Chapter 25
Dealing with Worst Cases

The previous chapters of this manual have dealt primarily with the subject of how to avoid problems in specified areas, or how to prevent problems in these areas from reaching the stage where they can be addressed only through some form of legal action. In this chapter we will review basic factors that a CLT must consider if it does face certain of these “worst case” situations. Specifically, we will discuss issues involved in dealing with homeowner mortgage default and foreclosure, non-permitted mortgages, monetary lease defaults, and nonmonetary lease defaults. And finally we will look at some legal options available to CLTs that are unable to sustain their stewardship functions and must therefore seek help from other entities, or transfer property to other entities.

Dealing with Mortgage Default and Foreclosure

Chapter 23, “CLT Post-Purchase Stewardship,” describes the important monitoring and support activities by which a CLT can help homeowners avoid mortgage default, or, if they do default, help them avoid foreclosure. Chapter 20, “Financing CLT Homes,” describes the CLT’s basic concerns regarding mortgage default and foreclosure and the provisions of the Model Lease that give the CLT certain rights in dealing with these concerns. These rights include (1) the right to cure a default on behalf of the homeowner, (2) the right to purchase a defaulted mortgage from the mortgagee, and (3) a right to buy back a foreclosed home from a mortgagee that has taken title to it.

In this chapter we will focus on worst-cases where the homeowner’s default cannot be cured and where it is not possible to arrange resale of the home before foreclosure ensues, so that the CLT must deal with the foreclosure process if it is to regaining control of the home and its affordability. For those who do have to deal with the foreclosure of a CLT home it will be important to work with an attorney who is familiar with the details of the foreclosure process as defined by the laws of the state in question. It is also important for CLT personnel themselves to have a clear basic understanding of how that process will work.

Foreclosure issues in “lien theory” and “title theory” states. State foreclosure laws can differ with regard to a number of details, but in general these laws take one or the other of two distinct approaches. One is the approach taken in “lien theory” states, where the homeowner/mortgagor retains title to her property, with the mortgagee holding a lien on the title for the life of the mortgage. In the event of an uncured default, the mortgagee can bring suit against the homeowner, initiating a judicial process whereby the lien can be foreclosed and title to the property awarded to the mortgagee. The other approach is that taken in “title theory” states, where the “mortgage” (to use the more general, less precise term) takes the specific form of a “deed of trust” or “trust deed” or “mortgage deed,” whereby title to the mortgaged property is not actually held by the homeowner/mortgagor but is held by a trustee (usually a title company), for the mortgagee until the loan is repaid. In the event of an uncured default, the mortgagee can, without the action of a court of law, ask the trustee to sell the property at auction and use the proceeds to repay the loan.

Deeds of trust are the most common or only mechanism for financing real estate purchases in the 30 “title theory” states: Alaska, Arizona, Arkansas, California, Colorado, the District of Columbia, Georgia, Hawaii, Idaho, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, North Carolina, Oklahoma, Oregon, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, West Virginia, and Wyoming. However, most of them (all except the District of Columbia, Michigan, New Hampshire, Tennessee, and West Virginia, where the deed of trust is the only financing mechanism) also allow judicial foreclosure. Trustee sale and judicial foreclosure are equally used in Arkansas and Hawai. Judicial foreclosure is more common in Oklahoma and South Dakota. The 21 other states generally use mortgages (in the strict sense of the term) though trustee sale is allowed in Iowa and Rhode Island with trustee sale more common than judicial foreclosure in Rhode Island.

With either approach, the mortgage or deed of trust normally gives the mortgagee the right to “accelerate” the loan in the event of an uncured default. When the loan is accelerated, the entire unpaid balance of the loan – rather than just the accrued unpaid amortization payments – becomes due and payable. Acceleration of a mortgage loan is thus the necessary first step in preparing for foreclosure, enabling the mortgagee to pursue a claim for the full amount owed to it.

The length of time during which the homeowner/mortgagor has a right to cure a default, and thus prevent acceleration of the loan and eventual foreclosure, varies greatly from state to state (for instance, it is less than 30 days in Texas and close to 450 in New York). The time then required to complete the foreclosure process also varies from state to state. It should be noted, too, that special legislation may have been passed in some states to expand the rights of mortgagors-in-default in the wave of home foreclosures that followed the “bursting of the housing bubble” in 2007-2008.

The difference between the judicial foreclosure of a mortgage and the non-judicial foreclosure of a deed of trust can sometimes be significant for a CLT seeking to regain title to a foreclosed property. The Model CLT Lease provides that, in the event a mortgagee takes title to a CLT home through foreclosure, the CLT shall have “an option to purchase the Home and Homeowner’s interest in the Leased Land from the Mortgagee for the full amount owing to the Mortgagee” (such an option is also granted in some specific CLT-mortgagee agreements, including the Fannie Mae Rider). This option is an important opportunity for the CLT. The question, however, is whether the mortgagee will *necessarily* hold title to the home for any period of time when a foreclosure occurs. In title theory states, when a deed of trust gives the trustee the right to auction the home in the event of an uncured default, it is possible for a third party to place a successful bid, with the result that the title never passes through the mortgagee and the CLT will have no post-foreclosure option to purchase.

In most cases, in both title theory and lien theory states, the mortgagee *will* place a bid and take title to the property through the auction. Other bidders are usually bargain-hunters, whose highest bids are likely to be less than the market value of the property and may also be less than the amount owed to the mortgagee. When such is the case, the mortgagee will be motivated to acquire the property in the hope of liquidating it for a higher amount. This will not *always* be the case, however, particularly in situations where the loan has been paid down significantly and/or the market value of the property has appreciated significantly.

At any foreclosure auction the CLT can itself bid on the property – and would be wise to do so as long as it can purchase the property for a price no higher than what will allow the home to be resold on terms affordable for an appropriate income level. However, it should be noted that, whereas the mortgagee can bid at such auction without submitting evidence of credit, any other bidder should expect to be required to demonstrate that it can complete the transaction for the amount of its bid.

Finally it should be emphasized that, even when the CLT does have an option to purchase a home from a mortgagee who has in fact taken title to the home through foreclosure or a deed in lieu, the employees or agents of the mortgagee who are dealing with the matter will not necessarily be aware of this fact. The Model Lease and other documents that convey such an option to a CLT do normally require the mortgagee to give notice to the CLT that title to the property has been acquired and that the CLT has an option to purchase during a period of time beginning with the date of the notice. A failure to give notice to the CLT could undermine the mortgagee's right to convey title to a third party; nonetheless, it is possible for the CLT's rights to go unnoticed by all parties. For this and other reasons, it is important that the CLT communicate as closely as possible with those handling the foreclosure for the mortgagee.

Dealing with Non-Permitted Mortgages

CLTs are normally in position to control the kind of mortgage financing available to a homebuyer at the time of purchase, but it can be difficult for them to screen *subsequent* financing. The current Model CLT ground lease contains special provisions for the screening and approval of subsequent financing that a homeowner may seek for the purpose of either refinancing the original mortgage loan or accessing additional credit through a second mortgage loan. Nonetheless, such loans may still occasionally be made without the CLT's knowledge or permission. When this does happen it is usually the case that the lender was not aware that the permission of the ground lessor was required for any mortgage loan (and may even have been unaware that the homeowner did not hold fee simple title to the property). If a CLT discovers that such a loan has been made, what can it do about the situation?

Assuming that the lease is based on some version of the Model Lease, it is important to understand, first, that in granting a mortgage without the CLT's permission the homeowner has violated terms of the ground lease and is therefore in default under the lease, and, second, that the lease does not give a non-permitted mortgagee those protections that it gives a Permitted Mortgagee. These basic facts should give the CLT a good deal of leverage in dealing with the mortgagee. Even if the mortgage is not in default when the CLT discovers its existence, the CLT (with its attorney) should sit down with the homeowner and mortgagee (and their attorneys) and review the terms of both the lease and the mortgage, with the following questions in mind:

1. Has the homeowner "mortgaged" an ownership interest that he or she did not hold (as will be the case if the mortgage is not a leasehold mortgage)?
2. Does the total amount of debt secured by all current mortgages approach or exceed the current purchase option price?
3. Is the total debt service required by all current mortgage loans affordable for the homeowner?

If the answer to the first question is that, yes, the homeowner has signed a conventional mortgage document that was intended to apply to the CLT's fee interest in the land as well as the homeowner's interest in the improvements, then it may be possible to negotiate a permissible leasehold mortgage to replace it, with terms that are workable for the homeowner and CLT. The mortgagee clearly has an interest in replacing the potentially unenforceable security document.

If the answer to the first question is yes, and the answer to the second question is that the non-permitted mortgage has raised the total mortgage debt to a level exceeding the purchase option price, then it may be possible to negotiate a deal with the mortgagee whereby the CLT agrees to permit a leasehold mortgage for a lesser amount – with the mortgagee accepting the reduced amount in return for the legally enforceable security.

If the answer to the first question is yes, and the answer to the third question is that the homeowner's total debt service is not – or may not be – affordable, then it may be possible to negotiate a permissible leasehold mortgage with a new amortization schedule that will be affordable.

If a non-permitted mortgage is reported to be in default, it will be particularly important for the mortgagee to understand the legal difficulties it would face in trying to foreclose the mortgage and take title to the property. Once the difficulty is understood, it should be possible to work out an arrangement that will resolve the problem of the reported default in a way that will serve the interests of both the homeowner and the CLT.

Dealing with Monetary Lease Defaults

A monetary lease default, as described in Section 12.1 of the Model CLT Lease, occurs when a lessee fails to make payments that the lease requires him or her to make to the CLT. If the CLT has duly notified the lessee of the failure to pay and the lessee then does not rectify ("cure") the default within the time allowed, then a formal "event of default" has resulted, giving the CLT a right to proceed with termination of the lease and eviction of the lessee.

A number of CLTs have experienced persistent problems in collecting ground lease fees, and some have been frustrated by the fact that the basic recourse of termination and eviction is so harsh that it is rarely employed (at least as long as the lessee continues to occupy the home). Because lessees are aware that termination and eviction are highly unlikely, they may feel less pressure to pay this monthly expense than other expenses, such as mortgage payments and utility bills, where failure to pay has predictable serious consequences. It can therefore be tempting for low-income homeowners to defer payment of these fees from month to month until the accumulated debt becomes a "worst-case" problem.

The total amount owed to the CLT may be increased when other types of obligations are added to the lessee's obligation to pay a lease fee to the CLT. Section 5.7 of the Model CLT Ground Lease allows the total obligation to be increased through interest charged on the unpaid balance. Section 6.4 allows taxes that the lessee is obligated to pay but has not paid to be added to the lease fee. Section 7.4 allows the addition of amounts paid by the CLT to discharge liens against the Home or Leased Land.

Basic concerns and methods related to the collection of lease fees are discussed in Chapter 13, "Establishing and Collecting Fees." As noted in that chapter, some CLTs avoid the difficulties of collection by arranging for the homeowners' mortgagees to collect and escrow lease fees as part of the single monthly payment that also covers principal, interest, taxes and insurance costs. Other CLTs, however, choose to forego this convenience because they want to retain the monthly contact with their homeowners that comes with the payment of ground lease fees directly to the CLT. Both Chapter 13 and Chapter 23, "Post-Purchase Stewardship," emphasize the importance of consistent, methodical month-to-month practices that can prevent unpaid fees from accumulating until they become the kind of worst-case situation that is discussed here.

For CLTs dealing with accumulated unpaid fees, two kinds of legal recourse are available, in addition to the possibility of terminating the lease: the CLT can sue in a small claims court to collect the amount owed, and/or, when the home is eventually sold, it can take action to collect what is owed from the proceeds of sale.

Collection through small claims court. Such courts have been established by most states to deal with disputes involving relatively small amounts of money (for example, in some states, amounts not exceeding $15,000) through a relatively simple and economical legal process. The exact nature of the disputes over which such courts have jurisdiction and the exact rules governing the process do vary from state to state, and a CLT should consult its attorney regarding the applicable law of its own state before taking a claim to such a court. However, a primary purpose in establishing such courts has been to simplify the process to an extent that will allow parties to present their own cases without needing to be represented in the courtroom by an attorney.

The dollar amount of unpaid lease fees that a CLT will typically seek to collect will usually fall within the range that a small claims court is authorized to deal with, but, if the homeowner's total debt to the CLT has been substantially increased, for instance by taxes paid by the CLT or by loans from the CLT for home repairs or to cure a homeowner's mortgage default, then the CLT should be sure that the total amount of the debt does not exceed the dollar amount to which the court's jurisdiction is limited. If the total debt does exceed this limit, the court may dismiss the case altogether even if the CLT would have been satisfied to collect that portion of the debt that did fall within the court's jurisdiction.

Most small claims courts encourage the parties to a dispute to seek alternative means of resolution, such as the mediation and/or arbitration processes permitted under most CLT ground leases. Again a CLT should consult its attorney regarding the most appropriate approach. One factor to consider is that decisions by a small claims court can be appealed, whereas decisions by arbitrators generally cannot be appealed.

It is important to note that a small claims court judgment in favor of a CLT's claim does not insure payment of the debt in the same way that, for instance, a judgment against an insurance company does normally insure payment by the company. If a lower income homeowner cannot access the amount in question, then the CLT may focus on securing incremental payment over time. If the homeowner is working and receives a regular paycheck it may be possible to get the court to order that his or her wages be garnered to pay the debt through installments that will not seriously undermine the household's financial stability.

Even if a homeowner does not have the income needed to pay the debt over time, it may still be in the CLT's interest to seek a judgment in small claims court as a legal basis for later collecting the debt from the proceeds of sale when the home is eventually sold (as discussed below). It may also be that by systematically utilizing the small claims court when the total amount of a lessee's unpaid lease fees reaches a certain threshold, a CLT can increase the likelihood that the basic obligation to pay the fee will be taken seriously by its leaseholders.

Collection from Proceeds of Sale. The Model CLT Ground Lease explicitly establishes the CLT's right to collect unpaid lease fees from the proceeds of sale when the lessee's home is eventually sold. Section 5.8 of the Model (2011 version) reads as follows:

> "In the event that any amount of payable Lease Fee remains unpaid when the Home is sold, the outstanding amount of payable Lease Fee, including any interest as provided above [Section 5.7], shall be paid to CLT out of any proceeds from the sale that would otherwise be due to Homeowner. The CLT shall have, and the Homeowner hereby consents to, a lien upon the Home for any unpaid Lease Fee. Such lien shall be prior to all other liens and encumbrances on the Home except (a) liens and encumbrances recorded before the recording of this Lease, (b) Permitted Mortgages as defined in section 8.1 below; and (c) liens for real property taxes and other governmental assessments or charges against the Home."

As is noted in the commentary on this Section 5.8 in Chapter 11-B, the CLT should consult its attorney regarding actions that it may need to take, under locally applicable law, to ensure that the lien is recognized and can be perfected so that the CLT's claim will be fully enforceable at the time of sale.

Collection upon Termination of Lease. As noted above, CLTs have rarely sought to terminate a lease as a means of collecting unpaid lease fees as long as the lessee is occupying the home and is otherwise in compliance with the lease. However, the kinds of serious non-monetary defaults discussed below as possible cause for lease termination may be accompanied by failure to pay lease fees or other amounts owed to the CLT. When a CLT does take action to terminate a lease in such situations, the collection of money owed to it will be one of its concerns.

Section 12.4 of the (2011) Model CLT Lease gives the CLT the right to terminate the lease (or exercise its purchase option) if the lessee has defaulted and the default has not been cured in the time allowed. In addition, Section 12.4(a) states:

> CLT shall have such additional rights and remedies to recover from Homeowner arrears of rent and damages from any preceding breach of any covenant of this Lease. If this Lease is terminated by CLT pursuant to an Event of Default, then, as provided in Section 7.7 above, upon thus assuming title to the Home, CLT shall pay to Homeowner and any Permitted Mortgagee an amount equal to the Purchase Option Price calculated in accordance with Section 10.9 above, as of the time of reversion of ownership, less the total amount of any unpaid Lease Fee and any other amounts owed to the CLT under the terms of this Lease and all reasonable costs (including reasonable attorneys' fees) incurred by CLT in pursuit of its remedies under this Lease.

For a CLT that has adopted a provision such as Section 12.4(b) of the Model it may be possible to respond to an Event of Default by exercising the purchase option rather than by terminating the lease. In such a case the CLT should be able to subtract the amount owed to it from the purchase option price, as provided by Section 5.8 of the

Model, quoted above. Again, it should be emphasized that a CLT exercising its purchase option should consult its attorney regarding steps that may be needed to perfect the lien described in Section 5.8 (steps that may or may not be needed if the CLT proceeds with termination rather than exercise of the option).

Dealing with Nonmonetary Lease Defaults.

Nonmonetary defaults by current lessees. The nonmonetary defaults that may be committed by current lessees include some potentially serious problems. In violation of the lease, a lessee may be causing serious physical damage to a home, or may be failing to repair serious damage from fire or other causes. Or he or she may be dealing drugs or engaging in other criminal activity on the premises. Or a lessee may have moved out of the home and sublet it for a market-rate rent, thus violating the affordable owner-occupancy requirement stated in section 4.5 of the Model. In any of these situations, when serious violations are not “cured” in accordance with provisions such as those contained in Section 12.2 of the Model Lease, a CLT can end its relationship with the lessee through the kind of termination process described in Section 12.4-a of the Model (or through the exercise of the purchase option if the lease contains a provision such as Section 12.4-b of the 2011 Model).

Before taking any action to terminate a lease and evict the lessee, a CLT should be sure to consult its attorney regarding the exact steps that must be taken in order to comply with all applicable laws, including state landlord-tenant law. Unlike earlier versions of the Model Lease, which spelled out such steps more extensively, the 2011 NCLTN Model defers more explicitly to locally applicable law. Section 12.4-a of the current Model states: “CLT may terminate this lease and initiate summary proceedings under applicable law against Homeowner, and CLT shall have all the rights and remedies consistent with such laws and resulting court orders to enter the Leased Land and Home and repossess the entire Leased Land and Home, and expel Homeowner and those claiming rights through Homeowner.”

It should be noted that, in some cases, the legal enforceability of a CLT’s right to terminate the lease in response to serious nonmonetary violations may be undermined by a lease rider or agreement with the lessee’s mortgagee (but the right to exercise a purchase option as provided in section 12.4-b may still stand, as noted below). Some financial institutions will not make leasehold mortgage loans if the terms of the lease can result in termination for nonmonetary violations. Their concern is that, although a mortgagee has the ability to cure a monetary violation, it generally does not have the ability to cure a nonmonetary violation, and could not, by that means, prevent such a violation from resulting in termination. CLT leases do, however, provide other protections for a mortgagee in such situations – including provisions denying the CLT a right to terminate the lease while a permitted mortgagee is pursuing foreclosure and, if it does terminate the lease, requiring it to enter into a new lease with the mortgagee (Sections B-4 and B-5 of the Model Exhibit). These protections should be pointed out to potential CLT leasehold mortgagees in an effort to persuade them that the CLT’s essential right to terminate a lease when important lease provisions are violated should be allowed to stand.

It should be noted that the Fannie Mae CLT Lease Rider (in Section F) prohibits “forfeiture or termination” of the lease for nonmonetary violations *except* for violations of the important occupancy and resale restrictions. It should also be noted that, although the Fannie Mae Rider does prohibit forfeiture or termination for all other types of non-monetary violations, it does not explicitly prohibit the description of these violations as "defaults" or the provision for exercise of the purchase option described in section 12.4-b of the Model as a remedy. When negotiating the terms of lease riders with other potential mortgagees, CLTs using a lease that includes such a purchase option provision should try to be sure that the language of the rider will not prevent exercise of the option in the event of a nonmonetary violation.

Some CLTs facing mortgagee prohibitions against termination for nonmonetary violations have adopted lease provisions that impose monetary penalties for these violations. To be effective, these penalties need to be large enough so that whatever benefit a lessee may gain from the violation – e.g., profit from subleasing a home for more than the lease permits – is outweighed by the cost imposed by the penalty.

Of course some types of nonmonetary violations of a CLT lease undermine the interests of the mortgagee as well as those of the CLT, and may in fact constitute defaults under the terms of the mortgage. Examples include failure to make necessary repairs to the home, or violations of building codes or other laws. A CLT that is aware of any such violations and has been unable to get the homeowner-lessee to correct them should usually consult with Permitted Mortgagees about possible courses of action that will serve the interests of both the mortgagee and the CLT.

Nonmonetary defaults by ex-lessees. Among the most serious types of lease violations that a CLT may discover – if not *the* most serious type – are those involving transfers of the home and leasehold interest in violation of the explicit restrictions on transfer (as spelled out in Article 10 of the various versions of the Model Lease). If such a violation has taken place, the CLT's recourse is obviously not a matter of terminating the rights of the party that now claims to have transferred those rights to another.

How a CLT reacts to such a situation will depend, first of all, on the details of the purported transfer. Before a CLT takes any legal action it will want to determine the facts of the matter – and in particular who the purported transferee is and what he or she knows about the ground lease. One possibility is that the ex-lessee has "sold" the home without any reference to the ground lease, so that the transferee, being unaware that the home was owned subject to a ground lease and that the seller had no authority to transfer fee simple ownership, may innocently believe that he or she did in fact purchase a fee simple interest. (It is possible in such cases that even the "seller" – perhaps an heir or executor of the original lessee's estate – was innocently unaware that the land was leased, and on terms that restricted transfers.) It should be noted, however, that such a transaction would be unlikely to involve a conventional mortgage lender, since such a lender will normally require the sort of title work that should bring to light the existence of the lease. If there is a mortgage, it is more likely that it is held by a friend or relative of the buyer.

Another possibility is that the seller has acknowledged the existence of the ground lease but has willfully deceived the buyer (and possibly a mortgagee) by forging the signature of a CLT representative on a document purporting to transfer the lease to the buyer. And, finally, it is possible that the seller has conspired with a knowing buyer to carry out an illegal transfer.

If the CLT determines that, regardless of the motives of the seller, the *buyer* had no intent to defraud and was in fact income-eligible, then the CLT will normally want to meet with that person, review the terms of the lease and determine whether the buyer understands the terms and is willing to sign a "letter of agreement" and enter into a new lease with the CLT. If the person is in fact eligible, informed, and willing to accept the terms, there may be no need for further action – unless the price paid by the buyer exceeded the purchase option price. If the price was in fact higher than the lease permitted, then the seller should be required to refund the excess amount to the buyer. (Even if the buyer was able to afford the higher price, the buyer's actual investment should be brought back down to the purchase option price at the time of transfer, which will then be the base price to be used in calculating the maximum allowable price at the time of the next resale.) If the seller will not refund the required amount willingly, the CLT will need to consult its attorney regarding the best legal means of compelling payment – perhaps through small claims court as with the collection of unpaid lease fees discussed above.

If the buyer is ineligible and/or unwilling either to accept the terms of the lease or cooperate with the CLT in otherwise resolving the situation, then the CLT must consult its attorney regarding the best way of addressing the problem in order to return the property to its intended use as an affordable home for income-qualified owner-occupants who accept the restrictions on ownership that are established in the lease.

When a CLT Is Unable to Sustain its Stewardship Functions…

The important subject of organizational sustainability is addressed in Chapter 24, with particular emphasis on the sustainability of the CLT's stewardship functions. Whereas other functions – in particular the acquisition and development of real estate – may be suspended when they cannot be sustained at a given level, a CLT's stewardship responsibilities cannot be suspended. When acquisition and development work is suspended, the amount of property for which the CLT has stewardship responsibilities will of course cease to grow, but the organization's responsibility for stewarding the property it already holds will not be diminished. Sustaining the capacity to carry out these stewardship responsibilities in the absence of development activities – thus in the absence of development fees or development-related income of any sort – can be a difficult challenge for a CLT. Chapter 24 suggests ways of coping with the situation. In reality, however, some CLTs may reach a point where they simply do not have, and are not capable of developing, the resources needed to carry out their responsibilities alone.

A CLT that is unable to fulfill its stewardship responsibilities may (or may not) be able to work out a legally defined arrangement with another institution that is better able to provide some or all of the necessary stewardship services. The possibilities for such a CLT will depend not only on the nature of the CLT's particular stewardship responsibilities and on the particular circumstances responsible for its inability to fulfill these responsibilities, but also on the availability, capacity, and willingness of another nonprofit or governmental entity operating in or near the CLT's service area. In the discussion that follows we will assume: (1) that the CLT owns real estate that does generate some level of revenue in the form of rents or ground lease fees, but that this revenue is not sufficient to cover the CLT's administrative and stewardship costs; (2) that the physical condition and net worth of the CLT's real estate portfolio is such that another entity might be willing to assume responsibility for it; and (3) that one or more such entities do exist in the CLT's locality or region. The *ultimate worst case* situation is one in which at least some of these assumptions *do not* apply – a situation in which the CLT's financial position may be such that at least some of its real estate will have to be sold to other-than-charitable entities in order to pay creditors, and/or that the CLT may have to declare bankruptcy. Parts of the discussion that follows (in particular the part dealing with dissolution) may be useful to a CLT in certain such situations, but we will not try to offer generalized advice that would be applicable for all such situations.

Types of stewardship sustainability problems. Most CLT stewardship responsibilities fall into one or the other of two broad categories: the maintenance and management of affordable rental housing, or the monitoring and support of affordable homeownership on CLT-owned land. For smaller CLTs that do hold rental housing (as a number of neighborhood-based CLTs do), the responsibilities of maintaining and managing a relatively small number of rental properties for the long term can be particularly difficult to handle. The per-unit cost of stewarding smaller numbers of rental units is great (especially in distressed neighborhoods) and may require more resources than a small CLT can command. Furthermore, the demands that rental management makes on whatever resources such organizations do have will make it difficult or impossible for them to expand their rental holdings in order to achieve economies of scale. In effect they are trapped beneath a ceiling that they cannot break through. And, being trapped this way, unable to grow, they may lose credibility and financial support.

CLTs that do not hold rental housing – those whose stewardship responsibilities are limited to monitoring resident-owned CLT homes and providing certain kinds of support for those residents – may not face the particular difficulties faced by those that do have small rental holdings. However, they may face other kinds of problems. They will not have the level of cash flow that even smaller rental programs generate, and they may therefore have more difficulty paying the staff needed to carry out the responsibilities they do have. They will also lack the mortgagable assets that a rental program entails and that a CLT may be able to borrow against when it needs to fund replacements or repairs or other long-term costs. And finally, CLTs that do not operate rental programs may be so focused on expanding the homeownership opportunities they offer that they fail to make realistic plans for carrying out the stewardship responsibilities they are accumulating, which, though less obvious than those entailed by rental management, are still substantial. Thus it is possible that even these CLTs will at some point find themselves looking for help from another institution.

Legal options. We will look at five legal processes by which a CLT may involve another institution in carrying out its stewardship responsibilities.

1. *Contract for services from another entity.*
2. *Transfer of real property assets to another entity by a CLT that will continue to exist*.
3. *Merger of with another not-for-profit corporation*
4. *Restructuring as an affiliate of another not-for-profit corporation*.
5. *Transfer of all assets to one or more entities by a CLT that will then be dissolved*.

We will review basic practical and legal considerations involved in each of these approaches. We will also note some potential advantages and disadvantages of each, though it should be emphasized that the best approach for a given CLT will depend on the particular circumstances of both the CLT and whatever other entities may be involved.

Contract for services. A CLT may be able to contract with another entity to carry out some (or perhaps most) of its necessary functions. When it is possible, this may be the simplest and most practical approach for a CLT that is struggling to manage its rental property but is capable of handling certain other responsibilities. The other entity in this case might be a CDC or other nonprofit that already has the necessary staff, equipment and record-keeping systems to manage a larger rental portfolio. Or it might be a local housing authority, or even a for-profit rental management company. For any such entity to be willing to provide rental management service to the CLT, the rental income will usually need to be sufficient to cover the institution's additional expenses (though, on a per-unit basis those expenses can be less than they would be for the CLT). That entity will also want to see that there is a source of funding to cover the capital needs of the property in question. If the CLT has not been able to accumulate sufficient reserves for this purpose, then either there must be sufficient equity in the property to allow borrowing the necessary funds or grant funding must be sought from public or charitable sources.

If the services in question are limited to rental management, then the contract with the other entity may take the form of a common type of rental management contract. In some cases, however, it may be possible for a CLT to contract for other necessary services – perhaps including administrative functions, and perhaps the monitoring of resident-owned homes – from a larger institution that is able to employ qualified, specialized staff on a cost-effective basis. The more comprehensive the terms of such a contract become, the more important it will be to have an attorney's help in addressing the many potential questions regarding who will be responsible for what and who will be liable for what. Apart from the drafting of the contract, however, the contract for services approach does not entail the kinds of legal issues relating to state agencies and the IRS that other approaches may entail.

The major advantage of this approach is that it is a relatively straightforward process through which a CLT may be able to fulfill its responsibilities while continuing as an independent organization and retaining ownership of its real estate holdings. It also has the advantage that it can be terminated, or its terms modified, if the CLT finds it is not working as intended. The major disadvantage is that, on a day-to-day basis, a separate entity is inserted between the CLT and its constituents (tenants and perhaps ground lessees) and may not be as responsive to those constituents as the CLT would like.

Transfer of real property assets by a CLT that will continue to exist. While continuing to operate as an independent organization, a CLT may transfer ownership of some or all of its real estate to one or more entities. A CLT might, for instance, transfer all of its rental property to to another entity with existing rental management capacity while continuing to own and steward land beneath owner-occupied CLT homes. Or it might choose to transfer all real property assets while continuing to operate other programs such as housing-related training programs or neighborhood planning and advocacy programs. In any transfer of property, the CLT will be concerned with seeing that the transferee has both the capacity to carry out necessary stewardship functions and a commitment to doing so for the long term.

In any such transactions, the transferee will need to accept responsibility for all mortgage debt secured by the transferred properties, and will need to agree to use the properties in accordance with the terms of any subsidies invested in them. And the holders of all such mortgages and the sources of all such subsidies will have to consent to the transfers in question. The legal work required to see that all responsibilities are formally transferred and that all necessary parties have given written consent may take time and may entail significant expense. The CLT will need to work closely with its attorney to complete the process,

The primary advantage of this approach is that, while retaining the ability to carry out certain functions such as educational, planning, and advocacy activities, the CLT is able to pass on to a more qualified institution a set of stewardship responsibilities that it does not have the capacity to carry out. The primary disadvantage is that, unless the transferee is itself a CLT with a proven track record, it will be hard to be sure of the long-term capacity and commitment of that institution (whose bylaws are unlikely to contain the kinds of permanent stewardship requirements that are typical of CLT bylaws). It should also be emphasized that the legal process entailed by this approach is much more extensive and complicated than what is entailed by a contract for services.

Merger with another not-for-profit corporation. A CLT may arrange to merge its assets, liabilities and corporate identity with those of another 501(c)(3) charitable corporation, on terms and conditions agreed to by both parties. In recent years a variety of nonprofit housing organizations have merged with others. Some of them have been relatively strong organizations seeking to gain further strength and sustainability through economies of scale. Others have been facing worst-case situations where they were unable to carry out basic stewardship responsibilities alone.

A merger effectively terminates the legal existence of one of the two corporations (the “disappearing” corporation), which is absorbed into what is deemed the “surviving” corporation, even if the terms of the merger include changing the survivor’s name. A CLT could enter into a merger as the surviving corporation, but if the CLT is a relatively weak organization merging with a stronger one it may be that the merger will mean the termination of the CLT’s corporate existence. Even in this case, however, the features of the surviving corporation – including the composition of the board of directors, officers, and staff – are matters to be negotiated and established by the parties in a written merger agreement.

For whatever plan is agreed upon, the CLT will need to identify, with its attorney, the mortgagees and subsidy sources with an interest in its properties that will need to consent to the transfer or redefinition of ownership that the merger will entail.

Unless merging with an entity that is not a 501(c)(3) charitable corporation (which would raise a number of concerns and should normally be avoided), a “disappearing” CLT may only need to notify its state’s Attorney General’s Office of the merger before the “surviving” 501(c)(3) corporation files the merger agreement with the state’s Department of State and duly notifies or reports to other state agencies as necessary. In any case a final federal 990 tax return will need to be filed for the CLT as of the time of the merger.

The merger can be a good way of addressing CLT sustainability problems when there is an appropriate organization to merge with. A merger of two CLTs serving adjacent territories, for instance, can be a way for both to increase their sustainability without substantially compromising their (presumably similar) missions. For a CLT exploring merger possibilities with a different sort of nonprofit – perhaps a more conventional sort of housing organization or CDC – one crucial question will be how willing that organization is to accommodate the CLT's mission, governance principles, and client relationships. Obviously, the more dissimilar the two organizations are the more problematic a merger will be. The task of negotiating and implementing any merger will necessarily require much work and much time. It is also likely to involve some painful personnel decisions as the two organizations become one.

Restructuring as an affiliate of another not-for-profit corporation. While retaining a separate identity and board of directors, a CLT may be restructured (under new or revised bylaws) to give another nonprofit corporation some degree of control over it. The most extreme form of restructuring can establish the other organization as the sole "member" of the CLT with the right to appoint all members of the CLT's board – the CLT thus becoming, in effect, a "subsidiary" of the other organization. Classic CLTs, with their very different and distinctive membership structures, will normally want to resist giving up this much control over their board composition. However, a CLT that has stopped growing, and therefore no longer experiences the excitement of new projects, can find it difficult to sustain enough energy at the board level to support effective governance. This sort of loss of momentum can be self-perpetuating. At a certain point, a subsidiary relationship with a stronger organization may be the best way for such a CLT to see that necessary stewardship activities will continue to be carried out.

For CLTs less in need of a major infusion of new leadership, a less extreme form of restructuring may be appropriate. In such cases another organization may be given a certain number of seats (ranging from one to a majority) on the CLT's board while other seats continue to be reserved for constituent-elected representatives.

Any form of structural affiliation can be accompanied by a contract for services, as discussed above, so that the other organization can provide a significant degree of staff support to the CLT – and can thereby have a significant degree of control in the hiring and supervision of staff as well as in the selection of board members.

Of course there are also other potentially important forms of affiliation that do not involve any degree of subordination of one organization to another but that provide a formal mechanism for collaboration and mutual support. Local community development alliances and regional networks are examples of this kind of affiliation.

Dissolution with distribution of all assets. This approach will involve all of the actions and issues noted above for a CLT that will transfer some major assets but will continue to exist, plus the actions and issues involved in dissolving the CLT corporation. It can be a reasonably satisfactory response to an unsustainable situation when there is at least one nonprofit or governmental entity that will take ownership of the CLT's housing assets and will have the capacity to steward them in keeping with the CLT's original intent. In the absence of such entities, the situation is indeed a worst case – a situation in which the CLT must focus on distributing its assets in a way that will do as little harm as possible to residents, funders, and other affected parties.

Needless to say, if a CLT is to be dissolved, all of its assets *must* be transferred to someone or some entity. For a CLT that is forced to plan the distributions of its assets, it is important, first of all, to be clear about what is required and what is permitted by (a) federal law for 501(c)(3) organizations, (b) the CLT's own bylaws, (c) the ground leases for owner-occupied homes on CLT land, (d) subsidy sources, and (e) state laws re. corporate dissolution.

- *501(c)(3) requirements.* For a nonprofit corporation to qualify for 501(c)(3) status, its articles of incorporation must state that in the event of dissolution all of its remaining assets, after payment of all expenses, shall be distributed to another 501(c)(3) organization or a government entity. This does *not* mean, however, that CLT property – including CLT land – cannot be sold to other types of buyers as the CLT prepares for dissolution. As far as the tax code is concerned, the land beneath a CLT homeowner's home can be sold to the homeowner, for a below-market price if the sale serves the charitable purpose of the overall homeownership program, or, otherwise, for a market price. In fact, the land, as well as other assets, may be sold to *any* party for a *market* price, with the proceeds then being used to pay the organization's debts and with any remaining proceeds distributed to another 501(c)(3) or government entity.
- *CLT bylaws.* Bylaws vary, so be sure you know exactly what your CLT's bylaws say about the sale of land and the dissolution of the corporation. Bylaws based on the "Model Classic CLT Bylaws" presented in Chapter 5-A call for a special process to authorize any sale of CLT land. Article VI, section 3, of the Model states: "The sale of land does not conform with the philosophy and purposes of the Corporation. Accordingly, land shall not be sold except in extraordinary circumstances, and then only in accordance with the following guidelines." The guidelines require approval by at least two thirds of the *entire* board of directors *and* two thirds of the members in a membership meeting at which a quorum has been assembled." Article IX of the Model requires the same two-thirds approval by board and membership for a decision to dissolve the corporation. It is possible that a badly weakened and perhaps paralyzed organization will find it difficult if not impossible to assemble the necessary numbers of directors and members to achieve approvals on these terms. In such a case you should consult your attorney regarding possible alternative means of proceeding under the laws of your state.
- *Ground lease requirements.* Section 3.3 of the Model CLT Lease contains two provisions that provide crucial protection for the homeowner in any situation where the leased land is to be transferred. First, the section states, "If ownership of the Leased Land is ever transferred … to any other person or institution, this Lease shall not cease, but shall remain binding on the new land owner as well as the Homeowner." Secondly, the section states that, "if the CLT agrees to transfer the Leased Land to any person or institution other than a non-profit corporation, charitable trust, government agency or other similar institution…, the Homeowner shall have a right of first refusal to purchase the Leased Land" for the price agreed upon between the CLT and the third party. Note, however, that nothing in the lease prohibits a CLT in this situation from offering the land directly to the Homeowner for any price.
- *Funder requirements.* It is common for CLTs to enter into written agreements with the sources of subsidies (whether the subsidy is structured as a grant or deferred loan). If the CLT ever seeks to transfer ownership of subsidized property (or otherwise fails to comply with the terms of a funder agreement), the subsidy source commonly has a claim either on the dollar amount of the subsidy or on the

subsidized property itself. A CLT contemplating dissolution should meet with such funders, should determine exactly what requirements will apply to the distribution of property subsidized by each funder, and should seek approval for any planned distribution of subsidized property to other parties subject to the subsidy agreement.

- *State legal requirements.* State laws regarding corporate dissolution vary in their details, and the guidance of a local attorney will be essential. Before taking any steps, the CLT should gain a clear understanding of exactly what steps must be taken, with what state agencies, in what order. In most states, an organization pursuing dissolution will need to notify its state's Attorney General's Office and get a written waiver of objections to its plan for liquidating and distributing its assets before notifying its creditors of its plan to do so (but should discuss the plan with subsidy sources *before* notifying the AG's office). In completing the process, the organization will typically also need to deal with its state's Department of State and perhaps other state agencies involved in overseeing tax-exempt organizations. And finally the CLT must disclose its dissolution to the IRS by filing its final 990 report.

In some cases it may be possible for a CLT to turn over all of its assets to a single nonprofit or governmental entity that will be capable of employing the CLT's real estate and other assets in ways consistent with the CLT's mission. When the recipient is a nonprofit the arrangement could be quite similar to a merger in which the CLT is the "disappearing corporation." In such case, the CLT may try to negotiate an agreement whereby the recipient nonprofit will appoint some of the CLT's directors to its board and/or hire some of the CLT's staff.

It is also possible that a CLT may distribute its assets to two or more nonprofit or governmental entities – for instance transferring rental properties to a municipal housing authority or nonprofit rental program while transferring land beneath owner-occupied homes to a separate governmental or nonprofit homeownership program. In such cases the CLT will probably want, after paying all debts, to distribute any remaining current assets to one or more of the recipients of the CLT's real estate to help support ongoing stewardship functions.

Research and due diligence re. potential partners or transferees. Organizations that are struggling to survive may not have the time and resources needed to perform all of the research and document reviews that would ideally be called for. Nonetheless, a CLT that is considering turning over significant property and/or control to another organization must do all that it possibly can to be sure that the organization really has the capacity to provide what the CLT is seeking. Even if the CLT has known, and perhaps worked with, the other organization for many years, it should check a number of things methodically, and with professional help where appropriate and possible.

Up-to-date financial reports will of course be crucial. The CLT should ask the organization for both audited financial reports and copies of federal 990 reports for recent years, as well as internal reports covering whatever time has elapsed since the most recent audit. If the CLT does not have enough financial expertise among its own personnel to complete a meaningful analysis of these documents, it should seek help from someone outside the CLT, such as someone with experience as CFO of a another nonprofit housing program. Depending on the nature of the organization's programs and on what questions are raised by the basic financial reports, the CLT should be prepared to ask for more detailed financial information in certain areas (e.g. financial performance of rental properties). Today's accounting software usually makes it possible to generate a number of specialized reports when they are asked for. The goal in a financial review of this sort is not only to gather essential information but to gauge the organization's ability to understand and manage its own finances.

Knowledge of the organization's personnel is also crucially important. The CLT should request an up-to-date board list (which can also be found in the 990), and if a significant number of board members are not known to at least a few CLT personnel, then the CLT should make an effort to meet as many members as possible. The qualifications of the organization's staff are even more important. If staff are not already known to CLT personnel, a meeting or meetings should be arranged. And resumes should be requested.

Equally important will be first-hand observation of the current condition of real estate that the organization owns and/or manages or otherwise stewards. In the case of any rental housing that the organization manages, the CLT should ask to see the interior as well as exterior of at least some buildings.

Due diligence should also include a review of the following.

- Corporate documents (articles of incorporation, bylaws, and any amendments to either).
- Minutes for board and membership meetings for at least the past year (with attention to whether meetings are held and decisions are made in compliance with the organization's bylaws)
- Evidence of tax status (application for 501(c)(3) status, IRS determination letter, and recent 990 reports).
- Grant and loan agreements (with attention to restrictions and conditions).
- Reports to grantors.
- Insurance policies.