BARRY MALLIN & ASSOCIATES, P.C.
ATTORNEYS AT LAW

132 NASSAU STREET
NEW YORK, NEW YORK 10038
212-285-1200 FAX (212) 285-1202

February 15, 2017

Attention: HDFC Boards of Directors and Shareholders

Re: <u>HPD's Tax Abatement and Regulatory Agreement Proposal</u>

Dear HDFC Boards of Directors and Shareholders:

HPD is proposing a new tax abatement and Regulatory Agreement for HDFCs. This proposal is causing intense debate among shareholders, activists, and HPD about the future of HDFCs. Many of our clients have attended HPD's meetings, joined organizations lobbying for or against the proposal, and reached out to our firm for guidance. To help HDFC boards and shareholders better understand the proposal, this letter will provide a general analysis of its key provisions.

The proposal offers HDFCs a more valuable real estate tax exemption in return for adopting the new 40-year Regulatory Agreement.[1] HDFCs without a regulatory agreement will have their existing DAMP tax exemption revoked. HDFCs with an existing regulatory agreement can sign the new one, but will keep their DAMP exemption if they decline. Any change to the DAMP tax must be approved by the City Council.

HPD believes the restrictions in the new Regulatory Agreement are necessary to preserve HDFCs as affordable housing. We think the proposal goes beyond what is necessary to achieve its desired effect. However, each board of directors should carefully review the analysis below and all available guidance to make its own determination about whether it makes sense for their HDFC.

We encourage you to reach out to our office if you have specific questions about how the Regulatory Agreement could affect your building.

---

[1] Under the new tax exemption, shareholders can save up to $750 per year over the existing DAMP exemption. *See* Preserving Affordable Home Ownership: HDFC Coops and Our Community, Slide 8, *available at* http://www1.nyc.gov/assets/hpd/downloads/pdf/Owners/hdfc-coop-december-shareholder-forum.pdf. Depending on where the building is located and other exemptions it receives, the revocation of the DAMP exemption could have minimal or no effect or could substantially raise maintenance costs.

CHANGES IN MANAGEMENT:

The Regulatory Agreement requires boards of directors to submit the following documents to HPD each year:

- Annual Budget
- Financial statement
- Certification the financial statement has been distributed to shareholders
- Certification of who is occupying apartments with maintenance and rent arrears
- Certification of list of sales
- Certification of leases and sublets approved, including names of renters
- Certification of withdrawals from reserve fund
- Certification of annual election and notice
- Certification maintenance has increased by 2% as required
- Training plans for the prior year and next year

Since boards will have to keep this information for their internal use anyway, the disclosure requirement does not impose a significant burden.

More controversially, all HDFCs must hire a monitor. The monitor will oversee nearly every aspect of the board's management, including elections, sales, subleases, board training, withdrawals from the reserve account, and notifying shareholders of violations. This would be fairly straightforward if the monitor was simply given the power to check the board's work to ensure compliance with the Regulatory Agreement. But the Regulatory Agreement goes beyond that, giving the monitor independent discretion over several key areas of board control.

For example, the monitor appears to have independent discretion over interviewing and approving proposed purchasers. This will not be a problem if the board and monitor agree. But if the monitor thinks a proposed purchaser is not a good fit for the cooperative, it could deny the applicant even if the financial requirements are met and the board approves. This takes away one of the fundamental rights of cooperative owners, which is the ability to decide, through their board, who will become their neighbors.

Unless HPD issues a waiver, HDFCs must also hire a manager. The requirements for a waiver do not appear in the Regulatory Agreement, but HPD has stated it will waive the manager requirement if the HDFC meets the following criteria:[2]

- Maintain six (6) months' of maintenance in a reserve account(s)
- Less than one quarter in DEP or DOF payment arrears
- Current in all mortgage payments, if applicable
- HPD or DOB violations on less than 20% of dwelling units
- At least 85% rate of maintenance and rent collection for the previous year

---

[2] *See* Proposed Changes for HDFC Coops Frequently Asked Questions § 3, *available at* http://www1.nyc.gov/assets/hpd/downloads/pdf/Owners/hdfc-coop-regulatory-agreement-faq.pdf

- Proof of annual board elections for past 3 years
- All documents required by a regulatory agreement submitted to HPD

The waiver must be renewed annually and there is no assurance that the same requirements will always be applied.

The HPD-approved manager further limits board control. Among other things, the manager has independent discretion to reject commercial tenants, leading to the same concerns as with the monitor's ability to reject residential tenants explained above. More troublingly, the board has little power to fire its manager for poor performance. If the manager is removed, HPD can appoint a new manager without consulting the board. At this point, we do not know who the HPD-approved managers will be, making it impossible to assess their qualifications and trustworthiness. Many of our clients have decided to be self-managed after having bad experiences with the quality of managers in the price range available to HDFCs.

HPD will have increased leverage over the HDFC. HPD and the HPD-approved manager can each sue the HDFC to enforce the Regulatory Agreement, Monitoring Agreement, Private Housing Finance Law, Business Corporations Law, or any other law or agreement. This is extraordinary power to give to a contractor. Managers are supposed to be agents of, and subservient to, the board. This turns that on its head. On the other hand, this could be an effective check on boards that are behaving badly.

HPD can sue the HDFC to enforce any applicable agreement or law, no matter whether HPD would otherwise have such enforcement power. HPD can also call board members to appear for recorded, under oath oral examinations on ten days' notice, even without a lawsuit. It is unclear if board members can be represented by counsel at these oral examinations, if they have to hire their own attorney or can use the HDFC's attorney, or what the penalty is for failing to appear.

Boards are prohibited from leasing HDFC-owned commercial space with a term of more than two years without prior HPD approval. As a practical matter, because retailers generally put considerable resources into renovating a new commercial space, nearly all commercial leases will have terms of more than two years and be subject to HPD's prior approval.

As a result of these provisions, HPD will have broad control over HDFCs. HPD believes this level of control is necessary to keep HDFCs affordable.

<u>CHANGES FOR EXISTING SHAREHOLDERS:</u>

The Regulatory Agreement requires existing shareholders to submit annual certifications to HPD. The certifications include the following:

- Number of nights spent in their apartment
- Affirmation they list the HDFC as their only residence on their taxes
- Affirmation they list the HDFC as their only residence on their voter registration

- Affirmation they list the HDFC as their only residence on their driver's license
- Affirmation they list the HDFC as their only residence on any other document

Shareholders may not acquire property within 100 miles of New York City except through inheritance. Inherited property within that range must be sold within a year.

All shareholders must spend 270 nights in the apartment per year. This is more than is required for rent stabilized tenants (183). It is unclear why HDFC shareholders need to spend more time in their apartments than rent stabilized tenants.

Shareholders may sublet their apartments, but only to income-eligible tenants and not for more than 18 months in any five (5) year period.

Maintenance must go up by 2% per year. This does not take into account whether the HDFC has profitable commercial properties that can reduce or eliminate the requirement for maintenance increases. It also does not take into account low and fixed-income shareholders who may not be able to afford the increases.

CHANGES TO SALES:

Incoming shareholders can make up to 120% of AMI, as shown on their federal tax returns. This is a change from the current use of state tax returns. In 2016, that is $76,125 for an individual, $87,000 for a family of two, $97,875 for a family of three, and $108,750 for a family of four.

Incoming shareholders' assets are limited to no greater than 175% of AMI, which includes all monetary and non-monetary assets except retirement accounts. In 2016, that is $111,125 for an individual, $126,875 for a family of two, $142,800 for a family of three, and $158,550 for a family of four.

Sales prices are capped according to a 30-year schedule written into the Regulatory Agreement. For this year, the schedule caps prices at $286,296 for a studio, $347,636 for a one bedroom, $412,022 for a two bedroom, $476,712 for a three bedroom, $539,880 for a four bedroom, and $601,830 for a five bedroom. HPD calculated the schedule to be affordable at 110% of AMI. It is unclear how it calculated the projected AMI increases over the next 30 years.

HPD has proposed a carve-out plan that allows HDFCs to specify up to one-third of its apartments that can be sold at 165% of AMI with no asset or sales price cap. In 2016, that is income of $104,775 for an individual, $119,625 for a family of two, $134,640 for a family of three, and $149,490 for a family of four. In the event the carve-out plan is found to be illegal, the default income, asset, and price caps apply. Because its legality has not been tested, HDFCs should be wary of relying on the carve-out plan to escape the sales restrictions in the regular agreement.[3]

[3] Business Corporations Law § 501 generally prohibits cooperatives from imposing sales restrictions on some apartments and not others, but there are exceptions. As HPD itself acknowledges, the survival of the carve-out provision is not certain.

A flip tax on sales is required. Flip tax is set at 30% of profit (profit being sales price minus the seller's purchase price and closing costs) if the shareholder has owned the shares for more than three years or received ownership through foreclosure or inheritance. If the shareholder has owned for less than three years and does not fit within the other categories, the flip tax is 100% of the profit.

Some shareholders will lose equity in their homes under the proposal. Some HDFCs have been operating for decades under HPD's guidance that income should be restricted to 165% of AMI but without other sales restrictions.[4] Others have signed regulatory agreements that imposed income restrictions at 120% of AMI but mandated no other sales restrictions. Shareholders who recently purchased at prices affordable at 165% or 120% of AMI will almost certainly lose equity in their homes if their HDFC adopts price caps limited to what is affordable at 110% of AMI.

<u>CONCLUSION:</u>

We have serious concerns about whether the proposed Regulatory Agreement is in the best interest of our clients. We share HPD's policy goal of preserving HDFCs as a continuing reservoir of affordable housing, but take issue with the heavy weight of HPD regulations and rules to achieve that goal. The Regulatory Agreement gives HPD and HPD-approved contractors broad control over corporate governance. Yet experience has shown HPD is unlikely to have the capacity to adequately oversee this system.

Moreover, the Regulatory Agreement's price and asset caps are likely to cause some shareholders to lose equity in their homes, and recent purchasers could end up selling at a loss. The carve-out plan does not entirely remedy this because it will impose the default restrictions if the carve-out is found to be illegal, resulting in loss of equity for some shareholders.

HPD believes the proposal will keep HDFCs affordable, but ultimately it is up to the shareholders to determine whether the new tax exemption is right for their building. Each HDFC has unique circumstances that will make the Regulatory Agreement more or less attractive, including its history of sales restrictions and ability to pay higher property taxes. Please contact our office if you have further questions or would like to set up a consultation to discuss issues specific to your building.

Sincerely yours,

Barry Mallin
Matthew Maline

---

[4] Sales restrictions are one of the most frequently misunderstood concepts about HDFCs. According to HPD, unless a lower income limit is specified in the HDFC's corporate documents or a regulatory agreement, the income limit for incoming shareholders is 165% of AMI. *See* Fact Sheet for Cooperative HDFC Shareholders § 1, *available at* http://www1.nyc.gov/assets/hpd/downloads/pdf/Owners/hdfc-coop-fact-sheet.pdf.