LAWLOR & ORDER

421a Stalemate: What's Next?

The stalemate over the extension of the 421a program continues, with no indication that a resolution is near. The governor's representatives have indicated that the program is dead, while the program's critics continue to question whether 421a is even worth reviving.

This tax incentive program was created at a time when real estate development in New York City was virtually at a standstill. Developers and financers were looking at a city with swaths of vacant land and a city flirting with bankruptcy. Over time, the program was reformed to encourage development in certain areas of the city and to include affordable housing. Obviously, the real estate climate has gone from ice cold in the early days of 421a to the current red-hot market that the Big Apple has enjoyed for the past few years.

The stalemate should be no surprise to anyone familiar with the parties to the negotiations, trade unions and the real estate industry. The two parties have a long history of battling over whether publicly financed developments containing affordable housing should be treated as though they were public projects and thus be subject to prevailing wage requirements.

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The real estate industry has fought this idea using persuasive arguments. Prevailing wage laws only cover public work projects such as roads and bridges; prevailing wage rates and benefits artificially inflate labor costs, and prevailing wage requirements can increase construction costs by 50 percent—essentially making affordable housing development infeasible.

Trade unions similarly present compelling arguments: that workers need to be paid decent wages, that sub-par wages result in sub-par construction and that many construction workers cannot afford the rents charged for affordable rentals.

The idea that the two sides would come together to resolve these fundamental differences is wishful thinking, at best. Clearly it is time to explore alternatives to the 421a program despite the ingrained bias in real estate development toward change. New York State and City have an arsenal of programs that can be modified, resurrected or expanded to fill some of the void left by the death of 421a.

Many existing state and city programs (i.e., Private Housing Finance Law Articles V and XI) create a role for not-for-profit community-based organizations by providing tax benefits when those organizations are part of the ownership structure. Additionally, many not-for-profit organizations own property that could be accessed for affordable housing opportunities.

The state's prevailing wage program is far from efficient or accurate in establishing wage rate. If it is to be included in affordable housing programs, the program should be revised to base wage rates and benefits on current conditions and similar development projects.

City and state regulations are necessary, but there is room for improvement in the scope of the regulations and the administration of these programs. The need for affordable housing should be the impetus in looking at the building codes and the rent regulation laws in order to identify and eliminate impediments. For example, the rent laws could be amended to allow demolition of existing buildings if tenants are relocated and the number of affordable units in the new building is greater than what existed before. Finally, the city and state should look to waive filing fees and create expedited reviews of filings in order to facilitate development of affordable housing.

Given the magnitude of today's crisis of income inequality and the shortage of affordable housing, it is time for all interested parties—the government, real estate developers and labor unions—to come together to creatively and comprehensively address the impediments and reform the opportunities for the creation of more affordable housing.

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STEIN'S LAW

Can a Legal Loan Become Illegal Just Because it has the Wrong Buyer?

Banks originate all kinds of loans and often sell them—sometimes to other banks, other times to other types of investors. Loan trading plays a huge role in real estate finance. It gives banks liquidity and an exit. Banks and other lenders often originate loans simply to sell them. They collect fee income from origination and move on to the next thing. It's part of what they do.

As an apparently unrelated matter, many states have usury laws that set a maximum interest rate that any lender can charge. Under federal banking law, though, as long as a national bank complies with its home state's usury law, no other state's usury law matters.

Now consider this sequence of events. A Delaware bank makes a loan to a New York borrower. Delaware has a high maximum interest rate, and the loan complies with that limitation. But the interest rate on the loan exceeds New York's maximum rate. The bank can still enforce the loan; it remains perfectly legal.

But what happens if the Delaware bank sells that loan to a private investor instead of a bank? One might think that because the loan was legal when closed, it remains legal when sold.

Not so fast! A recent federal appellate decision, *Madden v. Midland Funding LLC*, concluded that once the bank sells that loan to a non-bank, the purchaser loses the benefit of Delaware usury law. Instead, the loan potentially becomes subject to the usury law of New York, the borrower's home state. So a loan that started out perfectly legal in the hands of the originator could suddenly become illegal and usurious because the buyer made the mistake of not being a bank. If New York usury law applies, then it invalidates the entire loan and allows the poor victimized borrower to recover twice the interest they paid.

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This decision, which applies in New York and some nearby states, means that the nature and enforceability of a loan originated by a bank could change based on who owns it. If the originator bank sells it to a non-bank, then the loan changes its character and might become illegal.

This seems quite inconsistent with what business people and lawyers ordinarily expect: Once a loan closes, its terms and legal implications are set, subject only to later actions or inactions of the parties. The *Madden* decision means, in contrast, that a loan purchaser must figure out which state's law will apply after the sale, and whether the loan remains legal under that law. For the *Madden* lender, New York courts might very well solve the problem by deciding to apply Delaware usury law. But no loan purchaser wants to go through this brain damage. These issues could chill any transaction where a bank originates a high-interest loan in reliance on its home state usury laws and then sells to a non-bank.

For example, suppose a bank simultaneously originates a mortgage loan and a higher-cost mezzanine loan and plans to sell the mezzanine loan to a fund with no usury exemption. That structure might no longer work. Ordinary A/B structures might face similar issues. If a bank wants to sell a portfolio of high-interest loans, someone must pick through them to identify and analyze any loans that might, through the sale, become illegal.

If a bank's sale of a legal high-interest loan to a non-bank can make that loan illegal, then any sane non-bank investor will hesitate to buy this type of loan. Thus, even if it makes business sense—for example, because a private investor rather than another bank may be the best buyer for a "problem" loan—the bank may have trouble selling the loan except to another bank.

The preceding discussion probably just scratches the surface of how the *Madden* decision might disrupt trading of high-interest loans originated by banks. Robert J. Jackson Jr. and Colleen Honigsberg, researchers at Columbia Law School, say their preliminary research, not yet published, shows that some high-interest loans to New York borrowers have already started to trade at a higher discount.

The Supreme Court may decide to hear an appeal of the *Madden* decision. Industry organizations have tried to persuade the Supreme Court to do that and reverse *Madden*. It's an uphill battle. One can hope that if the Supreme Court doesn't do something about the *Madden* decision, Congress will.

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