

Real Estate Title Insurance & Construction Law

Discouragement of Affordable Housing Development and Financing

Low- and moderate-income residents and developers take notice

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A recent New Jersey Superior Court decision will discourage financing for affordable housing in New Jersey and make it more difficult for developers to sell affordable housing units in inclusionary developments. The decision sends a clear warning to creditors intending to foreclose upon residential real estate or threatened with a possible bankruptcy filing that their loans and collateral may be worthless if affordable housing regulations were violated by such financing. In *Novastar Mortgage, Inc. v. Koerner, et al.*, Docket No. SOM-F-5085-07 (December 2008), the trial court voided Novastar's loan and the effectiveness of the related security documents because the lender failed to comply with COAH regulations. This decision will reduce financing available to low- and moderate-income residents and to developers, despite the fact that COAH regulations

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were intended to promote the availability of affordable housing by stimulating construction, rehabilitation and improvement.

Susan Koerner qualified to participate in the Bridgewater Township affordable housing program in 1989 and purchased a condominium unit shortly thereafter. Ms. Koerner accepted title with affordable housing restrictions incorporated into the deed. She subsequently granted a total of six mortgages against the condominium unit with the last financing being a 2006 mortgage in favor of Novastar Mortgage, Inc., that purportedly secured a \$192,000 promissory note. Novastar was apparently unaware that (1) the condominium unit was deed restricted, (2) the deed restrictions set a maximum resale price of \$77,000, (3) the deed restrictions required the township's consent prior to extending financing, and (4) such financing could not exceed 95 percent of the \$77,000 maximum resale price. Novastar would have realized that the condominium unit fell under COAH regulations and the maximum resale value of the condominium unit

if it had conducted proper due diligence because the financing restriction was disclosed on both the condominium unit deed and the master deed and the maximum resale price was disclosed in the tax records. Mary Pat Gallagher, "Mortgage Voided for Exceeding COAH's Cap," 195 *N.J.L.J.* 1, 4 (2009).

Novastar filed a foreclosure action and obtained a default judgment of foreclosure after Ms. Koerner defaulted. The township intervened as an interested party prior to the sheriff's sale and successfully vacated the foreclosure judgment. Although it was not named in the foreclosure action, the township successfully argued that it should be permitted to intervene because it was charged by law with enforcing affordable housing deed restrictions. Novastar then filed a motion seeking a determination regarding the validity of the mortgage in light of the affordable housing deed restrictions. Conceding the existence and validity of the deed restrictions and attempting to cut its losses, Novastar unsuccessfully argued that the loan should only be voided with respect to the amount in excess of the COAH ceiling.

The New Jersey legislature created COAH and granted that agency the authority to adopt rules and regulations necessary or desirable to carry out the purposes of the New Jersey Fair Housing Act (N.J.S.A. 52:27D-301 et seq.) ("FHA"). COAH's

mandate includes ensuring that financing secured by mortgages upon a deed-restricted affordable housing unit does not exceed certain limits. The owner of any deed-restricted units must notify an administrative agent of any intended financing and receive a written determination that such financing is in compliance with regulatory requirements. N.J.A.C. 5:80-26.8. The total indebtedness secured by an ownership unit cannot exceed 95 percent of the maximum allowable resale price. New Jersey's affordable housing regulations were extensively amended in 2004, including the Housing Affordability Controls set forth in N.J.A.C. 5:80-26.1 et seq. The 2004 revisions included a provision which voided any loans violating the regulations and the underlying mortgages and other security instruments securing the loans. N.J.A.C. 5:80-26.18(e).

Novastar did not dispute the validity of the deed restrictions and conceded that the deed restricted the price it could command at a sheriff's sale. However, Novastar argued that the loan should be reformed to the maximum amount allowed by the regulation, which would promote the availability of affordable housing financing and comport with the policy goals of FHA and COAH regulations. Novastar argued that this would avoid the "highly unjust and inequitable" result of relieving Ms. Koerner from all loan and mortgage obligations.

The township, urging literal enforcement of N.J.A.C. 5:80-26.18(e), asserted that COAH's regulation was not unconstitutional or ambiguous, declared that any loan violating the 95 percent ceiling of the maximum selling price to be void as against public policy, and mandated that the Novastar loan be deemed void. The township argued that in light of the mandatory language, the court had no discretion to reform or modify the underlying mortgage. The court agreed and voided the Novastar loan, allowing the municipality to foreclose on the Koerner property and utilize the entire proceeds to defray administrative costs. Essentially applying a strict liability standard, the court noted that mortgage lenders who, even unwittingly, advance credit beyond the ceiling set by COAH contribute to the financial burdens of towns related to foreclosure litigation.

The court refused to reform the loan documents or reduce the amount secured by the mortgage, finding that there was no mutual mistake. The court voided the loan and security documents to deter lenders from advancing credit beyond permitted regulatory limits. The court recognized the harsh consequences of its decision, but concluded that Novastar had claims against its title agent, title insurer, and the defendant. The court concluded that the township was the logical and deserving beneficiary of the effects of the COAH regulations and stayed its ruling until the township concluded its foreclosure of the condominium unit so that Ms. Koerner did not benefit from the mortgage cancellation. Thus, the county clerk was directed to discharge the mortgage only upon application of the purchaser of the condominium unit at a sheriff's sale.

The *Novastar* case is the first use of the regulation promulgated at N.J.A.C. 5:80-26.18(e) as a remedy in a foreclosure proceeding. This decision should serve as a compelling reminder to lenders, title agents, and title insurers to closely evaluate and modify their underwriting practices and procedures to understand and address affordable housing restrictions. The failure to do so poses unacceptable risks because the penalties for noncompliance are severe.

In all real estate acquisitions and financings, prudent due diligence requires owners, developers, borrowers, and lenders to thoroughly analyze all deed restrictions. The *Novastar* case also puts developers on notice that construction financing may be more difficult to obtain and that acquisition financing may be less available to the ultimate purchasers. As a result, affordable housing development risks have increased at a time when the residential real estate market already is depressed. Developers required to construct affordable housing units have the burden of trying to market and sell these units to low- and moderate-income individuals who cannot qualify for loans because of the unstable and tight credit markets. This decision will likely exacerbate these problems.

Lenders must make sure they obtain a title search and scrutinize it for affordable housing restrictions. Title com-

panies must do the same, and include specific exceptions in Schedule B of any commitments and policy relating to affordable housing. Lenders should attempt to require an ALTA 9 endorsement to the loan title policy to provide coverage over restrictions, while title companies and insurers should be cautious in issuing such endorsements and while carefully underwriting the risk. Title insurers should also require that borrowers furnish proof that a loan or sale amount is within affordable housing restriction limits and that written authorization for the sale or refinance was obtained from the designated administrative agent. Lenders with existing loans should order and carefully review title searches for affordable housing controls prior to commencing foreclosure proceedings. All lenders who knowingly or unknowingly violated COAH regulations are at risk if their borrowers file for protection under the bankruptcy laws because a knowledgeable trustee may evaluate the loan for compliance with the affordable housing regulations and/or deed restrictions, and seek to set aside the loan and underlying security documents.

Until N.J.A.C. 5:80-26.18(e) is amended or repealed, the *Novastar* decision is a poignant reminder to developers, lenders, owners, title agents, and title insurers that all parties must be cognizant of affordable housing deed restrictions and complete comprehensive due diligence and underwriting with respect to same. Any lender considering foreclosure of an existing mortgage should first undertake a complete analysis of the transaction to assess the likelihood that its loan documents may be declared void if the transaction violated affordable housing requirements. Lenders must also be aware of the extremely unpleasant possibility that their loans may be challenged by a trustee if their borrowers file for protection under the bankruptcy laws. Such lenders must consider their alternatives and develop strategies for handling such situations, including possibly proactively approaching borrowers to recast their loans and security documents. Lenders who suffer such losses are almost certain to file suits against their title insurers. ■