

PUBLICATION

HUD Proposes Expanding Indebtedness Eligible for Refinancing with FHA-Insured Loans

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The U.S. Department of Housing and Urban Development (HUD) recently published proposed revisions to its Handbook covering its Healthcare Insurance Mortgage Program under Section 232 of the National Housing Act (the Section 232 Handbook). Of particular note in these revisions are proposed changes to Chapter 3 of Section II that expand the indebtedness and related costs eligible to be refinanced with an FHA-insured loan. Three of the most significant of those proposed changes are outlined below.

Eligibility of Prior Indebtedness Used for Equity Distributions

Section 232/223(f) of the National Housing Act (the Act) permits refinancing of existing residential care facility indebtedness with an FHA-insured loan. Section 223(f)(4)(B) of the Act requires that residential care facility borrowers use 100% of the proceeds of any Section 232/223(f) refinancing loan solely to retire the existing indebtedness and pay the related costs.

HUD has never allowed Section 232/223(f) refinancing of existing indebtedness that a borrower used for an equity distribution within the two-year period prior to the date of the Section 232/223(f) loan application. HUD's stated basis for this rule is to allow a period of time for a project to demonstrate its ability to generate sufficient cash flow to support its value and pay debt service. However, the effect of this rule has been to impose a two-year waiting period that has arbitrarily prevented some residential care facilities from receiving the benefits of the low fixed rates of FHA-insured financing, even if they have more than sufficient value to support the loan amount.

In order to encourage more widespread use of the Section 232/223(f) program, HUD is now allowing certain exceptions to this "two-year rule." Under the proposed revisions, HUD would allow a borrower's application for a Section 232/223(f) loan within two years after the borrower used the existing indebtedness for an equity distribution, but only under the following two circumstances:

(1) If (a) greater than 50% of the existing indebtedness was used for project purposes (*i.e.*, not for an equity distribution), and (b) the requested FHA-insured loan would have a loan-to-value (LTV) equal to or less than 70%; or

(2) If (a) less than 50% of the existing indebtedness was used for project purposes, and (b) the requested FHA-insured loan would have an LTV equal to or less than 60%.

HUD normally permits FHA-insured loans under Section 232/223(f) to have LTVs as high as 85% for for-profit borrowers and 90% for nonprofit borrowers. The effect of these changes is to allow the earlier refinancing of equity take-out loans for projects with a lower LTV in recognition of the demonstrated financial strength of these projects.

Eligibility of Licensed Operator Indebtedness

HUD's proposed revisions also provide that a licensed operator's debt would be eligible to be refinanced under Section 232/223(f) so long as the debt was used for project-related costs as supported by documentation satisfactory to HUD (*i.e.*, costs for the purchase of additional furniture fixtures and equipment, working capital related to lease-up and stabilization of the project, and other capital expenditures). Until now, only debt of the real estate owner and not of the licensed operator was technically eligible for refinancing with a Section 232/223(f) loan.

Eligibility of Certain Defeasance Costs

In another proposed change, HUD would allow Section 232/223(f) refinancing of defeasance costs associated with underlying bond financing, yield maintenance, swap termination fees, or costs to satisfy similar derivative instruments, up to 10% of the requested loan amount. Given the current interest rate environment, this change may benefit prospective borrowers whose prior high-interest rate debt contained yield maintenance payments or required interest rate swap contracts because those costs and fees may be quite high. The inability to have those costs and fees reimbursed by the proceeds of an FHA-insured loan was a significant barrier to the ability of a borrower to enjoy the lower rates of FHA-insured loans. It is important to note that HUD would continue its prohibition on allowing refinancing of penalties arising from the defeasance of tax-exempt and taxable bonds.

These are only a few of the most significant proposed changes to the Section 232 Handbook. Comments are due from the public no later than June 1, 2016.

If you have any questions about the proposed Section 232 Handbook revisions or HUD's Section 232 program, please contact Jim Levine or any of the attorneys in Baker Donelson's Long Term Care Group.