

Public Housing Affiliates 101

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THE TREATMENT OF affiliated entities under general corporate and tax law is a mature area of study and practice, but until recently one could only guess at how affiliates of public housing authorities would be treated under the complex rules and regulations of the U.S. Department of Housing and Urban Development (HUD) applicable to public housing development. Public housing authorities (PHAs) have increasingly relied on affiliated entities to achieve various sound business objectives—to limit liability, add flexibility and retain control, and to take on development activities directly and decrease the transaction costs and fees associated with private sector partners. However, lacking any substantive guidance from HUD, for years PHAs have had to employ affiliated

entities at their own risk—including the risk of being investigated by the Office of Inspector General. But today, PHAs and their private partners may rely on PIH Notice 2007-15, issued by HUD on June 20, 2007 and officially expiring on June 30, 2008, which is a useful tool for navigating the complicated arena of public housing affiliates, although limited in scope and lacking the legal weight of regulations.

The scope is limited in that the notice only applies to entities that both 1) use public housing funds and 2) engage in housing development activities. Within this context, the notice re-affirms certain fundamental rules: for example, even when an affiliated entity is involved, public housing assets cannot be pledged without HUD approval, including through guaranties, and grant funds cannot be used for ineligible uses. The notice

also addresses more complex issues that have long raised concerns among industry experts, such as: how should an affiliated entity be structured? How do procurement and program income rules apply? What funds can be used by the affiliated entity? How do conflicts of interest rules apply to a staff member who works for both the PHA and the affiliated entity?

The core principle of the notice is relatively simple: if the entity is “legally and effectively controlled” by the housing authority, then under the notice it is called an “Instrumentality,” is subject to all rules and regulations to which the PHA itself is subject, and will be treated by HUD as if it is the PHA. On the other hand, if the entity is not legally and effectively controlled by the housing authority, then it is called an “Affiliate” and for the most part is treated like an

unrelated third-party contractor. The terminology is somewhat confusing, as the terms “Instrumentality” and “Affiliate” have other historical and legal associations, but for the purposes of the notice, the key distinction between the two types of entities is whether the PHA legally and effectively controls it. This is the essential definition from which all of the rules in the notice flow.

The notice actually contains little that is surprising to the seasoned practitioner, and that in itself is significant. It is a relief for many in the industry to have written confirmation, even if in the form of informal guidance, that many practices already in widespread use are indeed acceptable to HUD. The notice could have taken different approaches on numerous legal and policy issues, and HUD’s general openness to the limited comments it received fortunately resulted in more effective and practical guidance. However, that is certainly not a substitute for widespread public participation that formal rulemaking would have provided. The public input process was extremely limited—consisting primarily of comments submitted in response to drafts of the notice posted on the HUD website and a handful of informal discussions which only a very limited group of interested parties were able to attend.

That aside, the issuance of the notice is welcome, given the scarcity of other guidance and the fact that the Office of Inspector General (OIG) has repeatedly audited PHAs using affiliated entities. According to the OIG the last notice on the subject was issued 16 years ago, and while 24 C.F.R. Section 943 Subpart C addresses the use of PHA affiliated entities for certain functions, those regulations are limited in scope and explicitly not applicable to public housing development. The 2007 notice is in fact a direct

response to OIG Audit Report 2004-AT-0001, which recommended that HUD issue guidance on the topic, based on a finding of violations by 15 housing authorities who used affiliated entities for development activities.

Below are some frequently asked questions about the use of affiliated entities in the public housing development process, and a brief summary of the applicable notice provisions. Again, it is important to remember that the scope of the notice is limited in that it applies only to public housing development activities where public housing funds are used, and it does not apply to Section 8 activities.

How should I structure my entity and why does it matter?

The corporate structure of the affiliated entity, including the structure of the board, is key to determining how much control the PHA wields over the entity and thus whether the entity is an “Instrumentality” or an “Affiliate.” As noted above, if the PHA “legally and effectively controls” the entity, it must abide by all federal public housing requirements just as the PHA does, such as procurement under 24 C.F.R. Part 85, program income requirements, and reporting requirements. If the entity is structured in a way that it is not “legally and effectively controlled” by the PHA, then it is largely freed from those requirements, even if the PHA has some element of control over or participation in the entity. For guidance, the notice provides a list of “indicia of control,” including how the entity is treated under the Governmental Accounting Standards Series, but it is important to remember that the list is not all-inclusive or definitive of whether an entity is an Instrumentality or an Affiliate.

Interestingly, the first draft of the notice appeared to apply federal public housing requirements to *any*

entity with some sort of relationship to a housing authority. Potentially, under the language of the first draft notice, an entity on which any PHA employee was a volunteer board member might have been deemed subject to all public housing requirements. In contrast, the final notice clarifies that only where PHAs have the requisite control must the entities follow those rules, and that entities with lesser relationships with the PHA do not and are for the most part treated like any unrelated third party contractor. Clearly, this is a threshold matter in considering whether an agency’s needs are best suited by an Instrumentality or an Affiliate.

How does procurement work?

Under the notice, a PHA need not procure an Instrumentality in accordance with Part 85. However, an Instrumentality must procure its own contractors, as does a tax credit owner entity that has an Instrumentality as general partner. In dealing with Affiliates, a PHA does need to procure an Affiliate in accordance with Part 85, just like it must procure any unrelated third party, and certain practical issues must be worked out in order to do this appropriately. However, a properly procured Affiliate in turn does not need to procure its own contractors. This rule flows from the definitional issues describe above and again, can be a decisive factor for a PHA when determining whether to create an Instrumentality or an Affiliate.

Can PHA staff work for the related entity? What about conflicts of interest?

It is common practice for a PHA to share its staff and resources with either Instrumentalities or Affiliates. While the OIG has in the past cited such overlapping roles as potentially problematic, the notice acknowledges the reality that

shared resources lead to higher efficiencies, and that such arrangements are not always prohibited under conflicts of interest rules.

The notice clarifies that PHAs and Instrumentalities (and PHA staff working on behalf of either Instrumentalities or Affiliates) must always abide by all applicable conflicts of interest rules, such as the standard prohibitions on contracting with prohibited persons set forth in Section 19 of the Annual Contributions Contract and 24 C.F.R. Section 85.36(b)(3). The notice also emphasizes that HUD is “most concerned” where a “personal financial interest” creates “a perception of abuse of authority and self-dealing,” and naturally, abuses of power remain forbidden, such as using overlapping roles to wrest assets from a housing authority. But the notice helpfully acknowledges that no conflict of interest exists where an individual merely works on behalf of more than one entity and receives a normal and customary compensation package in connection with his or her services to those entities. This interpretation is a practical one, which recognizes that regulatory requirements are not necessarily incompatible with good business practices, such as the establishment of distinct corporate forms staffed by the same individuals.

What funds can the entity use?

A basic statutory requirement, which remains unaffected by the notice, is that grant funds may only be used for eligible purposes. A PHA or an Instrumentality, as the grant awardee, may only use and disburse grant funds for eligible purposes. An Affiliate, for its part, must abide by any restrictions passed on to it in connection with its receipt of grant funds, just as any unrelated contractor must.

One nuance set forth in the notice is that public housing funds may be used for the formation of



an Instrumentality or Affiliate only if its first development phase includes public housing units. Another nuance is that, where grant funds pay for costs incurred by the PHA, Instrumentality or Affiliate—including for staff and overhead costs shared by the entities—those costs must be properly allocated among the entities in accordance with OMB Circular A-87, Cost Principles for State, Local, and Indian Tribal Governments. Staff should, for example, keep time records reflecting the time they spend on eligible and ineligible activities, and the salary, overhead and employment benefits of the staff should be allocated accordingly. Furthermore, to the extent that a PHA pays a salary out of grant funds, but the staff member has engaged in ineligible activities, the appropriate portion of the salary must be refunded by the Affiliate out of other funds.

The importance of documentation evidencing the proper use and/or reimbursement of grant funds in transactions involving related entities should not be underestimated. Lack of documentation evidencing the propriety of expenditures is usually a violation of grant requirements in and of themselves. It is also often assumed by the OIG that simply because

expenditures are insufficiently documented, those expenditures were in fact improper.

In terms of eligible uses of grant funds, the notice affirms that PHAs may claim 3% of development costs for its administrative costs for a mixed-finance transaction. It is also worth noting that guarantees and indemnities—whether made by the PHA, Instrumentality or Affiliate—must always be carefully designed so that public housing assets are not at risk. And a PHA and its Instrumentality are subject to program income requirements where fees such as developer fees are earned, whereas such income to an Affiliate is unrestricted.

What kind of HUD oversight can I expect?

There is no special HUD approval needed to create or utilize an Instrumentality or an Affiliate in development transactions. The mere fact that a related entity is involved, for example, does not mean that organizational documents, contracts between the PHA and the entity, or procurement documents must automatically be submitted to HUD (though HUD may affirmatively request to review them). However, all HUD approvals that are necessary to development transactions generally are still required, including approval of the transaction itself, approval of any encumbrances or dispositions of public housing assets, approval of a general contractor with an identity of interest with the developer, relocation approval, etc.

Since the notice was issued in direct response to the OIG's finding that HUD failed to properly monitor and oversee development transactions involving related entities, the notice tasks Field Offices with reviewing any red flags raised by the audited financial statements and Annual Plans, such as unapproved encumbrances on public

housing assets. The notice makes clear that these reviews are not limited to transactions involving Instrumentalities and Affiliates, but rather that any inappropriate activities will be addressed by the Field Office and/or the Office of Public Housing Investments. The notice includes a checklist intended to guide Field Office review, which states that if the questioned transaction has previously received HUD approval, further review is not to be conducted. Therefore, PHAs should not expect that already-approved transactions will be open to further scrutiny simply because of the increased focus on Field Office monitoring.

What paperwork do I need to do?

PHAs must continue to report all development transactions and public housing budget estimates in the Annual Plan, and should be sure to explain how that information relates to its Affiliates and Instrumentalities. Furthermore, PHAs must disclose activities involving Instrumentalities and Affiliates in the PHA's annual audited financial statements. The notice also states that unless it is made clear to HUD that an entity is an Instrumentality, it will be treated as an Affiliate, so the distinction should be disclosed to HUD upfront.

Although it may seem unnecessary where a PHA works closely with or even shares staff with an affiliated entity, carefully prepared legal documentation of a PHA's business agreements with its related entities is essential. As noted above, agreements related to the sharing of staff and resources, and to the appropriate allocation of costs to each entity and the repayment of any grant funds that may be advanced by the PHA on behalf of its entities for ineligible purposes, are especially important. Ground leases, loan documents and other standard agreements necessary to all development



transactions are equally necessary where affiliated entities are involved. Copies of the entities' organizational documents, board resolutions, and corporate minutes, evidencing adherence to corporate formalities, must also be prepared with care and retained on file.

What happens if I haven't complied with these rules in the past?

Although the notice does not confirm this in writing, HUD officials verbally expressed in group discussions regarding the draft notice that it did not intend to retroactively apply rules that were not clearly established prior to the notice. However, it is clear that violations of requirements that pre-dated the notice—such as restrictions under the ACC and U.S. Housing Act of 1937 on the encumbrance or disposition of public housing assets without HUD approval—are to be remedied by reimbursement of the improperly-used funds and/or possible unwinding or restructuring of the transaction.

What other issues should I consider when working with Instrumentalities and Affiliates?

Although outside the scope of the notice *per se*, no discussion of related entities would be complete with-

out at least passing mention of some other important considerations. Before utilizing Instrumentalities or Affiliates, PHAs should consider whether their enabling statute authorizes such activities, and how sunshine laws and real estate and income tax rules apply to the entities. And of course, the notice does not affect the impact of any local, state and internal conflict of interest policies and requirements.

In summary, the notice should give PHAs additional confidence in expanding their use of affiliated entities. For the most part, the notice seeks to accommodate certain practical realities of development, and refrains from imposing unnecessary or overly prescriptive requirements regarding reporting processes, corporate structure, and the contents of legal contracts. Opportunities also exist under the notice to seek HUD approval for alternative methods of procurement and cost allocation. And while the notice is technically applicable only within the context of public housing development, its basic principles may also be helpful to PHAs using affiliated entities in other ways—an increasingly important option as agencies look beyond the traditional frameworks and seek new ways to accomplish their missions and goals.

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