PUBLICATION

HUD Issues Proposed Amendments to Regulations Governing Insurance of Health Care Facility Loans

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Under Section 232 of the National Housing Act, the U.S. Department of Housing and Urban Development (HUD) provides certain qualified lenders with insurance against loss on defaults under loans to nursing homes and assisted living facilities. This program gives owners of these facilities access to low-interest, fixed rate loans backed by the full faith and credit of the United States government. Today, the interest rates on these loans are hovering at close to three percent for terms as long as 40 years. Because financing for long term care facilities on such beneficial terms is unavailable from any other source, large numbers of nursing homes and assisted living facilities are taking advantage of HUD's Section 232 program for construction, substantial rehabilitation, acquisition or refinancing.

On May 3, 2012, HUD issued proposed rules that would amend its regulations governing insurance of health care facility loans under Section 232. This is the first time HUD has amended these regulations since 1996. HUD's reason for the amendments is to "reflect existing practices in financing and refinancing healthcare facilities, and to decrease risk to the program due to outdated regulations and the need for greater accountability by healthcare facility operators."

One of the most significant changes that HUD is making in the proposed rules is the addition of a requirement that all borrowers maintain a long-term debt service reserve account during the life of the loan. The amount that would be required to be maintained in that account would be determined in the loan underwriting process. HUD would only allow facility operators to take distributions if the debt service reserve accounts maintain funding at their required minimum levels.

The proposed rules loosen up the restrictions on distributions made by borrowers. Instead of restricting distributions to annual or semi-annual distributions with the consent of HUD, as is currently the rule, the proposed rules permit more frequent distributions so long as borrowers can demonstrate positive surplus cash in their financial reports. From a practical perspective, this change will not have much of an impact on facilities in which the real estate is owned by a separate entity and leased to the operator because these restrictions only apply to the borrowing entity. (In HUD-insured financing, the real estate owner is the only borrower, and the operator is not required to be a borrower if different from the real estate owner.) However, for facilities owned and operated by the same entity, this is positive news.

Under the proposed rules, any principal of an entity that is the borrower under a HUD-insured loan will not be permitted to receive a salary or any payment of funds derived from the operation of the facility, other than permissible distributions. In addition, any person in violation of this rule (or any provisions of the regulatory agreements executed in connection with a HUD-insured loan) would be subject to double damage penalties.

Another big change is that HUD would require all operators to be single asset entities without a specific waiver from HUD. This means that a licensed operator of a facility with HUD-insured financing would not be able to operate any other facilities. Operators of multiple facilities would, therefore, need to go through a re-licensing process for the HUD facility or their other facilities in order to assure that the operator of the HUD facility only operates that single facility. In addition, the new rules would not permit a facility operator to commingle funds attributable to a HUD facility with funds attributable to other facilities or businesses. Centralized accounting

systems involving funds of HUD projects would require prior HUD approval and must clearly delineate which portion of funds in an account are attributable to a particular facility.

With respect to financial statement reporting, HUD would continue to require borrowers to provide audited financials within 90 days after the end of the fiscal year. HUD would also continue its policy of not requiring that the financial reports of operators be audited, but HUD has proposed increasing the frequency of providing certified financial reports to quarterly instead of annually.

The proposed rules eliminate the requirement for HUD REAC (Real Estate Assessment Center) inspections for skilled nursing facilities that are routinely surveyed pursuant to Medicare or Medicaid regulations, unless there are special circumstances in which HUD determines that an inspection is necessary to assure adequate protection of the residents or preservation of its collateral. REAC inspections for assisted living facilities would also be eliminated if it were determined that the applicable state and local governments have a reliable and adequate inspection system in place.

If you have questions or would like to discuss the issues described above with one of our attorneys, please contact your Baker Donelson attorney.