years to create a homeownership program in a very poor, blighted area, where it seemed that no one would want to buy a home. The agency worked with a nonprofit to develop a 90-unit project. The agency put in millions of dollars. The County added millions more. Construction was a nightmare. The agency put in more money. The County put in more money. So as not to discourage homebuyers, the only resale restriction was an option for the redevelopment agency to purchase the home at the restricted resale price. If the agency didn't exercise the option, the homeowner could sell at market, and the agency would get only an equity share based on its second mortgage.

One day a homeowner sent notice to the agency that he intended to sell his home. The agency had only 30 days to exercise its option. The agency's receptionist signed the certified mail receipt, but no one on the agency's housing staff remembers seeing the notice. The home sold for $300,000 over the restricted price. The agency could do nothing because it had failed to exercise its option in time. Its equity share was very small because it had provided most of its subsidy to the developer and not to the homeowner. The unit was lost forever as an affordable home.

A. AN ADMINISTRATION CHECKLIST

Implementing inclusionary ordinances requires dedicated staff and training in the mechanics of the program. It cannot be done on the cheap. Familiarity with deeds of trust, defaults, subordination, and secondary financing is not a typical "core competency" of cities and counties, except perhaps in the largest and most experienced of agencies. Keeping units in the program and ensuring that they are not lost to defaults, fraudulent sales, or lack of knowledge requires a commitment to monitoring, training, and adequate staff.

The following administrative tasks need to be done as part of any homebuyer program:

- Negotiate with developers and prepare master developer agreements.
- Calculate affordable sales prices, at least annually.
- Income-qualify buyers.
- (Optional but desirable): Assist in finding qualified buyers and establish a waiting list for resales.
- Respond to payoff demands from title companies. In an equity-sharing program, calculate shared appreciation due.
- In a resale restriction program, calculate the restricted resale price at the time of sale.
- If the agency has an option to purchase upon resale, respond to notices of intended sale from homeowners.
- Respond to subordination requests from homeowners who wish to refinance their first mortgage.
- Respond to notices of foreclosure and bankruptcy. The agency needs both adequate funds to exercise its option if foreclosure is threatened and legal counsel who can enforce the agency's rights. Localities need to be prepared to make a claim in bankruptcy and, in the event of foreclosure, may need to get a temporary restraining order or injunction to exercise their option and prevent the foreclosure sale. They may also need to undo an illegal sale.
- Respond to hazard insurance notices.
- Establish a data base that includes all homes in the homebuyer program, so that initial costs and other provisions can be tracked.
- Create a Housing Trust Fund and reinvest the funds generated by equity-sharing or payment of excess proceeds notes.
- Periodically meet with realtors, lenders, brokers, and title companies to create familiarity with the program.

B. DEVELOPING MANAGEMENT SYSTEMS

Ideally, localities should also implement an annual monitoring program that would include a minimum of three steps. First, the agency should review the assessor's records annually for changes in title and to ensure that the homeowner's exemption is still being claimed. Second, the agency should send an annual notice verifying owner occupancy. For agencies that have resale restrictions in place, a good practice is also to include a statement estimated resale value of the property if it was sold that year at its restricted price in order to minimize misunderstandings at the time of resale.

Third, the agency should also check to see if any new documents have been recorded against the title to identify subordinate loans or other liens that may jeopardize the agency's interest in the property. Many counties now show all recorded documents on line. An alternative is to establish a contract with a title company to review annually any new recorded documents. Finally, local agencies should be alert to neighbor complaints and police reports that indicate there is a problem. A large number of problems will come to the attention of local governments due to neighbor complaints.

The agency should also to establish a fixed procedure for reviewing notices of sale, requests for subordination and loan payoffs, hazard insurance notices, notices of defaults, and all other documents. Some agencies, such as Monterey County, have prepared detailed guidelines. Some local governments have entered into agreements with realtors, lenders, or nonprofit organizations to administer their program. Entities that commonly administer homebuyer programs for local government include:

- ***County housing authorities, or other public agencies***. The Marin County Housing Authority, for instance, administers homebuyer programs for most of the cities in the County. Some experienced cities have offered to administer the programs of smaller or less experienced cities.

- ***Nonprofit housing corporations***. The Palo Alto Housing Corporation administers the City of Palo Alto's program; South County Housing assists some communities in Santa Clara and Monterey counties. BRIDGE Housing Corporation has a special purpose affiliate called Homebricks which administers affordable homeownership programs for various public agencies, including Dublin and American Canyon.

- ***Private realtors.*** The City of San Mateo contracts with one realtor, selected through an open process, to maintain the waiting list and handle all resales.

- ***Private management companies***. Some private companies have started to specialize in this area.

In each case, however, local agency oversight is critical to ensure that the consultant understands the local program and is administering it in accordance with the agency's goals.

Communities often pay for administration by charging a "transaction fee" upon resale (typically 2% to 3% of the sales price) or when specific requests are made (such as a request for subordination). Other sources may be Community Development Block Grants or redevelopment agency housing set-aside funds (if the affordability restrictions meet the requirements of California redevelopment law). In any case, however, an agency considering an affordable homebuyer program should make provisions for administrative costs upfront and not as an afterthought. Without adequate administration, affordable homes will be lost.

C. KEEPING DECISION-MAKERS SUPPORTIVE

Case 6: "It's Not Fair"

In 2001, moderate-income homeowners purchased homes for $255,000 that were actually worth $305,000. Three years later, their houses were worth $430,000 at fair market value, but the restricted resale price—which would enable the city to sell the homes to other moderate-income buyers—was only $275,000. The homeowners appealed to the City Council, arguing that they could not buy a comparable house in the area for the $275,000 that they were entitled to. The Council agreed to consider whether the homeowners could be provided some "financial relief."

It is not uncommon for homeowners who were thrilled to purchase homes at a below market cost to be angry and upset when they discover how little equity they have gained at resale. Between the late 1990s and mid-2000s, household incomes were increasing at rates substantially slower than the rate of increase in new home prices. Homeowners in affordable units often found that they were falling farther and farther behind in their ability to purchase another house, rather than keeping up with increases in housing costs like other homeowners. Without a legal remedy, homeowners often complained to City Councils and Boards of Supervisors and asked for relief.

The agency's remedy is to ensure that the decision-makers understand the consequences of their program when they adopt it—and to keep re-educating newly elected officials. Communities must choose between maintaining affordability and allowing homebuyers to keep up with rising home prices. Strict resale restrictions will maintain affordability but will not allow homeowners to gain enough equity to buy an equivalent house on the open market. More generous equity sharing will require the public agency to provide additional subsidies with every resale to keep the homes affordable. Decision-makers need to understand at the beginning and throughout the implementation of the program

which choices have been made. If they wish to make changes, the trade-offs should be made clear.

VI. Conclusion

California cities have been implementing homebuyer programs for over 30 years. The pioneers found that the programs were far more complicated than they could ever have anticipated. The experience of these cities has resulted in a significant body of knowledge about how agencies can best secure their investment. By recording the proper documents and understanding the issues that often arise, agencies should be able to ensure that the homes that they have worked so hard to create remain affordable.

For more information about implementing inclusionary housing programs, including sample forms for agreements and ordinances, visit the Institute's Housing Resource Center at www.ca-ilg.org/hrc.

Endnotes:

[1] Ehrlich v. Culver City, 12 Cal. 4th 854, 876 (1996).

[2] Developers may also construct affordable housing to receive a density bonus and other incentives under the state's density bonus bill (Government Code Section 65915). Local agencies can similarly impose conditions to ensure that the affordable units that are the basis for the various incentives are, in fact, built.

[3] Note that there is an extensive literature on the constitutionality of inclusionary ordinances themselves. *See, e.g.*, Barbara Ehrlich Kautz, In Defense of Inclusionary Zoning: Successfully Creating Affordable Housing, 36 U.S.F.L. REV. 971 (2002); INSTITUTE FOR LOCAL GOVERNMENT, CALIFORNIA INCLUSIONARY HOUSING READER (2003) (*available at* www.ca-ilg.org/inclusionary); CALIFORNIA AFFORDABLE HOUSING LAW PROJECT & WESTERN CENTER ON LAW & POVERTY, INCLUSIONARY ZONING: LEGAL ISSUES (2002).

[4] Civil Code section 1213.

[5] Note that in some cases affordable housing obligations are imposed as conditions of another recorded agreement entered into between the local agency and the developer. These agreements may include Development and Disposition Agreements and Owner Participation Agreements entered into between a redevelopment agency and a developer; or Development Agreements pursuant to Government Code section 65864. If these contain appropriate provisions to ensure the construction of the affordable housing, they are adequate substitutes for master affordable housing agreements.

[6] Technically, the lender (called the beneficiary in the deed of trust) appoints a trustee (usually a title company) who is authorized to foreclose on the property in the event of default by the borrower (called the trustor in the deed of trust). Details of the drafting of a promissory note and deed of trust are beyond the scope of this paper.

[7] Note that in rare instances, where no loan is involved, homes are sold without title insurance, and holders of deeds of trust may not be notified of the sale.

[8] *See* California Housing Financing Agency, Program Bulletin # 95-08 (March 1995); United States Department of Housing and Urban Development, Office of the Assistant Secretary for Housing-Federal Housing Commissioner, Mortgage Letter 94-2 January 11, 1994.

[9] *See* Federal National Mortgage Association, Announcement 06-03, Properties Subject to Resale Restrictions or Located on Land Owned by Community Land Trusts (March 22, 2006); Federal National Mortgage Association, Community Seconds Program (Dec. 1999). A number of local agencies have refused to subordinate their resale restrictions to first lenders. However, prior to FNMA's change in policy, refusing to subordinate created difficulties for homebuyers in obtaining a first loan and/or higher interest rates. The change in policy may relieve these problems.

[10] FHA requires that the homeowner be allowed to recover at least the original purchase price, real estate commission, and cost of capital improvements.

[11] Civil Code section 2920(a) (a deed of trust is security "for the performance of any act").

[12] Civil Code section 2924b(c)(2)(B).

[13] Civil Code section 2924c(a)(1).

[14] Note that FNMA, CalHFA, FHA, the federal HOME program, and other housing finance programs restrict the terms that local governments can apply to their own secondary financing. For instance, they limit the interest rate and the local government's share of appreciation, may require a minimum down payment from the buyer's funds, and do not permit both interest and an equity share. The documents listed in footnotes 9 and 10 should be consulted for specific requirements.

[15] Civil Code section 2920(a) (a deed of trust is security "for the performance of an act."). The courts have upheld use of a deed of trust to secure the performance of a contract. *See Stub v. Belmont*, 20 Cal. 2d 208, 213-14 (1942).

[16] 127 Cal. App 4th 248 (2005).

[17] Civil Code section 2924b(b)(1).

[18] Civil Code section 2924b(c).

[19] Civil Code section 1632.

[20] Section 1632(b)(4).

[21] Under recording laws, the agency's resale restrictions and deed of trust would ordinarily have priority because they were recorded first. However, by signing a written agreement to "subordinate" its deed of trust and/or resale restrictions, the agency agrees that the new first loan will have priority, despite being recorded later. If the local agency has a resale restriction recorded but not a deed of trust, the lender may or may not ask that it be subordinated to the new first loan. While the resale restriction is then enforceable even if the homebuyer defaults, the agency may not hear of the default until after the foreclosure sale. It may well be required to go to court to enforce its resale restriction. See later discussion of subordinate loans.

[22] State law gives single-family homeowners the right to prepay a loan at any time (Civil Code section 2954.9). Prepayment penalties may only be charged for fixed-rate loans, for the first five years, and if more than 20% of the loan is prepaid in any one year.

[23] *See* Civil Code section 2924b(c)(2)(B) (requiring that notice be given only to the beneficiary of a deed of trust recorded subsequent to the deed of trust being foreclosed).

[24] Note that Civil Code section 711.5 permits a local public entity "directly or indirectly" providing housing purchase loans to require the payment of the entire amount due on the agency's loan if a subsequent purchaser does not meet the agency's eligibility requirements.

[25] *See* Civil Code section 2924g(a). However, the highest bidder purchases the property subject to all superior liens and encumbrances on the property. Consequently, this provision should not restrict the local agency's ability to enforce its resale restriction. Nonetheless, collecting on an excess proceeds note may be simpler than trying to undo the foreclosure sale or trying to force the purchaser (who may have had constructive, but probably not actual knowledge of the resale restriction) to abide by the restriction.

[26] *See* 12 U.S.C. § 1701j-3(d)(1). Regulations established by the federal Office of Thrift Supervision, Dept. of the Treasury, preempt all state laws related to enforcement of due-on-sale clauses. *See generally* 12 CFR Part 891.591. The prohibition on defaults due to subordinate liens on owner-occupied single-family homes is included in 12 CFR section 591.5(b)(1)(i).

[27] Civil Code section 2949(a).