City of Palo Alto
City Manager's Report

TO: HONORABLE CITY COUNCIL
FROM: CITY MANAGER
DATE: MAY 7, 2007

SUBJECT: PRESERVATION OF THE BELOW MARKET RATE UNIT AT 502 THAIN WAY IN BARRON SQUARE: 1) APPROVAL OF THE CITY’S ACQUISITION OF 502 THAIN WAY FOR THE PURPOSE OF RESALE TO A NEW BMR BUYER; AND 2) AUTHORIZATION FOR A DEFERRED PAYMENT LOAN FOR REPAIRS AND RENOVATION

RECOMMENDATION
Staff recommends that the City Council:
1. Authorize the acquisition by the City of the Below Market Rate (BMR) unit located at 502 Thain Way (Barron Square) for the purpose of preservation and resale as a BMR unit; and
2. Authorize a deferred payment loan of up to $45,000 from the City to the buyer for repairs and renovation; and
3. Direct the City Manager, or his designee, to execute all documents and deeds necessary to complete the purchase, resale and the renovation loan.

BACKGROUND
502 Thain Way is one of six, one-bedroom BMRs in the 30-unit Barron Square condominiums located at Maybell Avenue and El Camino Real. The unit was built in 1979, and, at 28 years old, is one of the oldest units in the BMR program. The six BMR units are located together in one building with two similar market rate units. The Barron Square complex buildings are wood shingled and the setting is attractive with many trees and amenities such as tennis courts, a pool and a community building. With about 750 square feet of living space and large patios or decks, the six BMRs are fairly spacious compared to one-bedroom BMR units in other developments.

Like many other BMR units that come up for resale, especially those that have never changed owners or have been through probate, 502 Thain Way shows poorly: the carpets are dirty and worn; the walls and paint are dingy; the appliances are 30-years old; and the cabinets, sinks and counter tops are worn and dated. Sellers are very reluctant or lack the funds or expertise to get repairs done, replace carpets or do painting to make the units more attractive. In addition, the deed restrictions place only very limited obligations on sellers for the condition of units at resale. Few potential buyers on the City’s waiting list are interested in units in this kind of condition. If there are any potentially serious
problems, finding a buyer is problematic. Many BMR buyers utilize all their assets to purchase a BMR unit and need to move in immediately after closing. Remodeling the unit is not an option. Furthermore, as first time buyers who have been renters for years, they lack the skills and funds to undertake remodeling.

To improve the livability of resale units and to get old appliances replaced when a sale occurs, staff has increased the unit's resale price by an estimated amount for modest improvements. These funds are deducted from the seller's proceeds and held in escrow, together with any seller payments for deferred maintenance such as re-painting. The buyer is required to purchase and install any improvements and complete any deferred maintenance within 60 days of the escrow closing. Upon completion of the work, the funds are then released by escrow to the buyer. This system works since the buyer's natural motivation is to fix up this new home, but it can only be used for improvements that can be installed easily and quickly. It is not feasible for work that requires hiring a general contractor or that will take over 60 days because the escrow companies will not agree to complex arrangements.

DISCUSSION

502 Thain Way’s first, and original, owner passed away after a long illness in late 2004. Due to issues with her will, the probate process extended for one and a half years and it was not until June 21, 2006 that the City received a notice to sell, thus commencing the BMR resale process. For a variety of reasons, this resale has been burdened with delays and difficulties and it is now ten months since the notice to sell was received by the City. The City has identified a qualified buyer for the property. However, due to the poor condition of this unit, which includes problems with moisture intrusion, the prospective buyer is unwilling to sign a contract without contingencies. The heir is unwilling to agree to the contingencies. To ensure that the deed restrictions remain enforceable and the unit can be resold as a BMR unit, the City needs to step in, execute a purchase contract with the City as the buyer, and close the transaction with the heir before May 27th. The City will then enter into a purchase contract with the prospective buyer that includes his inspection contingencies and the offer of a renovation loan.

The BMR deed restrictions specify a 60 day period from receipt of an owner’s notice to sell for the City to exercise its right to purchase and then a 90 day period for the buyer to be selected, financing secured and escrow closed. For any BMR unit in good condition, there are many ready and willing qualified buyers on the waiting list. Currently there are about 180 potential buyers for one-bedroom units. Normally, the deadlines in the deed restrictions can be met, providing all parties (seller, buyer, City and PAHC) carry out their responsibilities quickly and in good faith. In this case, the City had to exercise its purchase right at the end of the 60 day time limit on August 21, 2006. This occurred even though the unit was still not ready to show to buyers and no agreement had been reached by the seller and the City Real Estate Division staff on the valuation of capital improvements claimed by the seller and deductions for deferred maintenance. Normally, marketing to the waiting list should be underway within the first 60 days, but that cannot occur until the resale price is set. In this case, it was not until late September that the final resale price was set and not until November 18 that the open house was held for the waiting list.

Even though Barron Square BMR units usually sell easily, there were few applicants for this property as a result of its poor appearance and obvious need for renovation and repairs. While the unit has
had a few significant improvements, such as new doubled paneled windows, the bath remodeling was poorly done and general maintenance was neglected. Due to the holiday season and the serious illness of the BMR administrator at PAHC, it was mid-January before an initial buyer was under contract for the unit. That buyer cancelled her contract two weeks later after reviewing letters in the property file regarding past problems with water leaks and mildew reported by the original owner in 1982. She was not willing to purchase the unit after she found that the homeowners’ association could not provide her with any records to verify that these past problems had been corrected.

Planning and PAHC staff then began working with the next buyer in line. To ensure that the buyer was fully informed prior to signing the purchase contract, additional time was provided for him to visit the unit again and examine the property file records that had caused the previous buyer to reject the unit. In order to minimize his risks in purchasing this unit, Planning also offered to reimburse the buyer for the costs of a full professional property inspection and a mold inspection with limited mold testing (up to $1,500 total). Additionally, Planning staff offered to request Council authorization for a deferred payment loan of up to $45,000 for the complete renovation, repair and updating of this unit.

Price Calculation for Sale by Current Owner: The original purchase price of 502 Thain Way in 1979 was $28,000. With the full CPI appreciation rate that was allowed in 1979, the $108,900 resale price includes $57,400 in appreciation for the seller. There is no mortgage on the property. The City is allowing the owner to recover $11,686 for the depreciated value capital improvements that were completed (electrical work, new windows and a new Jacuzzi bathtub) plus the full $8,826 she paid for a 2002 homeowner’s special assessment. $1,000 is to be deducted from the seller’s proceeds to pay for the estimated cost of interior painting and $3,000 has been added to the resale price to reimburse the buyer for the estimated cost for new carpets and kitchen appliances. The sum of these various additions and deductions results in a total purchase price of $108,900, with the seller receiving proceeds of $104,900 less the seller’s closing costs.

The $108,900 will be repaid to the City when the unit is sold. This was the purchase price the prospective buyer was offered last year when he submitted his application to PAHC to buy the property. The renovation loan will be eventually repaid the next time the unit is resold. The City’s other costs will not be recouped because to do so would require the prospective buyer to seek a large purchase loan, which he probably could not afford.

Risks for City: There are some uncertainties and risks with the City acquiring any BMR unit. Staff will require a title report and title insurance and the seller will be required to remove any liens, pay property taxes and HOA dues to the date of closing and transfer clear title to the City. In this situation, there are two main concerns for both the City and the new buyer: 1) whether there is any significant problem with indoor air quality from current or past water leaks and moisture; and 2) whether the HOA and its management company can be induced to quickly and effectively complete repairs to stop any current leaks and prevent future ones. To address and minimize these risks, the City is requiring the buyer to conduct a full set of inspections including initial mold testing. Further mold testing could be undertaken if that seems prudent. Copies of all reports and test results done must be provided to the City. If there is a major indoor air quality problem that would be very costly to correct, then staff will return to Council for direction on how to proceed.
RESOURCE IMPACT
Funds are available and budgeted in the BMR Emergency Fund (BMR Fund) for costs to preserve BMR units; there is currently an available budget of $380,300. The BMR Fund will be used to pay all costs related to the preservation of the 502 Thain Way unit, including the purchase price, the renovation loan, holding and closing costs and the potential cost of Menlo Park’s services. The $108,900 proceeds from the unit’s resale will be deposited back into the BMR Emergency Fund to be immediately available for any future needs related to the preservation of BMR ownership units. The buyer will execute a note and deed of trust in favor of the City for the renovation loan.

Renovation Loan Terms and Repayment: The loan is proposed to be offered at no interest and the buyer will be able to accumulate appreciation at the current one-third of CPI formula on the total of the purchase price and the loan amount as an incentive for the buyer to undertake purchase and renovation of a problem property. The note will only accrue interest if the buyer breaches the rules and restrictions of the BMR program such as if there is a default or an uncured and continual violation of the deed restrictions such as rental of the unit. Otherwise, the loan is only due on the sale, transfer or refinance of the property. In the event of a hardship, in which the BMR program goals would be better served by allowing an assumption of the loan (for example a transfer of title to an eligible person approved by the City), the City Manager could waive the repayment requirement and allow an assumption of the loan.

BMR Emergency Fund: Council authorized the BMR Emergency Fund (BMR Fund) in September 2002 as a housing program special revenue fund to clearly identify and set aside funding within each annual budget for the sole purpose of preserving the City’s 179 units of BMR ownership housing stock. This fund has been used for the City to acquire units threatened by foreclosure or to settle litigation and facilitate the resale to a qualified BMR buyer. A secondary purpose of the fund has been to provide deferred payment loans to extremely low-income BMR owners subject to special capital assessments from their homeowner’s association. The BMR Fund does not have its own revenue source; rather, it has been funded by transfers from the Residential Housing Fund, which in turn is primarily composed of BMR in-lieu fees from housing developers.

POLICY IMPLICATIONS
These actions do not represent any change to existing City policies. However, staff believes that there is a definite need for some type of limited loan program that could be available in similar situations in the future. Staff intends to develop and bring to Council in the spring, a loan program of a very limited nature only for units that are difficult to sell at the time of resale due to their condition. There is not sufficient City staff capacity to oversee a more extensive program, even with outside contract assistance.

TIMELINE
After approval by Council, a purchase contract will be prepared and executed with the City as the buyer without any contingencies other than City review and acceptance of a preliminary title report. The closing date will be Friday, May 25, 2007. The City will request that the seller grant permission to allow the inspections and testing to get underway prior to close of escrow and to permit the City to assign the purchase contract to the prospective buyer, should he be ready to assume ownership by the closing date instead of the City.
However, it is more likely that the City will need to close the escrow, expend the funds for the purchase price and become the owner. The City will then immediately enter into a purchase contract with the prospective buyer which will include his contingencies for inspections and testing with reasonable time deadlines for completion, review of the reports and closing of the escrow. Once the unit has been transferred to the new BMR owner, a work write-up for the renovations will be completed and the work put out to bid to general contractors. After a bid has been for the work and a construction contract has been prepared, loan documents for the City’s renovation loan will be signed and a deed of trust recorded to secure the City’s loan. At that point, the City will authorize the release of the $4,000 in repairs funds from the escrow. While these funds were intended for painting and appliances, the purpose of releasing them at the beginning of the renovation is to give the prospective buyer cash to front payments to the contractor pending disbursements of the City loan.

ENVIRONMENTAL REVIEW
The provision of City funds to preserve a single-family ownership unit as affordable housing is categorically exempt under Section 15326 of the California Environmental Quality Act (CEQA).

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