

# **THE CITY OF DAVIS AFFORDABLE HOUSING PROGRAM**

## **SUMMARY**

The Grand Jury investigated allegations of unfairness and misuse of public funds in the administration of the affordable housing program in the City of Davis (the City). The Grand Jury found that the City's efforts and policies administering affordable housing evolved over the past 30 years. The City's original vision was to allow low and moderate income households to achieve home ownership equity without restrictions on the resale value of the properties. There was no lottery procedure to select potential buyers and no open bid procedures to select potential developers.

Approximately 700 low and moderate income households achieved home ownership through the program. Due to the absence of resale restrictions on value, there are currently only 90 homes locked into the affordable housing program. In response to public comment about the loss of homes from the program and perceived unfairness in selecting eligible homeowners and developers, the City successfully evolved an affordable housing program that ensures fairness in the selection process and retains homes in the program.

The City was far less successful with the Davis Area Cooperative Housing Authority (DACHA). DACHA encountered practical and affordability problems from the outset and currently no longer exists as an entity. As of May 2011, the 20 properties built under the auspices of DACHA remained in the affordable housing program, but the DACHA cooperative has dissolved as a legal entity. The City has been involved in a lengthy and expensive legal dispute with the original developers/consultants for several years. This dispute has culminated in a lawsuit by the developers/consultants which seeks to take possession of the DACHA properties and any monetary proceeds from these properties from the City and its citizens. Better initial oversight of DACHA by the City could have prevented this. When the City has a financial interest in a project, especially one based on a new or different concept, the City should provide oversight to ensure that the project meets its goals and does not result in a loss to the public.

No inappropriate gift or use of public money was made at any time, for any purpose by the City in connection with DACHA. However, the City has incurred losses that may not be recovered and may increase in the future. Better initial oversight of DACHA could have prevented this.

## **REASON FOR INVESTIGATION**

Penal Code section 925(a) states "The grand jury may at any time examine the books and records of any incorporated city or joint powers agency located in the county. In addition to any other investigatory powers granted by this chapter, the grand jury may investigate departments, functions, and the method or system of performing the duties of any such city or joint powers agency and make such recommendations as it may deem proper and fit."

California Penal Code Section 933.1 further provides that “A grand jury may at any time examine the books and records of a redevelopment agency ... and, in addition to any other investigatory powers granted by this chapter, may investigate and report upon the method or system of performing the duties of such agency of authority.”

This investigation was initiated in response to complaints about the fairness, alleged cover-up and misuse of public funds in administering the Affordable Housing Program by the City and the Davis Redevelopment Agency (DRA) in general, and DACHA specifically. That these are matters of public interest to the citizens of the City and the Grand Jury is demonstrated by the many articles and public comments published in local media and the filing of multiple lawsuits.

## **ACTIONS TAKEN**

The Grand Jury interviewed City staff and attended City Council meetings to determine and understand the development, evolution and current administration of the affordable housing program in the City. The Grand Jury reviewed information on the City’s web site, communications from the public to and about the City, the ordinance concerning affordable housing, staff communications with the City Council, financial documents including audits, legal documents, and State and Federal government requirements for affordable housing.

The Grand Jury interviewed representatives of affordable housing developers of rental and ownership equity projects and representatives of the City. The Grand Jury also interviewed representatives of Rancho Yolo Senior Community concerning conversion to an affordable housing cooperative in the City.

## **WHAT THE GRAND JURY DETERMINED**

### ***AFFORDABLE HOUSING PROGRAM***

#### ***The 1990 Ordinance***

During the 1970s the City recognized a demand for affordable housing. A variety of housing types and options were available to meet this demand. Redevelopment agencies, including the DRA, were required by state law in 1986 to set aside at least 20% of their tax increment funds for affordable housing. Tax increment funds are generated from property value increases in the redevelopment zone. In 1987 the City Council adopted an inclusionary housing policy in its General Plan that required all new housing subdivisions to include provision for affordable housing. An inclusionary policy is a requirement that all residential projects provide a specified percentage of affordable housing in the development. This inclusionary requirement was subsequently approved as the City’s Affordable Housing Ordinance in 1990.

The 1990 requirements, which are still in effect, are: 1) Ownership projects with five or more units must have 25% of units be affordable; 2) Rental projects with five to 19 units must have 25% of units be affordable; and 3) Rental projects with 20 units or more must have 35% of

units be affordable. The ownership units are usually provided through a combination of on-site development by the for-profit developer and land dedication to the City that is used to develop affordable housing by a local nonprofit housing organization. Affordable rental units are usually either built within the market rate development or through a land dedication by the developer. To date, approximately 1,800 affordable units, of which approximately 1,100 are rental units, have been built in the City under the auspices of this program.

Under the 1990 ordinance a housing unit was considered affordable if it cost no more than 30% of an eligible household's monthly income for rent and utilities. Eligibility requirements for the units ranged from very low to moderate income levels. The moderate category was added in 2005 and suspended in 2009. An extremely low income household is currently defined as one with household income at or below 30% of the Yolo County median income (currently \$72,500 for a family of four) and a moderate income household is one at or below 120% of Yolo County median income. Thus, the maximum household income for inclusion in these would be \$21,750 and \$87,000 respectively. The maximum monthly rent would be 30% of these income levels, divided by twelve.

No equity accumulation restrictions were required in the loan documents or deeds for affordable ownership units under the 1990 ordinance. The City believed any increase in home value should be passed on to the low income homeowners. This meant that the original buyers of the affordable homes could sell the homes at market value to purchasers who had no income restrictions. The sole limitation put on buyers was a requirement they occupy the home for two years. No buyer/tenant selection guidelines such as lotteries were included in the 1990 ordinance.

### ***Evolution and criticism of the original program***

Most of the City's approximately 700 affordable housing ownership units were built during the 1990s and early 2000s. Of these 700 units, only 90 still remain in the affordable housing program. The rest were sold at market value with significant profit to the sellers. The resold units lacked affordable housing restrictions such as income restrictions for buyers and equity accumulation limits. The 90 affordable units are: a) 60 units built in Green Terrace during the 1990s, b) the 20 DACHA units built in 2003 and 2004, c) five units on Park Santiago, and d) five units on Cassel Lane. According to the City, the reason for the slowdown in unit construction is the lack of new building projects in the City over the last 10 years. There are currently five ongoing or proposed developments that include provision for affordable housing. These include 18 affordable units in the Verona subdivision which are currently under construction and approximately 20 to 21 units in the proposed development in Chiles Ranch.

There was considerable public comment as the loss of ownership units from the affordable housing program became apparent. The loss of units from Wildhorse and Simmons Estates in particular aroused significant public debate about whether permitting the sale of affordable units at market value was an appropriate use of land dedicated by the developers to the affordable housing program. Further questions were raised about the fairness of the selection process for the original low income buyers. The City responded by creating the Affordable Housing Task Force and amending the 1990 ordinance.

In 2005 the City Council amended the Affordable Housing Ordinance, altering the rules in several ways for access to affordable ownership units. The maximum percentage of family income that could be used to pay for housing costs and utilities was raised from 30% to 35% to help the program compete better in the then booming housing market. Resale equity escalation was limited to a small yearly percentage increase of the unit value. This is currently set at a maximum of 3.75% per year. The selection process for rental and ownership equity purchases also received greater scrutiny with provision for equitable selection processes such as lotteries and better oversight to ensure appropriate purchasers/renters. In 2006, the affordable housing ordinance was further amended to require all owners to sign the deed and occupy the unit for the entire ownership period. The City is continuing to review the affordable program and held a workshop in January 2010 to review all aspects of the program to meet the City Council's goal for housing. The City's goal is: "Advance an array of housing options targeting affordability, internal growth, University-related needs and housing needs of special populations".

The downturn in the current economy, combined with the City's limitations on growth, has resulted in less housing development and fewer affordable units becoming available. The downturn has also made the resale of affordable housing units with deed restrictions significantly restricting equity accumulation more of a challenge because of the availability of lower priced regular housing units with no limits on the potential resale profit. Another problem faced by the affordable housing program is the increased difficulty of obtaining financing for low end borrowers in the current market. The financing problem is exacerbated by the City's requirement that it have the "right of first refusal", which means that the City has the option to purchase the affordable unit in the event of sale. This enables the City to assure that any purchaser fulfills the income level requirements of the affordable housing program. Despite these difficulties the City reports significant interest in the affordable housing units in the new Verona development, as well as increased interest in available DACHA units.

The Grand Jury confirmed that the current affordable housing programs are operating as planned, with income confirmation, open bidding by developers for projects and lotteries of eligible buyers to ensure selection fairness. Tenants/owners informed the Grand Jury that they are satisfied with management of the units and are finding financing at interest rates low enough to keep the units affordable.

## **DACHA**

### ***Regulatory agreement basic structure***

DACHA was a limited equity housing cooperative, approved in 2002 by the City of Davis as part of its affordable housing program. Pursuant to the "regulatory agreement" signed by DACHA and the City, members were required to invest approximately \$16,000 to a maximum of \$20,000 to own a share of the cooperative. Annual equity accumulation was restricted to a maximum of 10% of the \$20,000 equity stake, or \$2,000. The houses were owned by the cooperative with the members owning a share in the cooperative organization. As shareholders, residents owned the cooperative as an undivided whole, with the exclusive right to

occupy a specific unit within the cooperative. The members were able to claim ownership tax benefits, and upon termination of their membership the initial share price plus any appreciation on the share price was returned. One of the hopes of the developers was that the local businesses would assist their employees with the purchase of the cooperative share to enable them to live in the City where they work.

The regulatory agreement with the City required the cooperative to charge members the minimum “carrying charge”. This was essentially a form of rent designed to recover mortgages, taxes and operating expenses. The carrying charges were limited to 30% of 110% of the median income in Yolo County to ensure affordability. This was approximately \$1,425 to \$1,568 per month initially, depending on whether the units were two or three bedrooms. The agreement also made DACHA responsible for all management functions, with the City retaining “the right to conduct an annual (or more frequently if deemed reasonably necessary by the City) review of the management practices and financial status of the Development.”

### ***A covenant running with the land ensured continuing affordability***

The regulatory agreement ensured that if units were sold by DACHA, future purchasers would be subject to the restrictions in the regulatory agreement. This was done by including a “covenant running with the land” in both the regulatory agreement and the deeds. This covenant permanently restricted subsequent purchasers/owners of the properties in DACHA to the rules embodied in DACHA’s regulatory agreement with the City, ensuring that the units would remain affordable in perpetuity.

An important impact of the DACHA covenant running with the land was that the City intended that the units can never be sold at fair market value. The maximum resale value of the property is determined by arithmetic formula, which is more easily understood by an example. The calculation is based on the “allowable monthly cost burden” for a family purchasing a three bedroom house. The example assumes a 30 year (360 month) mortgage at a 5% interest rate. The maximum allowable income for a family of four at 100% of area median income is \$72,500, and the allowable monthly cost burden is 35% of \$ 72,500 divided by 12, or \$2,115 per month. Impounds such as property tax, PMI and hazard insurance are subtracted, leaving \$1,546 per month available to service the mortgage. The allowable monthly cost burden is now multiplied by the number of months in the mortgage. In this example, the amount is  $\$1,546 \times 360 = \$556,410$ .

The formula now works backward to determine the principal, given the loan’s interest rate. In this example, assuming an interest rate of 5%, the restricted resale price is \$298,881. The results can be obtained using an amortization table. A simple way to summarize this formula is that lower interest rates, increases in the allowable cost burden percentage and increases in the percentage of area median income used to determine eligibility increase the sale price, and the opposite reduces the calculated value of the home for sale purposes. Table 1 illustrates these calculations.

<b>Table 1: Allowable Resale Price of DACHA 3 BR Unit - April 2011</b>			
<i>Assumptions:</i>			
1)	100% of area medium income for family of 4 = \$72,500		
2)	Allowable monthly cost burden available for PITI = Income x 35% / 12		
3)	Impounds for property taxes and mortgage and hazard insurance		
4)	Mortgage terms = 30 years (360 months) @ 5%		
<i>Calculations:</i>			
1)	Family's annual income		\$ 72,500
2)	Allowable monthly cost burden (income x 35% / 12)		\$ 2,115
3)	Tax and Insurance Impounds / Mo.		<u>(569)</u>
	Available for Debt Service / Mo.		\$ 1,546
Calculation of Mortgage Payout and Restricted Sales Price:			
	Available for Debt Service / Mo.		\$ 1,546
4)	Term (30 years @ 5%)		<u>360</u>
	Total Mortgage Payout - \$1,546 x 360		\$ 556,410
	Restricted Sales Price (\$1,546 / mo. @ 360 mos. @ 5%)		\$ 298,881

Although it was intended by the City that the DACHA units would always be subject to the restrictions in the regulatory agreement via the covenant running with the land, there was a limited exception arising from the method of financing. Private banks required that the covenant be subordinated to their rights in the event of foreclosure. This meant that the 13 DACHA units financed by the private banks (River City Bank and First Northern Bank) could be sold at market value to purchasers without income restrictions during a foreclosure sale. City representatives have steadfastly maintained throughout the Grand Jury's investigation that they know of no other way to remove the restrictive covenant.

#### ***DACHA's agreement with the developers/consultants***

Although DACHA was created under the auspices of the City's affordable housing program, DACHA was a private nonprofit corporation that contracted with a private consultant to assist in development of its housing. DACHA contracted with the consultant to construct a total of 67 units, with the consultant to receive "\$8,000 per unit for units that Consultant obtains from a private developer, where the consultant participates in the financing and marketing of the units, but does not have an active role in the architectural and planning portions of the development... and \$12,000 per units that Consultant initiates the development and participates in all phases of the development..." The consultant also provided extensive noncontractual consulting services, billed at \$120 and \$125 per hour.

DACHA incorporated in December of 2002. The articles of incorporation made the developers/consultants the beneficiary of DACHA's assets, including the housing units, in the event of DACHA's dissolution. Although the articles of incorporation thus made the developers/consultants the owner of DACHA's housing units if DACHA failed, the articles also required the beneficiary to pay off DACHA's debts. The developers set up DACHA, acted as consultant and broker, designated themselves as beneficiary and selected the original board of directors, which was comprised of prominent members of the community who were to be replaced by tenants as the number of units increased.

According to the City, DACHA was a private entity and the City had no direct connection to, or responsibility for, DACHA. The City indicated that although DACHA was established under City rules, partially financed by the City, and the City reserved the right to review the carrying charges and audit DACHA, the City's role was that of any other lien holder. The City also had the right to appoint a voting member of DACHA's initial board, but preferred a nonvoting "ex officio" seat. City staff regularly attended board meetings until 2005, when the City appointed a formal board member.

### ***The City's initial involvement with DACHA***

The City completed its assessment of DACHA in September of 2002, prior to incorporation. The City's projections showed DACHA's projected carrying costs exceeded the City's rules for low income housing. Accordingly it was recommended that the City finance the first loan in order to reduce carrying charges by \$200 per month. Even at that level the carrying charges were considered to be at the upper end of compliance with affordable housing rules. City representatives informed the Grand Jury that there was concern at the outset that the complexities of running and financing DACHA could prove difficult for low income buyers who were making their first real estate purchase. It was the City's understanding that DACHA members were to receive training and a packet of information with a facts and questions handout (FAQ).

A City staff report dated September 2002 requested a legal analysis of the relevant legal documents such as the bylaws, articles of incorporation and loan documents be performed by the City Attorney's office. This report was presented to the City Council.

### ***Financing DACHA***

In December 2002 and January 2003 the DRA approved a loan of \$100,000 for expenses related to creation of DACHA and \$1,140,000 for the first seven units. These were to be built on Tufts Place. The \$1,140,000 loan was a 30 year loan at 5.5% fixed interest, which was below market rates at the time. DACHA's monthly mortgage payment to the City was \$6,472.79. The \$100,000 loan was to be repaid in annual installments of \$10,000 beginning in 2013.

The next 13 units were financed by private banks. In order to keep the carrying costs at an amount allowed by the affordable housing rules, very little principal was paid. The payments were essentially "interest only". In 2003 and 2004 seven additional homes on Arena Drive,

Marden Drive and Albany Circle were financed by First Northern Bank. These loans had initial interest rates ranging from 6.25% to 6.67% and prepayment penalties of 5% in the first year, declining by 1% per year in subsequent years. In 2005 River City Bank financed the final 6 houses on Glacier Place with a loan of \$1,119,000. The interest rate was apparently fixed at 6.37% with a balloon payment of the entire amount due in 2015. Prepayment penalties were 5% during the first two years, decreasing by 1% every two years. Over the course of 3 years a total of 20 homes were built for DACHA. Table 2 illustrates the sources of financing to construct the 20 DACHA units.

**Table 2: Financing DACHA's Construction - 20 Units**

	Loan	Avg.		Mo.	Yrly.		#	
	Amount	Rate	Term	Pynt.	Pynt	Lender	Units	Notes
Jan-03	100,000	0.0%	120	-	10,000	City of Davis RA	-	DACHA formation costs; annual pynts beginning 3/13
Dec-02	1,140,000	5.5%	360	6,473		City of Davis RA	7	Construct @ Tufts Place
2003-04	1,198,000	6.5%	Unk			First Northern Bank	7	Construct @ Arena, Marden, Albany; Interest only
Jun-05	1,119,000	6.4%	240	Unk		River City Bank	6	Construct @ Glacier Place; balloon pynt in 2015
2004-05	152,000	Var	Var	Unk		Developers/Consultants	-	Personal loan to support purchase of individual shares;
							20	typical loan rate is 5 Year T-Bill plus 2.5% - 3%

Some of the applicants, who were all selected via lottery of eligible low income buyers, did not have the money required to purchase shares in DACHA. This was during a period of time in the housing market when most people could get a home mortgage with little down payment and minimal credit review. The developers/consultants decided to loan money to DACHA to complete the share purchase requirements. The total of these loans was difficult to determine. It appears to have been approximately \$152,000 to \$170,000. Some of these loans included a balloon payment and a prepayment penalty. Interest rates were typically 3% above a specified institutional rate such as five year treasury bills. The net result of these loans was increased economic pressure on DACHA, as repayment was in addition to carrying charges that were already at or beyond the maximum permitted by the regulatory agreement. The City indicated it was unaware of these loans, and that any discussion of the loans would have occurred during closed session of the DACHA board.

***Problems with DACHA first become apparent***

In May of 2005 DACHA members wrote the City Council (the City Council members also comprise the Board of the DRA) regarding purported high costs of DACHA above the carrying charges. These included management fees of \$900 to \$1,100 per unit per year, estimated consulting costs of \$690 per unit per year as well as landscaping and utilities of at least \$100 per unit per month. There was also concern about high turnover resulting in property tax increases as well as the approaching need to refinance, potentially increasing carrying charges.

At this point the carrying charges ranged between approximately \$1,520 to \$1,780 per month. Given the real estate boom at the time, DACHA was becoming less competitive in the market. The City responded by appointing a board member to represent its interests, asking staff to perform an analysis of DACHA, and paying \$18,000 for an audit.

### ***DACHA is audited***

The audit report was delivered in June of 2006. The auditor was unable to complete the fiscal analysis due to DACHA's inadequate record keeping. Financial data such as balance sheets, loan and interest information and minutes were missing, and there was no adequate explanation for money present in two DACHA accounts. However, the audit raised important questions regarding DACHA's financial viability. The auditor's main concerns were: 1) the absence of reserves that were required. The failure to keep reserves meant that the city would likely be responsible to fill the gap for such items as capital repairs and emergencies; 2) the employment of interest only loans was considered a long term risk to DACHA. They also posed a potential long term risk to city resources as they were an "indefinite debt"; and, 3) most troubling were long term projections by the auditor.

The most optimistic projection assumed a vacancy rate of only 3.5%, and showed a probable net loss for DACHA over 30 years of \$160,000. Under a worst case scenario of applicable variables, including a 5.5 % vacancy rate, the probable loss rose to over \$2,500,000. The audit concluded that DACHA's woes needed to be fixed before DACHA expanded and that it should be compared with other affordable housing models.

### ***The City becomes more involved with DACHA***

While the audit was pending DACHA cancelled its contract with the consultant and refused to build any further units. A lawsuit ensued and has continued in one form or another to the present. It is beyond the scope of the Grand Jury to prefer one side over the other, or to assess the various legal positions and theories, and this report makes no attempt to do so.

From its inception until March of 2007 DACHA regularly made its mortgage payments to the City. From March 2007 to August 2008 the City forbore to collect the mortgage payments in order to enable DACHA to pay its legal fees. The total forbearance amount was \$116,510.22. (18 months times \$6,472.79)

In January of 2008 the City decided to refinance DACHA using money exclusively from its redevelopment funds. The City considered the following factors important in making this decision: 1) cash flow problems encountered by DACHA; 2) affordability problems for DACHA members; 3) the small size of the units, the legal problems, and carrying charges in excess of local rents for comparable units made marketing difficult; 4) loan repayments were coming due and some lenders were prepared to reduce prepayment penalties if payment was made in the near term; and, 5) only commercial interest rates were available if the RDA did not refinance.

Another important reason for the refinance was the City's concern that the DACHA housing units remain in the affordable housing program. The covenants running with the land were subordinate to the interests of the private banks in the event of foreclosure. A refinancing by the City would permit the homes to stay in the affordable housing program if the City foreclosed. The City also was concerned about the beneficiary provision in DACHA's articles of

incorporation that made a third party the owner of the homes if DACHA dissolved. The loan refinance document made the City the sole beneficiary of the properties in the event of DACHA's dissolution. Additionally, if the City foreclosed it would obtain title to the DACHA properties from DACHA. There would therefore be no assets in DACHA to go to a beneficiary regardless of who the beneficiary was.

The refinance was completed in June of 2008 and the new regulatory agreement with DACHA was signed in August of 2008. The new agreement between DACHA and the City made the City DACHA's beneficiary if DACHA dissolved. It also changed the maximum carrying charges to 30% of 80% of the median Yolo County income, and continued the requirement that all affordability restrictions be covenants running with the land. This had the effect of making the units more affordable, but also had the effect of reducing the value of the property in the event it became necessary for the City to step in and sell all the properties. At this time the homes were valued at approximately \$235,000 for two bedroom homes and \$293,000 for three bedroom homes.

The amount of the loan was \$4,153,428.62 at 3% over a term of 55 years. Mortgage payments were \$ 12,877.16 per month. Table 3 shows the use of the refinance loan funds:

<b>Table 3: Refinancing Loan 2008</b>					
<b>55 years, 3% , City of Davis Redevelopment Authority</b>					
Consultant Loans (\$152,000 Principal, \$95,000 Prepayment Penalties & Interest)					\$ 247,030
Primary Loans repaid					
Private banks for construction					
First Northern					1,172,071
River City					1,129,151
Davis Redevelopment Authority for construction					1,173,177
Share Stabilization					202,000
Reserves (Capital, Maintenance, Vacancy)					230,000
					<u>\$ 4,153,429</u>

In addition to solving the pressing need to refinance the interest only private bank loans, this refinance was intended to resolve at least three other fiscal issues. First, the \$116,510 that the City forbore was "wrapped into the term" of the refinance loan. The City planned to recoup the money by extending the length of time for repayment. Second, although the original consultant loans were approximately \$152,000, the lien holder refused to waive any prepayment penalties or interest. DACHA borrowed \$247,000 to repay the \$152,000 consultant loan. Third, the \$202,000 share stabilization portion of the loan was made so that DACHA could refund money DACHA shareholders originally paid in excess of \$6,250 per unit. Thus, the share buy in became \$6,250 per unit rather than various amounts up to a maximum of \$20,000. Combined with the reduced carrying charges (30% of 80 % of the median Yolo County income) it was hoped the units were more affordable and marketable.

### ***DACHA legal problems***

From September 2008 to September 2009 DACHA paid the City the monthly mortgage payments. However, in June of 2009 the lawsuit by the developers/consultants against DACHA went to binding arbitration. The plaintiff asked for \$506,000. This was composed of a demand for \$376,000 in contractual damages for failure to build the additional 47 units (\$8,000 per unit times 47) and approximately \$130,000 for services not enumerated in its contract with DACHA, but which plaintiff asserted had been provided. The arbitrator awarded plaintiff \$331,872 plus 10% interest per annum beginning on June 18, 2009 (\$282,000 for unbuilt units and \$49,872 for noncontractual services). The arbitration award also stated "It is not the task of this arbitrator to wade through years of history between the City of Davis, DACHA and all other interested parties to determine who is right and who is wrong, as to the viability of this model or the financial health of DACHA or any of the myriad other issues involving these parties. The City of Davis maintains a very commendable goal of affordable housing. Along with this goal, there comes a host of other problems which are not part of this arbitration. One thing is clear from the audit report and that is that the criticisms in the report do not negate the contractual obligations."

In October of 2009 DACHA's bank accounts were levied to pay the arbitration award. The \$57,000 in DACHA's bank accounts was seized. To date, this is all that is known by the Grand Jury to have been paid by DACHA. However, the Grand Jury was informed that an attempt is being made to make some low income tenants pay the remaining arbitration award.

### ***The City forecloses on DACHA***

The seizure of funds to satisfy the arbitration award caused DACHA to default on its mortgage payments to the City, which then initiated foreclosure proceedings in December of 2009. From December 2009 until the foreclosure in April of 2010 the City required that all carrying charges be paid into a trust account created by the City pursuant to Civil Code sections 2398(c) and (g). The City told the Grand Jury that this was done to prevent attempts to collect the arbitration award from interfering with the City's collection of mortgage payments. During this 5 month period not all carrying charges were paid by DACHA shareholders. The total arrearage was \$13,229. The City made no direct attempt to collect the arrearage, instead taking the position that this was up to DACHA's management company. Despite the arrearage, the funds paid into the trust account were adequate to cover DACHA's mortgage obligations.

An important effect of the foreclosure proceedings would be to likely transfer ownership of the 20 affordable housing units from DACHA to the DRA, as the DRA would have a credit in the amount of its \$4,153,429 mortgage at the foreclosure sale. Thus, any competing purchaser would have to spend in excess of \$4,153,429 at the foreclosure sale to obtain the DACHA units. With the shareholders paying their carrying charges to the City rather than DACHA, and the impending foreclosure about to transfer title of the units from DACHA to the City, DACHA would have no assets left upon which to levy to satisfy the arbitration judgment. The original beneficiary would also be the beneficiary of no properties in the event of DACHA's dissolution.

In an effort to maintain its rights as a judgment creditor, the prevailing party at the arbitration filed a petition asking that DACHA be declared involuntarily bankrupt in Federal Court in Sacramento. This filing requested the foreclosure proceedings be stopped (“stayed”) and a finding that DACHA was not a nonprofit organization, based at least in part on the “share stabilization” refund of \$202,000 to DACHA’s members. The Federal Bankruptcy Court denied the request to stay the foreclosure proceedings, denied the petition to force involuntary bankruptcy on DACHA, and awarded DACHA \$45,000 in attorney’s fees. The order entering judgment in favor of DACHA stated “Also, DACHA’s partial refund of initial member contributions was not a dividend as it only refunded contributions. It was not a distribution or return of investments. And, it was a one time distribution, made with the intention of equalizing the members’ interests in DACHA. Paying interest on the partial refunds was not a dividend either because it was consistent with DACHA’s bylaws, adopted in 2002 upon its formation.”

During the bankruptcy proceedings a demand was made by DACHA’s bankruptcy attorneys upon the City to release approximately \$30,000 from the carrying charges in the City’s DACHA trust account to pay a portion of DACHA’s legal fees. The City complied. This was the only payment made by the City for DACHA’s attorney fees.

### ***The City’s ownership of DACHA***

The City completed its foreclosure on DACHA in mid-2010, becoming the owner of the units. The City paid \$20,267.58 for services to complete the foreclosure. The former shareholders signed leases and are now tenants paying rent rather than carrying charges. From the time of foreclosure through February of 2011 all rent has been paid with the exception of \$763.81 by an exiting tenant. The rent collected has exceeded the costs. However, the tenants no longer pay property taxes or management fees. As the owner of the properties, the City is now responsible for all management and maintenance of these units. The City believes that the staff time, expenses and expertise necessary to continue to manage these units as affordable housing make it impractical to continue as the landlord. In anticipation of these difficulties, in January of 2010 the City began to consider options such as selling or transferring the units to another agency or nonprofit to be leased as affordable housing, or selling the housing units as affordable housing units, with requirements of owner occupancy, a right of first refusal, and restrictions on price appreciation.

Beginning in early 2007 and ongoing to the present, the City has incurred significant legal fees in conjunction with DACHA. In October of 2010 the Yolo County Superior Court ordered that the City be added as a defendant to an ongoing lawsuit against DACHA. Although the Court dismissed the claim for monetary damages against the City, it allowed the issue of whether the original consultant or the City is the proper beneficiary of the 20 units in the event of the dissolution of DACHA to proceed to trial. Complainant also contends the refinance and subsequent foreclosure that transferred the title out of DACHA is invalid because the shareholders and board lacked the ability to authorize the transfer. The ownership of the units is at stake. This matter is set for trial in October of 2011. Additionally, a government tort claim for monetary damages was filed against the City. The City rejected this claim and contends it is time barred. On March 21, 2011 the developers/consultants filed a lawsuit against the City based on

the tort claim. The lawsuit seeks to take possession of the DACHA properties from the City and its citizens as well as any rents or proceeds from the properties. The City's legal fees to date are well in excess of \$200,000 and mounting.

During the City Council meeting on February 1, 2011 the City was presented with a staff proposal, which was in response to previous council direction, to sell the 20 DACHA units. The staff recommended the units be sold as affordable housing at 100% of Yolo County median income. The resulting proposal would sell two bedroom homes for a maximum of \$209,250 and three bedroom homes for a maximum of \$244,250. Families making as much as 120% of the Yolo County median income were to be allowed to purchase the homes to enlarge the pool of eligible applicants. The maximum sale price for the 20 units totaled \$4,500,000. After deduction of a broker fee of \$270,000, the City hoped to net \$150,000 after repayment to the City of the outstanding loan balance of \$4,081,844. It was unknown whether the City could actually sell the homes for this amount due to the impact the affordability covenants have on the value of the homes.

The developers/consultants alleged that the City's maximum sales price was a change from the sales price in 2008 that decreased the value of the DACHA units by approximately \$1,000,000. It was the City's position that this change made the units more affordable. In April 2011 the City released new valuations for the DACHA units. According to the City the same "affordable" units at 100% YCMI now have a maximum sale value of \$259,829 for two bedroom units and \$298,881 for three bedroom units. If successfully sold for these prices, the City would receive a minimum of an additional \$1,000,000. Settlement negotiations have begun.

Throughout the Grand Jury's investigation the City has been steadfast in its belief that the restrictive covenants could not be removed. However, during the City Council meeting of February 1, 2011, it was claimed by the developers/consultants that the homes could be sold for market value, provided all profits were recycled into the affordable housing program. The City council has asked that this legal question be researched by the City attorney. Council also asked that a market value appraisal be performed on the 20 DACHA units. The eight two bedroom units appraised at \$275, 000 through \$390,000, and the 12 three bedrooms units at \$320,000 through \$420,000. In total, 20 units appraised at \$7,021,000.

## **FINDINGS**

- F1.** The City has a long established program for affordable housing that has developed over the years by trying different models and using inclusionary programs to mix affordable housing with conventional housing. The City has worked hard to improve the affordable housing program, resulting in a program that has become fairer and more successful for all participants, including developers, renters and ownership housing buyers.
- F2.** The City has a currently well documented affordable housing program. Documents are posted on a web site and are also readily available at a counter at City Hall. The City was very cooperative and provided good information to the Grand Jury concerning the

affordable housing program. Much of this information is available for review by the general public.

- F3.** The ownership/equity based affordable housing model is challenging to develop, market and administer. There are many influences on the success of such projects, including unit availability, financing and resale restrictions. The difficulty of ensuring unit costs are competitive with local rents, and the state of the general economy, make it difficult to compete with units that have no restrictions on equity accumulation and the number of eligible buyers.
- F4.** In 1990 the City envisioned the affordable ownership units as a way to permit low to moderate income families to gain wealth through home ownership. This resulted in more than 600 of the approximately 700 affordable ownership units permanently passing out of the program. Due to the City's growth restrictions and the housing bubble, the net result is only 90 units are currently affordable.
- F5.** The DACHA project was approved when other equity type affordable housing projects were being criticized and a new affordable limited equity cooperative was conceived. This was to be a way to keep the units affordable forever and encourage people working in the City to live in the City and possibly have their employers help with the equity payment.
- F6.** Greater care should have been taken initially by the City and the DRA when performing legal analysis of documents such as DACHA's articles of incorporation and bylaws. Had the City been made DACHA's beneficiary at the outset it is probable that many of the current problems, including the ongoing lawsuit by the original developers/consultants seeking to take possession of the DACHA properties and their rents/proceeds from the City and its citizens, with resulting large attorney fees and staff costs, could have been avoided.
- F7.** The City has maintained that DACHA was a private organization and therefore the City had no greater responsibility to take a more active role than any other lien holder when DACHA was first formed. Although this may be technically or legally accurate, beginning in 2005 the amount of staff time and energy, constant oversight and investment of large amounts of public funds proves this initial attitude was unrealistic. If the City was going to assume the degree of responsibility observed by the Grand Jury, it should have done more from the outset. In particular, more should have been done to assist the shareholders to fulfill their obligation to create a total of 67 affordable housing units. The DACHA shareholders were inexperienced first time home buyers who were required to build and market 67 homes, manage the properties, assure capital improvement reserves were sufficient, and refinance sophisticated commercial loans. A handout with FAQ's was insufficient for this purpose.
- F8.** The City's awareness of financing issues that led it to make the first loan to DACHA, combined with the City's concern that initial carrying charges were at the maximum level allowed under its affordable housing rules mandated that the City monitor DACHA's progress carefully. There were not enough eligible buyers with required down payments for shares of DACHA. As a consequence personal loans with balloon payments and

prepayment penalties were made to DACHA in order to attract prospective share purchasers. There was insufficient discussion between the City and the developers/consultants regarding this problem. The City should have exercised its right to appoint a DACHA board member long before it did so in June 2005, when concerns by residents came to light. The failure to take proper cognizance of the developing problems and the failure to appoint a board member earlier was failure of oversight by the City.

- F9.** There were many factors in DACHA's failure, including the failure of oversight by the City, the collapse of the housing bubble, the recent recession, and the filing of a lawsuit against DACHA. No one factor is found to be the likely primary cause or a substantial factor in DACHA's failure.
- F10.** The City acted responsibly by making many attempts to preserve DACHA as part of its affordable housing program. These attempts include changing the maximum carrying charges, reducing the cost of the homes, reducing the initial share price to \$6,250 and refinancing the outstanding loans. The City's actions were made in good faith and with transparency. The Grand Jury found no evidence of a cover up.
- F11.** The loan of \$202,000 to DACHA for share stabilization was not an inappropriate gift of public money. A loan that must be repaid is not a gift. DACHA's insolvency due to a lawsuit means the loan will not be repaid. However, the filing of a suit and its aftermath does not transform the loan into a gift. Most importantly, even assuming the loan had not been made, the City and the DRA would have faced a significant moral dilemma at the time of foreclosure regarding whether to permit DACHA shareholders to receive a refund of some or all of their share investments, that is for the citizens and their elected representatives to decide.
- F12.** No improper gift of public money was made to pay DACHA's legal fees. The only money transferred from the City to DACHA to pay attorney fees was \$30,000 from a trust account created to protect the City's right to collect its mortgage. The money in the account was from the carrying charges received directly from DACHA and therefore was not public money. The City also forbore to collect \$116,510 in mortgage payments to permit DACHA to pay its attorneys. However, this money was "wrapped" into the refinance loan by extending its term and therefore was a loan rather than a gift.
- F13.** During the period of time DACHA's carrying charges were paid into the City's trust account, approximately \$13,000 in arrearages occurred. This did not result in any loss to the City or any gift of public money, as simple arithmetic shows that even after deduction of the \$30,000 in attorney fees to defend against the involuntary bankruptcy, the funds in the trust account were more than adequate to make the mortgage payments of \$12,877 per month.
- F14.** Although there may have been serious delinquencies in payments of carrying charges by shareholders to DACHA, there was no failure by DACHA to make mortgage payments to the City. The City was not damaged by any such delinquencies and no public money was lost as a consequence of any such delinquencies.

- F15.** Subsequent to the foreclosure, the City has successfully managed the former DACHA properties and collected almost every penny of rent due. There has therefore been no further loss to the city or gift of public money subsequent to the foreclosure.
- F16.** The City's assumption in February 2011 that it will show a "profit" of \$150,000 upon sale of the DACHA units for \$4,500,000 does not take into account significant costs and is therefore erroneous. Such costs as the audit (\$18,000), foreclosure costs (\$20,000), the forbearance money which will never be recaptured (\$116,510) and the legal fees (over \$200,000) should be considered in any profit/loss calculation. The new sale valuations of April 2011 may cover these expenses, assuming the units can actually be sold at these prices. However, the new valuations are less consistent with the affordable housing concept.
- F17.** Changes in the calculated value of a unit as a result of either including it in the affordable housing program or changes in the affordable housing rules or covenants do not cause an improper gift of public money to occur. Placing deed restrictions with affordability covenants on the properties is what makes them affordable. To call that a gift of public money is to call all affordable housing such a gift. To the extent the maximum selling price is approximately \$50,000 per unit less than in 2008, it is speculative to say that the units could now be sold at 2008 price points. Perhaps more fundamentally, to sell the units at the higher price level even if possible does not support the affordable housing concept. Unsustainable share costs with expensive financing were major factors in the DACHA debacle from the outset and are to be avoided if at all possible.
- F18.** No inappropriate gift or use of public money was made at any time for any purpose by the City in connection with DACHA. However, the City has incurred losses that may not be recovered and may increase in the future. Better initial oversight of DACHA could have prevented this.

## **RECOMMENDATIONS**

- R1.** The City and RDA need to be sure their oversight and expenditure of taxpayer dollar responsibilities are taken into account when affordable housing projects meet challenging implementation and sustainability problems.
- R2.** The City and RDA should do a more thorough job of analyzing the risks and benefits of any novel project before deciding to invest significant taxpayer funds in it. This should include public policy, legal and financial reviews of any documents that form the basis of such a project.
- R3.** The City and RDA should do a more careful job of deciding at the outset of any privately developed project involving the investment of significant public funds what the degree of public involvement will be, and ensure the plan has a clear means of implementation.

**R4.** If the City sells DACHA at market value, it should ensure that all funds received are reinvested in affordable housing.

## **REQUEST FOR RESPONSES**

Pursuant to California Penal Code Sections 933(c) and 933.05, the Grand Jury requests a response as follows:

- From the following governing body: Davis City Council and Davis Redevelopment Agency, Finding F4 through F18, R1 through R4
- From the Davis City Attorney: F6, R4

## **DISCLAIMER**

This report was issued by the Grand Jury with exception of two jurors. These jurors were excluded from all parts of the investigation, including interviews, deliberations, and the writing, review and acceptance of the report.