Portfolio Media, Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@portfoliomedia.com

HUD-Insured Financing For Long-Term Care Facilities

Law360, New York (May 18, 2010) -- As the traditional saying goes, money is honey, but health is wealth. Few of us would dispute that good health is of paramount importance, especially as all of us expect to live longer lives than those of previous generations. This is reflected in the fact that health care has become an enormous portion of our total economy.

Long-term care services, consisting of nursing homes, assisted living facilities and other institutions serving the needs of patients requiring long-term health care, account for approximately 10 percent of total U.S. health care expenditures.

As the population of elderly Americans continues to grow in the future, there will be an increased need for long-term care facilities to care for the infirm among them.

Funding Growth

The purpose of this article is to provide a brief overview of government insured health care financing available to owners of long-term care facilities.

As we know, commercial bank loans and other private sources of financing have become scarcer, and when found, have terms ranging from the merely onerous to the downright unacceptable.

To make matters worse, the maturities of commercial financing are relatively short, so in a few years one must go back and refinance again. Long-term care borrowers are experts in patient care, not financing, and periodic refinancing efforts drain time and funds away from the primary goal of patient care.

While current indications are that there may be an easing of the financing market in the future, it is safe to assume that it may be some time before owners of long-term care facilities will be able to obtain private financing at attractive rates. Therefore, many owners of long-term care facilities are taking a fresh look at government-insured financing.

Government-insured financing programs offering mortgage insurance for health care projects under Section 232 of the National Housing Act (HUD 232 Loans), have been available for many years[1].

HUD 232 Loans are offered by private lenders who qualify under U.S. Department of Housing and Urban Development (HUD) guidelines. Once the loan is closed in accordance with the guidelines, HUD issues mortgage insurance to the lender.

The mortgage insurance guarantees repayment of almost the entire loan amount in the event the borrower defaults, enabling the lender to offer financing at a lower interest rate.

There are a number of detailed requirements for application and closing of these loans[2]. In the past, many borrowers resisted using HUD 232 Loans because the process was time-consuming, cumbersome, and often quite frustrating.

As noted in the beginning of this article, current market conditions may cause borrowers to rethink their opinions. Also, HUD has recognized their prior processing issues and has introduced a new processing protocol called "Lean Processing," to streamline and greatly reduce the processing times.

Under Lean Processing, the application is longer and contains more items which in the past were submitted at closing. Therefore, the application process has been "front loaded" and the closing process is accordingly simpler.

Before Lean Processing was adopted in 2008, processing times for refinancing under Section 232 were in excess of seven months. New construction financed under Section 232 took almost 15 months.

Lean Processing aims to reduce the processing times to 30-90 days after application. Due to the high volume of applications HUD has received for Section 232 Loans, there are not enough HUD underwriters to evaluate the applications, and so there is a queue of approximately 100 days between the time that an application is filed with HUD and the time it is actually assigned to an underwriter at HUD for evaluation. Once the underwriter has been assigned, the process proceeds relatively quickly.

Attractive Terms

HUD 232 Loans offer very attractive terms. Interest rates are fixed and tend to be quite low (currently between 5 percent and 5.5 percent), with level monthly payments for a term of between 30 and 40 years.

Even better, they are generally without recourse to the borrower, which means that in the event of default, the lender (or HUD if the mortgage insurance is drawn upon) will recover the collateral but will not be entitled to sue the borrower if the value of the collateral is lower than the amount due under the loan.

Most HUD lenders require some sort of lockout period after the closing in which no prepayment is allowed. Thereafter, they generally will require a declining prepayment premium.

For example, a loan might be closed to prepayment for the first five years and thereafter may be prepaid with a 3 percent premium in the sixth year, a 2 percent premium in the seventh year, a 1 percent premium in the eighth year, and thereafter may be prepaid at par.

This is up to the individual HUD lender and, in general, the interest rates will be a little bit lower if there is a longer closed period.

Another attractive feature of HUD 232 Loans is that they are assignable if the purchaser qualifies under the HUD "transfer of physical assets" requirements. The process requires qualification of the purchaser, but since much of the underwriting analysis on the project has usually already been completed, the process can be much easier than obtaining a new loan.

Finally, the maximum loan amounts are very attractive. In the commercial market, it is difficult to obtain a loan for more than 75 percent of appraised value, or LTV.

For acquisition or construction of a skilled nursing facility, the maximum loan amount will be 90 percent LTV (95 percent for a nonprofit borrower), and for a refinancing it will be 85 percent LTV (90 percent for a nonprofit borrower).

The maximum LTVs for assisted living facilities is 5 percent less due to the history of defaults in the assisted living market, but even in the assisted living market an LTV of 75 percent is possible.

Qualifications

To qualify for HUD 232 financing, the borrower must be an "eligible borrower," the project being financed must be an "eligible project,” and the loan proceeds must be used to pay "eligible costs."

An eligible project for a HUD 232 Loan is a licensed health care project consisting of a nursing home, an assisted living facility, a board-and-care facility, or an intermediate care facility. To qualify as an eligible project, no more than 25 percent of the beds may be unlicensed beds.

An eligible borrower is a single purpose entity owning only the eligible project. It is very important to explore the ownership structure of a project owner early on, in order to determine whether any ownership changes will be required in order to meet the requirements for an eligible borrower.

If more than one facility is owned by a single entity, the ownership will need to be separated before the loan may be closed. Leased facilities are permitted. In fact, it is very common to have the borrower own a facility and lease it to a related entity which holds the license and operates the facility.

For example, to create eligible borrowers, a single company owning three facilities could form three new single-purpose entities, convey each facility's real estate to each of these three new entities, and then these new entities would be eligible borrowers which can lease each of the three facilities to the original owner as an operating lessee.

Structuring a transaction in this manner means that the licenses may be remain in the original entity without the need for cumbersome transfers of health care licenses.

Eligible borrowers may be either nonprofit or for-profit entities. As discussed above, nonprofit underwriting will permit a higher LTV than permitted for for-profit borrowers.

In return for that higher maximum loan value, however, nonprofit borrowers will be restricted from using residual receipts from the project (revenues after payment of operating expenses and debt service) for any corporate purposes other than as required by the mortgaged facility.

Proceeds of HUD 232 Loans must only be used for eligible costs. Loan proceeds may never be used to return equity to the owners. Proceeds must only be used to refinance eligible debt, acquire or construct a new facility, and/ or make needed repairs or modifications to the facilities.

As part of the application process, the lender will order a Property Condition and Needs Assessment (PCNA) which will be prepared by a third party consultant and identify the various capital needs based on the condition of the project.

The repairs will be divided into critical repairs and non-critical repairs. Critical repairs must be completed prior to the closing of the loan, while noncritical repairs may be completed using loan proceeds over the 12 months following the closing.

Another eligible project cost is refinancing eligible debt, which is debt related to the project which was incurred for the purchase, construction, improvement or repair of the project, or for project operating deficits.

Debt to a related entity will generally not be deemed as eligible debt for refinancing. This is because refinancing of affiliated party debt could be considered a disguised return of equity.

One very important area for consideration by long-term care borrowers is their need for accounts receivable financing. In traditional real estate projects, such as apartment projects, the tenants pay rent in advance so the landlord receives funds in time to pay debt service on the mortgage and operating expenses.

By contrast, in the health care world, the facility provides services to the patients first, and bills the residents' payor entities, either Medicare, Medicaid or private insurance, only after the services have been rendered. Then the invoices will not be paid for one to three months after receipt.

Meanwhile, during those months, employees must be paid, patients must be fed and the lights must stay on. Thus, most health care providers find it necessary to obtain working capital financing secured by a first lien on the accounts receivable.

In the past, it has been difficult to negotiate agreements between the HUD lender and an accounts receivable lender concerning the treatment of accounts receivable and application of revenues upon default.

The new Lean Processing guidelines now include accounts receivable financing and thus the process will be somewhat easier so long as a borrower works with an accounts receivable lender familiar with HUD insured loans.

Timing

The timing of applications will create an issue if the borrower is purchasing the facility and desires to obtain a working capital loan at the same time as the acquisition closes.

The application for the HUD 232 acquisition loan will be filed six months or more before the anticipated date of closing. Under Lean Processing, the application must specifically describe the terms of the accounts receivable financing.

However, six months before the closing, it is unlikely that the prospective borrower-buyer has obtained all of the due diligence information needed for the accounts receivable lender to determine the economic details of the loan, such as the total available loan amount, the qualified accounts, financial covenants applicable to the loan, and the like.

Typically, that information will only be available at the very end of the complete due diligence acquisition process, and that will likely be too late to be included in the loan application.

If it is possible for a purchaser to internally finance accounts receivable for the first few months, this will make it much easier to close the acquisition with a HUD 232 Loan.

Conclusion

It may seem as though the provisions of HUD insured financing make transactions more cumbersome and difficult to close. This may be true. However, the loan terms are so attractive that many borrowers will find it advantageous to press forward with their HUD 232 Loans despite the obstacles.

It is critical to work with an experienced lender. Because most government insured loans are not made to borrowers in the health care industry, the peculiar challenges of health care loans may not be particularly familiar to a lender without experience in the Section 232 program. This will prevent problems that can keep a borrower from obtaining financing.

--By Andrea C. Barach, Bradley Arant Boult Cummings LLP

Andrea Barach is a partner in the health care practice group at Bradley Arant Boult Cummings in the firm's Nashville, Tenn., office.

The opinions expressed are those of the author and do not necessarily reflect the views of Portfolio Media, publisher of Law360.

[1] 12 U.S.C.1715w(2009); see also 24 C.F.R. §232 (2009)

[2] U.S. Department of Housing And Urban Development, Guide to Multifamily Accelerated Processing (Map), Ch. 3