CITY OF COSTA MESA
INTEROFFICE MEMORANDUM

To: **City Council**

From: **Tom Hatch, Assistant City Manager**
Muriel Ullman, Neighborhood Improvement Manager
Alma Penalosa, Management Analyst

Subject: **Neighborhood Stabilization Program I (NSP-1) – Joint Partnership among Cities of Fullerton, La Habra and Costa Mesa**

Date: **September 13, 2010**

BACKGROUND

In July 2009 the United States Department of Housing and Urban Development (HUD) allocated $3.92 billion to all states with particular priority to hard-hit areas trying to respond to the effects of high home loan foreclosures and housing crisis. HUD's *Neighborhood Stabilization Program* (NSP 1) provides targeted assistance to state and local governments to acquire and redevelop foreclosed properties that might otherwise become sources of abandonment and blight within their communities. Only properties located in places with the greatest percentage of home foreclosures, sub-prime mortgages and/or significant foreclosure risk were eligible to receive allocations of HUD NSP 1 funds.

To use NSP 1 funds for the acquisition of foreclosed homes and down payment assistance, the properties must be purchased from a lender for a price that is at least 1% lower than the home's appraised value. In addition, the Home must be vacant in order to avoid relocation payment obligations. Middle Income households earning up to 120% of the Orange County area median income (AMI) are eligible to participate in the NSP 1 program.

Costa Mesa did not meet the criteria for a direct allocation of Tier 1 funds from HUD. However, in May 2009, the State of California distributed a Notice of Funding Availability (NOFA) for the "Tier 2" funds that the Federal government allocated to the State (State NSP 1). Under a formula established by the State, Costa Mesa became eligible for an allocation of $303,000 in State NSP 1 funds.

The State NSP 1 requirements include a $1 million minimum funding threshold. Jurisdictions receiving less than $1 million must enter into a partnership with other jurisdiction(s) in the same county to reach a combined award of at least $1 million. To comply with this requirement, Costa Mesa entered into a partnership with the City of Fullerton and the City of La Habra; these Cities are qualified to receive allocations of

$608,623 and $458,231, respectively. Fullerton agreed to act as the lead agency since they received the largest funding allocation of the three Cities. **A "Joint Partnership Agreement" was considered and approved by the City Councils of all three Cities (JPA Partners) in June 2009.** The Costa Mesa City Council and the Costa Mesa Redevelopment Agency also authorized the City Manager to negotiate and enter into a Sub-Recipient Agreement between the City of Costa Mesa and the City of Fullerton in a form approved by the City Attorney.

The City Councils for the JPA Partners authorized their staffs to prepare a Request for Proposals (RFP) to housing development organizations to undertake a foreclosure acquisition and/or down payment assistance and rehabilitation program. Costa Mesa staff worked with Fullerton and La Habra staffs in the RFP process; proposals were solicited in June 2009, and the responses were received by July 13, 2009. Mercy Housing California (MHC) was selected to implement the Program.

The JPA Partners unanimously deemed MHC the most qualified developer to administer a program of this type in such an abbreviated time frame. Their successful track record running acquisition rehabilitation programs nationwide, as well as their cutting edge experience running NSP programs will help ensure the success of this pilot program. Additionally, their connections with the National Community Stabilization Trust gives them access to a large inventory of foreclosed homes in all three cities which should help streamline the entire acquisition, rehabilitation and Home sale process.

Some of the challenges faced by the JPA Partners were:

1. The Federal and State Program regulations, guidelines, notices, and restrictions are extremely complex;

2. The Federal NSP 1 Program, as administered by the State, required the JPA Partners to commit at least 25% of the funds no later than December 2009, with all funds allocated no later than March 2010[1];

3. It was necessary to expeditiously negotiate and execute a contract among the three Cities and MHC, as the selected housing development organization, in order to meet the Program's funding commitment deadlines; and,

4. Costa Mesa staff has been working with Fullerton and La Habra staffs over the past year (and their respective consultants and counsels) to develop a sound NSP 1 program structure, negotiate the terms of, enter into, and begin implementation of the JPA Partners' NSP 1 allocations pursuant to the Neighborhood Stabilization Program Subrecipient Contract Services and Loan Agreement (NSP Agreement). (Attachment A)

[1] If a City has not obligated the funds by February 15, 2010, the unused funds may be reallocated to another City in the partnership.

To maximize the number of Homes that can be acquired, rehabilitated and sold for affordable housing in Costa Mesa, as a part of the City Council's approval of the NSP Agreement, the Council appropriated $360,000 from the Agency's Low to Moderate Income Housing Fund (Housing Fund) for supplemental funding for the NSP-I program, which brings the total assistance package for Costa Mesa's NSP Program to $663,000. However, it is anticipated that approximately $100,000 will remain in the Housing Fund after the NSP 1 projects are completed. The Agency approved the appropriation and expenditure of monies from the Housing Fund for implementation of the NSP Agreement and sale of Homes pursuant to the NSP Program requirements and also authorized the Executive Director to prepare necessary documents to carry out the homebuyer assistance component of the NSP Program with the resale of each Home to a qualified Middle Income Homebuyer which documents include a silent second trust deed with terms that will comply with CRL and NSP legal documents.

ANALYSIS

At its meeting of September 7, 2010, the City Council asked that staff return to a subsequent Council Meeting with a status report on the NSP-I project. Several questions arose regarding housing selection, occupancy requirements and justification for the proposed level of rehabilitation. Staff was also asked to evaluate the legal options that exist should the City Council choose to cancel the City's participation in the NSP-I Program.

Summary of business points is discussed below:

ORIGINAL BUSINESS TERMS

There have been no major changes to the NSP Agreement since it was originally presented to, considered, and approved by the City Council and Redevelopment Agency in November 2009. The fundamental components of the NSP Agreement and NSP Program are as follows:

- The NSP Program is administered by an experienced housing development organization, MHC.
- All Homes will be purchased by the organization and rehabilitated.
- Cities may issue inter-Cities loans in order to facilitate Home purchases.
- MHC can also obtain Other Financing in order to leverage NSP Program funds.
- MHC will resell each Home to a qualified Middle Income Household as an Eligible Homebuyer.
- The Homebuyer will be expected to contribute a down payment equal to 5% (but not more than 20%) of the purchase price

- Homes will be subject to income and affordability requirements imposed by the HUD HOME program and Community Redevelopment Law (CRL)

- The housing development organization cannot receive any profit from the sales of the Homes. The eligible expenses to be paid by and fees to be earned and paid to the housing development organization are detailed in the NSP Agreement among MHC and the City Parties and are in accordance with the State NSP regulations.

PROPOSED PROGRAM STRUCTURE

The NSP Agreement sets forth the following program implementation provisions:

Predevelopment Activities

- MHC identifies single-family properties that meet Federal and State NSP 1 requirements.

- The Cities have established a $75,000 per Home maximum for Rehabilitation costs. Under extraordinary circumstances, the cap can be exceeded with approval from the Program Manager.

- Once the Program Manager approves the preliminary loan package, MHC commences acquisition activities, prepares a detailed Rehabilitation scope, and obtains bids from three contractors.

- At the conclusion of the due diligence period for each Home, MHC submits a final loan package for Program Manager approval.

- If the final loan package does not exceed the established cost caps, the Program Manager approves the project.

Project Acquisition and Rehabilitation

- The two homes purchased with Costa Mesa NSP 1 funds are located on Harding Way and Paularino Avenue. These two homes will complete Costa Mesa's participation in and portion of the NSP 1 Program.

- The City's NSP Program funds has been the first funding source used in the property acquisition stage.

- The secondary funding source for property acquisition is inter-City loans among the City Parties.

- It is anticipated that the total acquisition and rehabilitation costs for each unit will exceed the City's State NSP 1 funding allocation. In that case, MHC is responsible for obtaining sufficient outside funding, called Other Financing, to fill the remaining gap.

- MHC will be responsible for completing the agreed upon Rehabilitation scope.

HOUSING CHOICE/SUITABLE LOCATION/RELOCATION

Attachment B is a map of foreclosed properties and high-risk areas for foreclosures as defined by HUD.

They are located mainly in the northern and southern portion of the City. NSP-I Regulations require that properties can only be purchased in these areas and that all eligible property must be foreclosed and/or abandoned.

Implementing a successful NSP Program has been challenging for cities such as Costa Mesa due to the limited number of lender-owned vacant and foreclosed properties as compared to other cities. Many of the properties for which MHC presented offers were either sold on the open market or withdrawn from the Community Stabilization Trust, the organization that facilitates the transfer of foreclosed and abandoned properties from financial institutions nationwide to local housing organizations. Other potential Homes considered for acquisition simply required too much rehabilitation.

Finally, NSP is governed by a myriad of tenant and owner protection laws and regulations such as the Uniform Relocation Act and the Protecting Tenants at Foreclosure Act (PTAF), each of which have specific noticing and relocation assistance requirements. These include strict requirements for timing of MHC's first written offer on each Home, minimum noticing requirements to "bona fide" tenants, and evidence that either a bona fide tenant or the owner of the property did not move based on proposed public acquisition of the property. Based on these relocation laws, it was determined that the City and MHC would only seek vacant properties. However, in summer of 2009 when staff for the three Cities and MHC were evaluating feasibility of the Program, based on information obtained from a local realtor, there were only 13 trustee pending sales and three foreclosed properties that were available from lenders. Additionally, MHC was limited to purchasing Homes only within the NSP-I target areas.

Since October 2009, MHC has evaluated nine Homes for potential acquisition while targeting encumbrance of the monies by March 2010 as required by NSP 1 regulations. To avoid relocation, MHC and City staff painstakingly attempted to locate properties in the eligible NSP-I areas that met these goals, including properties located on Iowa Street, Jasmine Circle, and Park Avenue. Unfortunately there were very few properties that met the necessary criteria due to the factors described. Even with the Harding and Paularino Homes (the two Homes in the City's Program), due to unusual ownership/tenancy patterns, Special Counsel had to investigate and evaluate the specific facts to qualify the acquisition under the NSP Agreement, including a City waiver of the condition of foreclosed *and* abandoned to allow for purchase of the Homes, which waiver will be evidence of compliance with the NSP 1 laws in the event of a HUD relocation audit. Additionally, court documents and other paperwork have been compiled for each property should HUD question circumstances surrounding each acquisition.

Rehabilitation Needed

3004 Harding

The property at 3004 Harding is 5 BR/2 bath of approximately 1550 square feet, on a 6440 square foot lot, and built in 1962. The property is currently owned by Mercy Housing. A contractor has been selected to rehabilitate the home, and it is anticipated that the home will be sold at market rate by the end of the year.

Upon original inspection of the property it was found to have been illegally modified with the garage having been converted to a 2 story living space and bath. The main entryway to the house had been converted to a breezeway to allow for a separate entry door to the illegal garage conversion, while also creating a new entry door to the original house. The laundry and subsequent plumbing had also been relocated from the garage to the breezeway. All of the illegal modifications will be removed and the original integrity of the house and garage will be restored. This will involve extensive demolition, removal of illegal electrical and plumbing, and complete reconstruction of the original entryway into the house.

The interior of the house is also in need of full rehabilitation with deteriorating flooring and damaged paint. The kitchen has inoperable appliances along with damaged ceramic tile and wood. The bathrooms have similar issues with damaged tiles and fixtures.

Exterior issues include demolition of the deteriorating wooden patio cover in the backyard and repair of the improperly graded concrete in the front and back of the house. Painting and repair of the exterior stucco will also be required due to damaged and peeling paint and debris. Yard clean-up and landscaping improvements are also included in the budget to bring the property up to the standards of the neighborhood.

Pictures of the property are attached as Attachment 3.

975 Paularino

The property ("Property") at 975 Paularino Avenue is 4 BR/2 bath of approximately 1831 square feet, on a 5936 square foot lot, and built in 1965. As of September 13, 2010 the property is scheduled to close escrow by the end of the week. A contractor has been selected for rehabilitation but no anticipated sale date has yet been provided.

Interior issues include upgraded electrical, lighting, and new appliances and fixtures in the kitchen to replace the dilapidated existing ones. The bathroom is also to receive new vanities, fixtures and tub enclosures. The deteriorated flooring in the bedrooms, hallway and stairs is to be replaced with new carpet and some subflooring, as needed. Also slated to be replaced is the stairway railing as the existing railing was determined to be in need of replacement. The interior will also be completely repainted.

Exterior issues include the roof which has to be completely replaced down to the sheathing due to it's deteriorated condition. The existing driveway is to be completely

replaced with a new concrete driveway due to severe cracking and damage. The property is to get all new windows with abatement of the lead discovered in some of the windows. Due to excessive damage to the stucco, the exterior of the house is to be sandblasted, re-stuccoed and painted. Yard clean-up and landscaping improvements are also included in the budget to bring the property up to the standards of the neighborhood.

Pictures of the property are attached as Attachment 4.

Occupancy Standards

As per Section 5.2 (d) of the Neighborhood Stabilization Program Subrecipient Contract Services and Loan Agreement with Mercy Housing, the household size for the two NSP 1 properties cannot exceed two persons per bedroom, plus one person per household (e.g. for a three bedroom home, the maximum number of persons in the household is seven persons.) These standards are adopted as per the Department of Housing and Urban Development's Housing Quality Standards (HQS) for all of the City's federally funded Housing and Community Development activities, including the NSP 1 properties.

Based on HQS and per the Agreement with Mercy Housing, the maximum allowable household size for 3004 Harding is 11 people (2 for each of it's 5 bedrooms and 1 additional per household) and the maximum allowable household size for Paularino is 9 (2 for each of it's 4 bedrooms and 1 additional per household)

Alternatively, the State of California's Uniform Housing Code (UHC) does not technically regulate occupancy but does provide guidelines on how habitable areas should be built, taking into consideration occupancy. Section 503.2 of the UHC, states the following:

> ***"****Dwelling units and congregate residences shall have at least one room that shall have not less than 120 square feet (11.2 m2) of floor area. Other habitable rooms, except kitchens, shall have an area of not less than 70 square feet (6.5 m2). Where more than two persons occupy a room used for sleeping purposes, the required floor area shall be increased at the rate of 50 square feet (4.65 m2) for each occupant in excess of two."*

Based on this code section and California court decisions, staff estimates that the occupancy for both houses could be more than doubled of what is allowed by the individual NSP agreements. The City Attorney will provide by separate report additional information regarding the City's ability to enforce residential occupancy limits, absent agreements such as the one required by the NSP program.

HOME BUYER SELECTION PROCESS/FIRST TIME HOMEBUYER LOAN

The NSP Agreement presented and approved at a joint Agency and City Council meeting November 2009 lays out the out basic terms of Homebuyer selection process.

All three Cities in conjunction with MHC are in the process of finalizing Homebuyer selection procedures and implementing documents.

Applicable Federal, State, and local laws and program policies require:

- Homes purchased by MHC pursuant to the NSP Agreement must be sold to qualified and eligible Middle Income Homebuyers (i.e., gross household income not greater than 120% of AMI adjusted for household size, which for a four-person household is at or below $104,650);

- Preference will be given to those that live or work in the City of Costa Mesa;

- Homebuyer must be a lawful resident of the United States;

- With limited exceptions, Homebuyers may not have owned any real property for three years prior to buying a NSP 1 Home;

- Homebuyers must have completed a Homebuyer education/housing counseling course;

- Homebuyers must undergo a stringent screening process that will include credit and background checks, criminal history, standard mortgage loan processing and underwriting procedures;

- Homebuyers must qualify for and obtain a fully amortizing, 30-year, fixed interest rate mortgage from an institutional lender to buy the Home, with a down payment of at least 5% but not more than 20%;

- NSP 1 and Agency Housing Fund monies will be used in part to provide a 45-year, 0% interest, second mortgage to the Homebuyer, in the event the first mortgage for which they qualify, along with their down payment, does not cover the appraised market value of the rehabilitated Home;

- **The City's second mortgage must be repaid by the Homebuyer upon resale of the Home, renting out of any part of the Home, other events of default, or when the owner pays off the first mortgage, then the second mortgage is repaid in amortized installment payments;**

- The City's second mortgage will require that the Home remain owner-occupied (i.e. they may not rent or lease any part of the property);

- The Homebuyer Loan Agreement includes occupancy standards (two persons per bedroom plus one person, i.e. a two bedroom house may not have more than five occupants, along with property maintenance standards that require ongoing upkeep of the Home; and

- If the Homebuyer sells the Home, an equity share amount is due to the City in an amount proportionate to the amount of the second mortgage to the original value of the Home—if the Homebuyer remains in the Home more than 30 years, then 1/15th of this equity sharing obligation is forgiven each year. This equity share is in lieu of an ongoing interest payment. The loan itself is never forgiven under any circumstances.

MHC will undertake initial screening and underwriting of the Homebuyer applicants. MHC will submit to the City their recommendations, which will be reviewed by a City loan committee comprised of the Assistant City Manager and HCD staff. Final selection may be by the City loan committee or a lottery will be held in the event there are several equally qualified Homebuyer applicants.

Legal Issues

In the event the City Council's direction is to cancel the NSP Agreement, the termination provisions and related legal requirements are set forth in the NSP Agreement. The contract reserves to each City Party an independent right to terminate the NSP Agreement for any reason without cause by written notice to MHC; however, there will be financial ramifications to the City. If the City Council were to elect to terminate, then MHC would be required immediately to cease all work as it relates to Costa Mesa unless the notice provides otherwise. If termination occurs, MHC would be entitled to full reimbursement of (1) all Project Expenses, Predevelopment Expenses, Rehabilitation Expenses, including the general contractor costs, Carrying Costs, Miscellaneous Expenses, and Disposition Expenses incurred prior to termination, and (2) all Participant Fees (compensation above expenses) that would have been payable if the contract had not been terminated. These expenses and fees would be significant and could exceed the $303,000 allocation of NSP 1 Funds to Costa Mesa because the funds could no longer be leveraged.

Under the NSP Agreement, the City must also repay in full to La Habra and Fullerton the inter-City loans advanced to Costa Mesa to acquire Homes. MHC also has secured Other Financing from an institutional lender, CDFI, to complete Rehabilitations of Homes in each City and to continue implementation of the NSP Agreement, which loans must be repaid too. Further, because MHC has already acquired Home(s) in Costa Mesa, termination of the NSP Agreement will require Costa Mesa to elect either to repurchase the Home(s) from MHC or to allow MHC to complete the Rehabilitation and resale of the Home(s) to Eligible Homebuyer(s).

If the Council's direction is to terminate the NSP Agreement, then along with the above costs and fees to be paid to MHC by the City there will be financial and Program impacts to Fullerton and La Habra. The proceeds of the inter-City loans and Other Financing have been expended to purchase Home(s) and undertake Rehabilitation for Resale to Eligible Homebuyers in those Cities, so termination of the NSP Agreement would have "domino" effects on Fullerton and La Habra. Without Costa Mesa's continued participation in the NSP Agreement, there may be insufficient funds for the other Cities to complete the Rehabilitation of the Homes they have already

acquired and are planning to acquire in order to prepare for and complete the Resales to Eligible Homebuyers.

Special Counsel and the City Attorney will prepare more detailed analyses of the legal options and issues if the City Council directs that the Joint Partnership Agreement and the NSP Agreement be terminated as to Costa Mesa.

ALTERNATIVES CONSIDERED:

The City Council may decide to terminate Costa Mesa's participation in both the Joint Partnership Agreement and the NSP Agreement. If termination is directed, then staff and counsel will carry out the noticing, determine the full expenses and fees due, and take the steps necessary to unwind the City's participation in the NSP 1 Program.

Attachments 1 – NSP Agreement
2 – HUD NSP-I Area Map
3 - Before Pictures 3004 Harding
4 - Before Pictures, 975 Paularino