

PUBLICATION

HUD Helps Clear Confusion in Loans to the Long Term Care Industry

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Overview - New Guidance from HUD. By now, long term care project owners are very aware of the advantages of HUD-insured financing. However, HUD's program policies continue to challenge some providers who own and/or operate multiple facilities.

On April 25, 2014, HUD helped clear up some confusion with its new Mortgagee Letter, which offered additional guidance on some questions raised by lenders and borrowers in connection with portfolio health care financing.

HUD's Rationale for Master Leases Restated and Explained. HUD clarified its reasons for its long-standing policy that requires master leases for groups of projects under common ownership or operation - 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 its purpose is to prevent defaults under the mortgages it insures. Thus, HUD agrees, and in this Mortgagee Letter has clarified, that project owners need a reasonable time to correct deficiencies and cure defaults before mortgage defaults are triggered. This offers comfort to some borrowers who may otherwise be reluctant to enter into the master lease.

In addition, HUD now expressly recognizes that future projects may be added to or removed from a master lease, and the new guidance states that the loan documents should contemplate amendments to add future HUD-financed facilities or remove facilities. This is a significant clarification and an endorsement of lenders' inclusion of provisions similar to partial release provisions in conventional financing.

The new guidance from HUD additionally reminds the long term care financing community that despite inclusion of multiple projects within the same master lease, each project stands alone, as a single underwritten loan, and must qualify, standing alone, for Section 232 financing. A poor project that would otherwise not qualify may not be financed under Section 232 by adding it into a portfolio of other very strong projects. This is not new, but it bears remembering.

Master Leases - HUD Guidance on Structural Issues. What may be most interesting is that HUD has finally weighed in on some significant structural issues that have caused many practitioners much anguish and confusion. In this author's opinion, we should view these new guidelines as very productive first steps, but not necessarily the final conclusion in every respect.

Multiple Minority Owners. Here, a portfolio of facilities with common majority ownership has different minority investors in each project (For example, Investor A owns 5 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 usable to support losses at Project B. HUD's guidance will now permit the minority interest to be free from the pledge so long as the majority owner's profits from each project are available to support all projects under the master lease. While simple in principle, negotiation of the actual detailed transaction structure may be challenging, and HUD recognizes that it will need to be creative to address situations with multiple minority owners.

Multiple Operators. This is the situation facing some real estate investment trusts (REITs). A REIT may acquire health care projects from different owners and thus have projects leased and operated by multiple unrelated operators, while the ownership interests remain aligned within the same REIT-affiliated group. Standard HUD policy requires that projects under common ownership be financed within the same master lease portfolio. However, if the operators are not affiliated with one another, a cross guaranty of sublease obligations, which is the heart of a HUD master lease, is not going to be palatable to them. With the new guidance, HUD recognizes that a single master lease is not feasible and will allow separate leases/master leases for each operator or affiliated operator group so long as the majority ownership group pledges profits from each master lease to support all of the projects. HUD suggests a "master landlord" structure would be used to create this overall pledge across the master leases. Borrowers and lenders will need to work together with HUD in order to craft a structure; however, this author retains some doubt as to the practicality of a master landlord concept. There may be alternatives to a master landlord that will fit into the program requirements, such as a pledge by the affiliated owner of surplus cash or the establishment of a reserve from surplus cash that will give HUD the protection of financial responsibility across the portfolio.

Multiple Lenders. HUD recognizes that a borrower may need or want to select different lenders for projects in its portfolio. Before the current letter, it was unclear whether future projects financed by a new FHA lender must be added to the owner's pre-existing master lease portfolio with its prior lender. HUD now acknowledges that the borrower can use separate master leases for each lender, so long as an uncured default under one master lease will trigger a default under all master leases. This could be very problematic for lenders. While a pledge of surplus cash accounts may be a workable solution, it is clear that borrowers and lenders will need to work with HUD to create a solution that works for all parties.

Conclusion. With this most recent guidance we have received some much-needed help in sorting through the challenging issues in the HUD master lease portfolios, but questions still remain, and the negotiation of actual documents may prove interesting in the days ahead.