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TO: The Honorable Julián Castro
Secretary of the U.S. Department of Housing and Urban Development

FROM: Nixon Peabody LLP
Reno & Cavanaugh PLLC
Klein Hornig LLP

Cc: Carol Galante, Assistant Secretary for Housing/Federal Housing Commissioner

DATE: September 11, 2014

RE: RAD2 and the PBV Rule Effective July 25, 2014

Our firms have come together to present to you a memorandum setting forth legal and policy reasons for suspending one recent change to the Project Based Voucher ("PBV") Rule or, at a minimum, exempting from that provision projects converting to PBV contracts under Component 2 of the Rental Assistance Demonstration program ("RAD 2"). Each of our firms have clients with RAD2 transactions that have previously closed or are scheduled to close this calendar year, all of whom have relied upon longstanding HUD policies and the RAD notice itself (and several updates/revisions) which provide that Davis Bacon does not apply if an "existing housing" contract is executed. All of these transactions are in jeopardy now, as are public housing projects converting to PBV under RAD and other preservation projects proceeding along more diverse paths.

We believe that the arguments set forth herein cast serious doubt as to the applicability of Davis Bacon to an existing housing contract as proposed by the new PBV changes. We would like to schedule a meeting with you and Carol Galante as soon as possible to discuss these important preservation issues – time is of the essence if the pending transactions are to close this year. Please contact us as follows: Nixon Peabody LLP - Stephen J. Wallace ((202) 585-8717) or Michael H. Reardon ((202) 585-8304); Reno Cavanaugh PLLC – George L. Weidenfeller ((202) 349-2464); and Klein Hornig LLP – Christopher W. Hornig ((202) 495-4088).

The following describes the legal background and the major rule changes that went into effect July 25, 2014 per the Final Rule published June 25, 2014 (the "Final Rule"). The full texts of the relevant authorities follow the discussion.

A. Section 12 does not mandate that Davis-Bacon apply to RAD 2 transactions.

Statute: Section 12 of the U.S. Housing Act of 1937 requires an "agreement" before applying Davis-Bacon to section 8 projects. Section 12 provides in part that Davis-Bacon shall apply to: "(. . . ***a project with nine or more units assisted under section 1437f of this title, where the public housing agency or the Secretary and the builder or sponsor enter into an agreement for such use before construction or rehabilitation is commenced) . . . ."*** It is consistent with the authorizing provisions that used to exist in section 8 for the New Construction, Sub Rehab, Mod Rehab and original PBV programs which had required that a prospective owner "agree" to construct, rehabilitate or upgrade eligible housing as a condition of entering into a HAP contract. (HUD's FY '01 Appropriations expanded PBV to include "existing housing".)

Regulation: The original section 8 regulations in 1974 show that HUD has always defined "agreement" to mean an Agreement to Enter into a Housing Assistance Payment contract ("AHAP"), which conditions receipt of the HAP contract and rental assistance upon completion of the construction work. The regulation at 24 CFR 983.4 before July 25, 2014 followed the statute closely and provided in part that Davis-Bacon would apply in the PBV program: "to an Agreement covering nine or more assisted units." The revised regulation that became effective on July 25, 2014 replaced the word "agreement" with "development." The Preamble to the Final Rule states that the revision "clarifies that Davis-Bacon requirements may apply to existing housing (which is not subject to the agreement) when the nature of any work planned to be performed prior to HAP contract execution or after HAP contract execution, within such post-execution period as may be specified by HUD, constitutes development of the project." This "clarification" changes the standard from requiring Davis-Bacon where there is an AHAP to requiring it where there is any development work. The revised regulation conflicts with the statute and HUD's longstanding implementation.

OGC Guidance: A December 16 1999 Memorandum from then-Associate General Counsel John P. Kennedy to David McDonough, then Director of OMHAR, addressed the basic question presented here. The Kennedy Memo states at pages 5 and 6:

> The novel question here is whether, where a project has already been under a Section 8 HAP Contract or other rental assistance contract, but HUD requires specified rehabilitation as a condition of receiving a 'renewal' with Section 8 assistance under MAHRA, Davis-Bacon wage rates must be paid for the specified rehabilitation. … We conclude that under the terms of Section 12 of the USHA, Davis-Bacon wage rates are not required to be paid on rehabilitation required to be performed under the terms of a Restructuring Plan ….

The Kennedy Memo includes extensive analysis and notes that the Department's historical view is that Davis-Bacon applies more narrowly to "development" for section 8 projects than for public housing projects. That view is based upon not only the language of Section 12, but also section 8(h) which provides that any provisions in the Act that conflict with section 8 provisions shall not apply to section 8 projects. The Kennedy Memo cites a prior OGC determination that certain portions of Section 12 that do not expressly apply to section 8 projects are inconsistent with section 8(e) which emphasizes the private nature of the section 8 program.

REQUEST: The Department should address this conflict, which is provoking considerable difficulties among HUD's partners and threatening the viability of scores of underway preservation projects, by immediately revising the RAD Notice to re-assert the long-time status-quo standard for applying Davis-Bacon to section 8 housing. Given the departure from the actual statutory language, the revision cannot

be viewed as a statutory mandate, and prior to issuing new guidance the Department should be willing to waive the revised regulation's new policy regarding the applicability of Davis-Bacon.

B. HUD violated the APA by rulemaking without public notice.

The Administrative Procedures Act ("APA") generally requires that an agency engaged in informal rule making publish a notice in the Federal Register that includes either the terms or substance of the proposed rule or a description of the subjects and issues involved. 5 U.S.C.A. § 553(b)(3).

An agency may promulgate a rule that differs from a proposed rule only if the final rule is a "logical outgrowth" of the proposed rule. Allina Health Services v. Sebelius, 746 F.3d 1102 (D.C. Cir. 2014). A final rule is a "logical outgrowth" of a proposed rule, for purposes of notice requirements, only if interested parties should have anticipated that the change was possible, and thus reasonably should have filed their comments on the subject during the notice-and-comment period. International Union, United Mine Workers of America v. Mine Safety and Health Admin., 407 F.3d 1250 (D.C. Cir. 2005). When a notice proposes to "clarify" existing policy and states that there will not be a major impact associated with the change, a regulation that completely reconsiders existing practice is not a logical outgrowth. Allina Health Services v. Sebelius, 746 F.3d 1102 (D.C. Cir. 2014).

Since the initial publication of the PBV regulations in 2005, the regs have indicated that (a) Davis-Bacon applies to an Agreement (defined as an AHAP), (b) the AHAP "… is not used for existing housing ...", and (c) "existing housing" is defined as existing housing units "… that substantially comply with HQS …." The relevant provisions of the statute have not changed in that time.

In its proposed rule implementing HERA published May 15, 2012, HUD proposed to change the definition of "existing housing" in 24 CFR 983.3 and 983.52. HUD received very substantial adverse comment to the changes and retracted them in the final rule, acknowledging that further consideration was required. HUD proposed no change to the "Labor Standards" provision of 983.4. Yet in the Final Rule, HUD without warning announced that it was "updating" and "clarifying" the Labor Standards provision in order to apply Davis-Bacon requirements to transactions in which they had never been applied (until a recent deal in which HUD anticipated its Final Rule). The most vivid illustration that the new rule overturned, rather than clarified, existing law is that it flatly contradicted the RAD implementation notice, in effect retroactively declared out of compliance (and exposing to wage claims) dozens of RAD 2 deals that had already closed, and rendered infeasible dozens more that had previously been approved.

C. RAD Clearance Process

HUD initially published a Notice (PIH Notice 2012-18) announcing the Rental Assistance Demonstration in the Federal Register (77 FR 14029) on March 8, 2012. That publication and Notice established eligibility and selection criteria and invited public comment. On July 26, 2012 HUD published PIH Notice 2012-32, which offered revised instructions for Rent Supp and RAD conversions. On July 2, 2013 HUD published PIH 2012-32 (HA) REV-1 as the RAD – Final Implementation. Each of those Notices and publications stated that in the event that a project to be converted from Rent Supp or RAP to RAD did

not meet HUD Housing Quality Standards, the PHA and Owner must enter into an Agreement to Enter into a HAP (AHAP). While none of the Notices addressing the conversion of Rent Supp or RAP to RAD, specifically addressed Davis Bacon, a requirement for execution of an AHAP would be the triggering event for compliance with Davis Bacon.

In addition to the HUD request for public comment on March 8, 2012, since RAD was a well-established priority of then HUD Secretary Donovan, HUD spent considerable time vetting the initiative- inside the Department and through outside industry consultations. Given the cross program implications, it was well understood that the highest levels of the Office of Housing, the Office of Public and Indian Housing, the Office of General Counsel and the Office of the Secretary were actively involved in consideration and resolution of issues. The clearance process for Notices with a priority such as RAD would generally include any Office that may be affected by or have a concern with the matter under consideration. It is anticipated that if there are matters cannot be resolved between Offices, they are raised to and finally decided upon by the Secretary.

HUD did publish its response to comments raised on the March 8, 2012 publication and the only reference to Davis Bacon was that relating to public housing conversions at following at section N 3.

3. *Commenters sought clarity on when paying Davis-Bacon wages would be required for public housing conversions.*

   HUD response: Under RAD, Davis-Bacon wages are required for public housing conversions to PBV or PBRA for the initial repairs identified in the Financing Plan as construction or rehabilitation when there are nine or more units at the project, regardless of financing source. Davis-Bacon is not required for subsequent repairs, unless as a condition of future sources of funding or financing.

AUTHORITIES

I. STATUTES—

Section 12 of the US Housing Act of 1937 (USHA)

§1437j. Labor standards and community service requirement

(a) Payment of wages prevailing in locality

Any contract for loans, contributions, sale, or lease pursuant to this chapter shall contain a provision requiring that not less than the wages prevailing in the locality, as determined or adopted (subsequent to a determination under applicable State or local law) by the Secretary, shall be paid to all architects, technical engineers, draftsmen, and technicians employed in the development, and all maintenance laborers and mechanics employed in the operation, of the low-income housing project involved; and shall also contain a provision that not less than the wages prevailing in the locality, as predetermined by the Secretary of Labor pursuant to sections 3141–3144, 3146, and 3147 of title 40, *shall be paid to all laborers and mechanics employed in the development of the project involved* ***(including a project with nine or more units assisted under section 1437f of this title, where the public housing agency or the Secretary and the builder or sponsor enter into an agreement for such use before construction or rehabilitation is commenced),*** and the Secretary shall require certification as to compliance with the provisions of this section prior to making any payment under such contract." (emphasis added)

Section 8(h) of USHA—42 USC Section 1427f(h)

(h) Nonapplicability of inconsistent provisions to contracts for assistance payments.

Sections 1437c(e) [section 5(e)] and 1437d [section 6] of this title (except as provided in section 1437d(j)(3) [section 6(j)(3)] of this title), and any other provisions of this chapter which are inconsistent with the provisions of this section shall not apply to contracts for assistance entered into under this section

II. REGULATIONS--24 CFR 983.3 and 983.4

24 CFR 983.4 (*Before* July 25, 2014)

The following provisions apply to assistance under the PBV program

* * * * *

"Labor standards. Regulations implementing the Davis-Bacon Act, Contract Work Hours and Safety Standards Act (40 U.S.C. 3701-3708), 29 CFR part 5, and other federal laws and regulations pertaining to **labor standards applicable to an Agreement covering nine or more assisted units."** (emphasis added)

24 CFR 983.4 (*Final Rule* effective July 25, 2014, at page 36165)

Sec. 983.4 Cross-reference to other Federal requirements.

The following provisions apply to assistance under the PBV program.

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"Labor standards. Regulations implementing the Davis-Bacon Act, Contract Work Hours and Safety Standards Act (40 U.S.C. 3701-3708), 29 CFR part 5, and other federal laws and regulations pertaining to labor standards applicable to development (including rehabilitation) of a project comprising nine or more assisted units."

24 CFR 983.3 (Unchanged by Final Rule)

"PBV Definitions. . . . ***Agreement to enter into HAP contract (Agreement)***. The Agreement is a written contract between the PHA and the owner in the form prescribed by HUD. The Agreement defines requirements for development of housing to be assisted under this section. When development is completed by the owner in accordance with the Agreement, the PHA enters into a HAP contract with the owner. The Agreement is not used for existing housing assisted under this section. HUD will keep the public informed about changes to the Agreement and other forms and contracts related to this program through appropriate means."

Preamble to Final Rule 79 Fed Reg 122 (June 25, 2014, effective July 25, 2014), p36149

"*Cross-reference to other Federal requirements (24 CFR 983.4) Revision to 'Labor standards' cross-reference.* In this final rule, HUD updates the reference to labor standards provisions applicable to assistance under the PBV program to **remove the reference to labor standards 'applicable to an Agreement'** covering nine or more assisted units and **substitutes a reference to labor standards 'applicable to development (including rehabilitation) of a project comprising'** nine or more units. This language clarifies that Davis-Bacon requirements may apply to existing housing (which is not subject to the agreement) when the nature of any work planned to be performed prior to HAP contract execution or after HAP contract execution, within such post-execution period as may be specified by HUD, constitutes development of the project." (emphasis added)

III. RAD Notice

Section 3.4 of Notice PIH 2012-32 (HA) Rev-1 (July 2, 2013)

D. Physical Conditions. The owner must provide evidence that the property meets one of the following standards:

1. For prospective conversions, the most recent Real Estate Assessment Center (REAC) score at the property must be 60 or above. HUD may make exceptions, but only if the owner demonstrates that there is a plan in place to obtain debt or equity financing that will address the physical needs of the project over the course of the PBV contract period.

Please note: as required by statute, prior to entering into a PBV HAP Contract, the PHA will inspect the units proposed for conversion to ensure compliance with Housing Quality Standards (HQS). The HAP Contract will not be executed unless and until the converting units meet HQS. This requirement stands even if HUD grants an exception to the requirement that the REAC score be 60 or above. **If the converting units do not qualify as existing housing, and therefore cannot be selected as such under the PBV program, the PHA and owner must enter into an Agreement to Enter into a HAP (AHAP) and all rehabilitation must be performed pursuant to the terms of the AHAP.** Upon completion of the

rehabilitation, and when all other regulatory requirements are satisfied, the PHA and owner shall enter into the HAP contract for the eligible units. If an AHAP is required, the project must meet Uniform Relocation Act (URA) requirements, if temporary or permanent relocation is required during repairs or substantial rehabilitation. The owner must also ensure that residents do not experience rent increases during the AHAP period.

2. For retroactive conversions, units to be converted must meet HUD's HQS as determined by the PHA. The PBV contract will not be executed unless and until the units meet HQS. **If rehabilitation is required to meet this standard, the PHA and owner shall execute an AHAP and all rehabilitation must be performed pursuant to its terms."** (emphasis added)

IV. December 16, 1999 Kennedy Memo

P.5 Note 4—"A memorandum of April 14, 1976 from the Assistant General Counsel for Public Housing noted that Section 8(e)(2) then required that contracts between HUD and the owner of new construction of substantial rehabilitation projects shall provide that 'all ownership, management, and maintenance responsibilities . . .shall be assumed by the owner….' **The [1976] memorandum noted that Section 8(h) provides that certain USHA provisions, and 'any other provisions of the Act which are inconsistent with the provisions' of Section 8, shall not apply to Section 8 contracts.** The memorandum stated that the provisions in Section 8(e), 'with their emphasis on leaving responsibility for maintenance in the hands of the private owner, were determined to be inconsistent with Section 12 which would require regulation and supervision of the wages made to maintenance employees'; accordingly, pursuant to Section 8(h), section 8 ACCs and HAP Contracts do not require payment of HUD wage rates to maintenance employees….While the 1976 memorandum did not address the question of Davis-Bacon wages for rehabilitation of a Section 8 project carried out subsequent to HAP Contract execution, we believe that a similar rational for non-imposition of prevailing wage requirements would apply."