PUBLICATION

New HUD Guidance for Long Term Care Industry

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Overview

On April 25, 2014, HUD issued a new Mortgagee Letter (Mortgagee Letter 2014-06) that implements revised policies with respect to master leases and portfolios for HUD-insured financing of long term care facilities. This letter fills in gaps and offers additional guidance to pressing questions that have been raised by lenders and borrowers in connection with portfolio health care financing with HUD.

Changes in Portfolio Classifications

The new Mortgagee Letter offers new guidance on HUD's portfolio processing and credit requirements. The size of portfolios considered to be "small" portfolios (and thus not requiring portfolio corporate credit review) is dramatically larger. Now, small portfolios can include up to 49 facilities with an aggregate mortgage amount of not more than $90 million, up from 10 facilities with an aggregate loan amount of not more than $75 million. If the aggregate mortgage amount reaches amounts greater than $90 million, then a portfolio of 49 facilities or less is considered to be a midsized portfolio so long as the aggregate loan amount remains less than or equal to $250 million. The definition of large portfolios remains the same: 50 or more facilities and/or an aggregate loan amount of over $250 million. However, large portfolios are now capped in size to not more than five percent of the current unpaid principal balance of HUD's entire portfolio of active 232 loans, protecting the overall viability of the Section 232 program.

In addition, the new Mortgagee Letter states that in determining what projects to include in a portfolio, HUD will consider projects submitted within a window that begins on the submission date of the application for the first loan and ends 18 months following the submission date for the last facility in the portfolio. This effectively lengthens the window set forth in prior guidance.

HUD's Rationale for Master Leases

The new Mortgagee Letter states the primary reason for the master lease requirement: to tie together multiple facilities with the same ownership so that revenue from each facility is available to support the other facilities within the portfolio. HUD expressly acknowledges that its purpose is to prevent defaults and thus that there should be a reasonable time to correct deficiencies and cure defaults before defaults are triggered. This assurance may be of comfort to some borrowers that may be reluctant to enter into the master lease. In addition, HUD recognizes that future projects may be added to or removed from a master lease, and thus has determined that the loan documents should contemplate amendments to add future HUD-financed facilities or remove facilities.

The new Mortgagee Letter reiterates HUD's long-held position that each project stands alone, as a single underwritten loan. Portfolios cannot be used to obtain financing for one or more poorly performing facilities by combining them into a portfolio with enough profitable facilities to cover their losses. Each facility must, standing alone, qualify for Section 232 financing.

HUD opens the door to possible waivers of the master lease if it is difficult to implement due to reasons such as a unique state law or excessively onerous asset transfer taxes, but in such event, HUD will likely demand an alternative structure that achieves similar protections for HUD.

Master Lease Structure Changes

Multiple Minority Owners. The new Mortgagee Letter provides guidance in situation where a portfolio of facilities have a common majority owner but have different minority investor. (For example, Investor A owns five percent of Project A but no interest in Project B, and Investor B owns 10 percent of Project B and no interest in Project A.) HUD recognizes that it is unfair to expect that Investor A's interest in cash from Project A would be subject to loss if needed to support losses at Project B. Thus, HUD now requires in this situation that the majority owner pledge its profits from each project to all projects under the master lease, and further requires that if the majority owner acquires additional interest by acquisition from the minority owner, the amount of financial support needs to increase, but will require individual minority owners to pledge only their interest in cash from the project in which it is an investor. This seems sensible in principle, but negotiation of the actual detailed transaction structure may be challenging. HUD recognizes that it will need to be creative to address situations with multiple minority owners.

Multiple Operators. HUD addresses the situation facing REITs that may acquire health care projects from different owners and have multiple projects leased and operated by multiple unrelated operators. Recognizing that a single master lease is not feasible with multiple operators, HUD now allows separate leases/master leases for each operator so long as the majority ownership group of the borrowers pledge profits from each master lease to support all of the projects. HUD suggests a "master landlord" structure to accomplish this goal. Further thought is needed however as to the details behind this structure, and borrowers and lenders will need to work together with HUD in order to craft a structure which meets HUD's stated goal.

Multiple Lenders. HUD recognizes that borrowers may need to have the ability to select multiple lenders for projects in a borrower's portfolio, and it now acknowledges that the borrower can use separate master leases for each lender's projects. This is a big improvement, as in the past it has been unclear whether separate master leases are permitted. It turns out, however, that this is not quite as simple as allowing multiple master leases. The new HUD guidance goes on to propose a multiple lender structure that would require a cross default provision that might allow a default under one master lease to trigger a default under all master leases if the borrower did not support the defaulted facility loan. This may be problematic to negotiate, as we can expect lenders to be resistant to any provision that would risk a default in its loans due to another lender's financed portfolio. Further work will be needed to work through issues with HUD and create a solution that works for all parties.

Conclusion

With this most recent guidance, the long term care industry has received some much-needed help in sorting through the challenging issues that have been arising in the HUD portfolio and master lease areas. However, questions still remain, and the negotiation of actual documents will prove to be an interesting exercise in the coming months.