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WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

April 17, 2014

Mortgagee Letter 2014-06

TO: All FHA Approved Multifamily Mortgagees

SUBJECT: Portfolio and Master Lease Guidance

PURPOSE: This Mortgagee Letter addresses and immediately implements policies with respect to portfolio applications and master leases as they relate to the Section 232 Program.

EFFECTIVE DATE: This Mortgagee Letter applies to all applications submitted to HUD on or after [date = publication date plus 30 days], 2014.

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I. Background & Overview

This Mortgagee Letter provides an overview of HUD's policy with respect to portfolios - multiple projects with the same ownership and master leases. This mortgagee letter supersedes previous guidance in HUD Housing Notice H 01-03: "Review of Health Care Facility Portfolios and Changes to the Section 232 Programs" issued in 2001, and Mortgagee Letter 00-42: "Headquarters Review of Certain Applications for Section 232 Mortgage Insurance" issued in 2000.

This policy update will enhance the ability of the Office of Residential Care Facilities (ORCF) to: manage risk in an ever-changing residential healthcare industry, ensure that the General Insurance Fund remains stable, and continue to support owners and operators of residential care facilities around the country.

Since 2000, HUD has seen an increase in the number of applications for financing of multiple projects under the same ownership and and/or operating structures. This grouping of projects also referred to as portfolios, with common borrowers and related or non-related operators, effectively concentrate a large amount of credit risk on a single parent entity. The risk profile of portfolios requires that HUD develop comprehensive measures to identify and mitigate the potential adverse impact of this risk.

In 2001 with Notice H 01-03, HUD prescribed a corporate credit review for midsize and large portfolio projects in order to assess the credit risk of the parent corporate or holding entity. HUD has always required that the lender submit a separate mortgage insurance application for each facility and that each project must individually meet HUD's underwriting requirements. HUD has also determined that for portfolios the overall financial, operational, regulatory and legal condition must also be evaluated to ensure that both the owners and operators have the experience and the financial strength to successfully operate a portfolio of residential healthcare facilities.

This mortgagee letter represents HUD's formal guidance on the use of master leases. The HUD master lease structure ties together the operating leases from each healthcare facility that makes up a portfolio into one master lease. The HUD master lease requires each facility operator to allow available funds from its project to be used for any other project in the master lease portfolio that is unable to generate adequate cash flow to make required lease payments to supplement any liquidity shortfalls. This includes portfolios that may have more than one master lease due to the use of minority partners or multiple lenders. Master leases are an important tool used to lessen the financial risk posed by a portfolio and provides assurance that all portfolio project resources are available to financially support troubled projects.

Portfolio corporate credit reviews and master leases are the primary tools The Office of Residential Care Facilities (ORCF) uses to identify and mitigate concentration risk associated with portfolio projects.

This Mortgagee Letter describes:

1. The criteria for conducting a portfolio corporate credit review of the parent owner and/or operator of a residential care facility;
2. The information required and the methodology for evaluating and processing a portfolio corporate credit review;
3. The criteria for establishing a master lease on multiple Section 232 insured facilities;
4. The requirements for utilizing a master lease structure; and
5. The required elements of an acceptable master lease structure.

Ongoing Asset Management of Portfolios Post-Endorsement

Lenders for portfolio projects should be advised that they now have a continuing obligation to monitor the performance of both individual portfolio projects as well as the financial condition of parent entities that own and/or operate portfolio projects after loan closing and until the loan is repaid. ORCF will continue to develop its oversight and monitoring asset management system for parent entities as a means to monitor project owners and operators, identify potential problems and work with lenders in a preemptive manner with needed risk mitigation efforts.

II. Effective Date

This Mortgagee Letter is effective _____.

All applications submitted after the effective date of this Mortgagee Letter must follow the guidance and requirements specified herein. In the case of applications that are part of the same ownership group, the master lease provisions will apply to all new submissions and could impact previous submissions that fall within the rolling 18-month look-back for portfolio reviews as described below and in Section V. HUD will require that any projects approved with the same ownership and operating structures within the past 18 months be added to the master lease unless there are extenuating circumstances that prevent their inclusion.

III. Terms and Concepts

A **portfolio** is defined as two or more borrower entities that are under common ownership and/or common control.

Common Control: Is exhibited by any individual(s) or entity(ies) that controls the borrower and/or operator regardless of the percentage of ownership interest, so long as the individual(s) or entity(ies) comprise each borrower and/or operator. Affiliated residential care facilities and/or healthcare operating entities will be grouped into a portfolio if they share common control as defined here. The type of corporate credit review will depend in part on the size of the combined mortgage amount of the portfolio (see Section V below).

Single Asset Entity: For each individual project, the mortgaged property shall be the only asset of the borrower and operator.

Affiliates/Affiliated: Any person or business concern that directly or indirectly controls the policy of a principal or has the power to do so.

IV. Criteria for Portfolio Corporate Credit Review

1. A portfolio corporate credit review is required for all midsize and large portfolios (See Section V below.) Portfolio corporate credit review procedures apply to owners and operators of residential care facilities and their affiliates in the following circumstances: An application for mortgage insurance for purchase or refinance of an existing facility, pursuant to Section 223(f);
2. An application for mortgage insurance involving new construction or substantial rehabilitation pursuant to Section 232 NC/SR;
3. A transfer of physical assets (TPA); or
4. A change of control of facility operators. This will generally be a change in the lessee of a facility, a change in the operating license holder, and/or a change in the entity that contracts directly with residents. In some circumstances, a management agent may fill one or more of those roles and could trigger a change of control review if the management agent assumes healthcare operational responsibility.

Portfolio reviews are not required for applications under Section 223(a)(7).

V. Portfolio Size Classifications

Portfolios are classified based on the combination of number of facilities and total mortgage amount reflected in the applications for mortgage insurance submitted within any rolling 18-month timeframe that begins when the first application is assigned to an ORCF underwriter. In the case of a TPA or change in control of facility operations, portfolio size classification will be based on the number of FHA-insured individual mortgages and the 18-month window will begin when the ORCF asset manager begins processing.

The submission of an application creates an open window for portfolio consideration. The window remains open for 18 months following the start of processing of the most recent application. Thus for multiple submissions, the cumulative open window may be longer than 18 months from the first application to the last.

This 18-month timeframe may be expanded, at the discretion of ORCF where necessary, to accomplish the intent of a complete portfolio review and to fully evaluate the risk to the General Insurance Fund. If the management of an accepted portfolio wishes to increase the number of projects and/or the total approved mortgage amount after the 18-month window, then ORCF will conduct an updated corporate credit review. Further, if 18 months or more passes after the issuance of a portfolio acceptance letter without any individual applications being submitted, and if management then decides it wants to begin submitting applications, ORCF will conduct an updated corporate credit review.

Portfolios shall be classified as follows:

A. Small Portfolio*:

1. Up to 49 facilities and aggregate mortgage amount less than or equal to \$90,000,000.
2. A portfolio corporate credit review is not required.
3. The Certification of Multiple Projects is required.

** The portfolio corporate credit review is not required for small portfolios; however, the projects in the small portfolio will be required to enter into a master lease covering each ownership and operating entity for all projects included in the portfolio.*

B. Midsize Portfolio:

1. Up to 49 facilities and total mortgage amount greater than \$90,000,000 and less than or equal to \$250,000,000.
2. Portfolio corporate credit review and the Certification of Multiple Projects is required.

C. Large Portfolio:

1. 50 or more facilities and/or an aggregate mortgage amount greater than \$250,000,000 and less than 5% of the current unpaid principal balance of the entire portfolio of active Section 232 loans.
2. Portfolio corporate credit review and the Certification of Multiple Projects is required.

Portfolio Classifications

#of Facilities / Total Mortgage	2 – 49	50+
\$0 < x ≤ \$90M	SMALL	
\$90M < x ≤ \$250M	MIDSIZE	
\$250M < x < 5% of UPB	LARGE	

ORCF will not approve portfolios with an aggregate mortgage amount in excess of 5% of the current unpaid principal balance (UPB) of the entire portfolio of active Section 232 loans. The current UPB amount may be obtained upon request from the Director of the ORCF

VI. Certification of Multiple Projects

The lender will obtain from the borrower for both current and proposed residential care borrowers and their Affiliates (whether as a borrower, sponsor, or principal as defined by HUD Previous Participation — 2530/APPS) who participates or proposes to participate in an application for Section 232 mortgage insurance, a TPA, or change in ownership or control of facility operations a Certification of Multiple Projects, found as part of the Consolidated Certification – Borrower. The purpose of this Certification is to ensure that HUD is fully aware of all residential care and/or healthcare projects that may be submitted as part of a portfolio application and/or any other FHA-insured residential care facilities with common principals to the current application. It is essential that HUD have this information to ensure that applications are processed properly and for accurate classification in the asset management system.

The Certification of Multiple Projects shall provide the following information:

1. The number, location, and estimated mortgage amount of all facilities that are or will be included in applications for FHA mortgage insurance that will be submitted within the 18-month open window as specified in Section V;
2. Each certifying borrower's, principal's, or affiliate's roles in the proposed project(s);
3. All current FHA-insured or HUD-held loans (include name and FHA number) for which the certifier is a borrower, operator, or other principal as defined by their HUD Previous Participation Certificate (/APPS) except that certifications submitted with an (a)(7) application) do not need to be included; and
4. Provide on the signature page of the Certification of Multiple Projects that the information on the certificate is accurate and include the following: "HUD will

prosecute false claims and statements. Convictions may result in criminal and/or civil penalties (18 U.S.C. §§ 1001, 1010, 1012; 31 U.S.C. §§ 3729, 3802).”

For midsize and large portfolios, submit the Certification of Multiple Projects in the portfolio corporate credit review package. For small portfolios, submit the Certification of Multiple Projects with each individual mortgage insurance application.

All applications for financing, refinancing, TPA, or change in facility operators of two or more Section 232 projects, or one project where the proposed principals already participate in other properties with mortgage insurance under Section 232, must include the certifications in their submission.

VII. Portfolio Corporate Credit Review Description

To assist ORCF in reviewing midsize and large portfolio qualifications, the lender must submit the information required for a portfolio corporate credit review. Lenders shall consult with the Director of ORCF regarding the financial, legal and organizational structure of a proposed portfolio submission at the beginning of the process of defining the scope of the portfolio corporate credit review. This communication with ORCF is necessary to ensure that the corporate credit review addresses the relevant information and risk factors. ORCF will determine the subject of the portfolio corporate credit review as the entity (both ownership and operational) that may potentially create a material risk to the projects and to the General Insurance Fund. ORCF will review all materials submitted in the portfolio corporate credit review and determine whether the portfolio is an acceptable risk to the General Insurance Fund based on operation and ownership experience, financial strength, quality indicators, and any pending legal issues including the jurisdictional regulatory environments. The Office of Risk Management (ORM) and the Office of General Counsel (OGC) are also participants in this review process.

ORCF will require a mortgage reserve fund for all midsize and large portfolios and may impose additional requirements and/or limitations on the portfolio as well as other risk mitigants. These additional requirements may include, for example, reserves for capital improvements, a higher mortgage reserve fund, lower loan to value requirements, professional liability insurance reserve funds, third party risk management programs for facility operations and quality of care, and limitations on cash distributions until certain sustained cash flow multiples are met.

The lender may not submit individual applications as part of a midsize or large portfolio to ORCF for processing until the portfolio acceptance letter, signed by the Office of Healthcare Programs (OHP) Deputy Assistant Secretary, has been issued.

The portfolio corporate credit review materials must contain the information identified in Section VIII and be presented following the list in Section IX below. The complete package must be

submitted electronically. If separate hard copies are delivered to HUD, all materials must be labeled and tabbed according to the outline.

The information in this package must be compiled by the borrower or the lender; however, the lender or borrower may engage a public accountant or other consulting firm with appropriate expertise to assist with the compilation of the information. The lender must notify HUD of what entity or entities prepared or substantially assisted in the preparation of the corporate credit review and any relationship that exists between the lender and the other parties preparing the documentation or involved in the transaction. ORCF may provide templates for inputting the portfolio corporate credit review contents as listed in Section VIII below.

The professional liability insurance (PLI) review and the accounts receivable (AR) financing review (if applicable) will occur in conjunction with the portfolio corporate credit review.

Any owner or operator of a healthcare facility or their affiliate or renamed or reformulated company that has *filed for, is in, or has emerged from* bankruptcy within five years period preceding the date that such lender submits information to HUD as part of the mortgage insurance process *is not eligible to participate* in any manner in a facility which seeks to have its mortgage loan insured through the Section 232 program.

A project in bankruptcy that is acquired by a non-identity-of-interest owner in good standing may be eligible for mortgage insurance, subject to HUD review. HUD will review updated financial information (post-bankruptcy) and the new senior management team.

VIII. Portfolio Corporate Credit Review Contents

A. Description of the Company (Reviewed Entity):

1. Narrative description of operations and products;
2. The management policies (including a detailed statement with the mission, vision, and financial policies);
3. The legal structure of the company (including an organizational chart);
4. An explanation of the management structure (including a management organization chart);
5. The strength of management (as measured by their biographies and industry experience);
6. A list of officers and directors or trustees of the company including names, Social Security Numbers or Employer Identification Numbers, addresses and titles of positions;
7. Current resumes on the company and principals and operating officers of the company;

8. Credit reports on the company and its operating officers (as provided by outside research firms);
9. Discussion of outstanding Federal or State litigation involving criminal actions, alleged fraud or abuse, any administrative or court complaints alleging fair lending discrimination; and/or other actions that may have an adverse financial or regulatory effect on the facility(ies) and
10. If available, a report, including rating, prepared by a rating agency (such as Standard & Poor's or Fitch);
11. Notify HUD if the owner of the proposed facilities to be financed have in the past two years been in negotiations to sell the portfolio entity or are contemplating a sale of the facilities or the company within the next three years.

B. List of All Facilities Owned by the Borrower and Operated by the Operator (including those facilities that are not part of the portfolio):

1. Legal names of the real estate and operating entities;
2. Location of each facility by city and state;
3. Number of beds and/or units;
4. Current debt attributed to each facility and the basis for allocation;
5. Trailing 12 months revenue for each facility;
6. Trailing 12 months Earnings Before Interest, Taxes, Depreciation, Amortization and Rent (EBITDAR) for each facility;
7. Trailing 12 months occupancy/census data and payor mix for each facility; and
8. Identification of the facilities to be included in the FHA financing.

C. Financial Summary:

1. Provide the most recent three years of audited consolidated financial statements including income statements, balance sheets, and cash flow statements for the parent entity (ownership and/or operating entity) that is under review. If audited financial statements are not available, the lender may substitute owner certified financial statements. The financial statements and any summaries must include all associated facilities, corporate overhead and other revenues and expenses as well as all notes to the financial statements;
2. Interim financial statements (through the reporting date), including trailing 12 months;
3. Operating and financial forecasts and plans, including corporate strategy and acquisition/disposition/new development strategy (as prepared by management);
4. Financial analysis and cash flow proformas that provide EBITDAR margins, leverage ratios and cash flows, and base case and worse case running scenarios on future cash flows (as prepared by management and compared to industry benchmarks of performance);

5. Projected cash flow analysis after the FHA refinancing including the anticipated debt service payment for the FHA mortgage. The mortgage payment should include the projected interest rate including the mortgage insurance premium and the correct term of the loan. The cash flow projections should have sensitivity analysis showing effects of reduced occupancy, lower government receivables, and higher than anticipated expenses.
6. Corporate debt structure including terms, rates, conditions and payment dates of all long and short-term debts and current debt obligations and standby credit instruments and violations of loan covenants that occurred in the past two years;
7. List of derivatives obligations including termination dates, maximum risk exposure, and interim payment requirements for swaps, credit derivatives and other derivative obligations. Include current market values and prepayment penalties if any; and
8. Capital/equity structure of the firm.

D. Operations:

1. Summary of three years of consolidated census data including beds/units available, beds/units occupied, and payor and quality mix;
2. Summary of three years of average daily rate reimbursement by payor type;
3. Description, breakdown and amount of ancillary revenue;
4. Management fee as a percent of revenue (if applicable); and
5. Provide information on therapy services provided by a non-related third party, if applicable.

E. Professional Liability Insurance and Risk Management:

1. Evidence of PLI coverage and supporting documentation in compliance with HUD Housing Notice H 04-15 or its successor;
2. Six-year loss history and calculation of dollar amount of claims per bed per year for all properties, including the non-HUD properties that will not be included in the portfolio;
3. Narrative of company's risk management and loss prevention policies;
4. Summary of State licensing surveys [inspection reports] for the past three years that address:
 - a. Quality of care issues;
 - b. Average citations for each facility showing both G and above and as compared to the state average in each state.
 - c. Citations of any previous uncorrected findings (rare); and
 - d. Civil money penalties imposed on the site.
5. Parent or captive actuarial statements if available;
6. Audited financial statements of the captive (last three years), if applicable;

7. Provide information on all ongoing or anticipated Qui Tam suits and/or State/Federal investigations on Medicare fraud or serious quality of care issues and any other material legal litigation;
8. CMS Star Ratings and CMS provider numbers for each skilled nursing facility; and
9. A list of any facilities on the CMS Special Focus Facilities list under the PLI.

F. Accounts Receivable Financing: (if applicable)

1. Evidence that any existing or proposed AR financing is in compliance with HUD requirements, including separate AR lines for FHA and non-FHA-insured facilities;
2. Name of AR lender; and
3. Terms and limits of the loan.

G. Other Lines of Business

The lender will review and analyze the financial condition of all other properties, business entities (for example, company-owned rehabilitation services), and lines of business under common control by the parent entity but are not being financed with FHA mortgage insurance. The review will include details of the financial relationships between the business entities and the proposed FHA portfolio projects, as well as an analysis of net cash flows, debt service coverage, and credit worthiness of the entity and its owner. The review is to determine event risk of the non-FHA pool of assets and its potential adverse impact on the FHA pool of assets.

If a public accountant, consulting firm, and/or lender identifies issues that may create financial or operational risk and could materially impact the FHA-insured assets, then the lender or his designee will perform a more in-depth analysis. The portfolio corporate credit review submission will provide this information to HUD along with the lender's analysis of all relevant information and recommendations.

H. Certification of No Investigation, Judicial or Administrative Action

The lender must certify to HUD that the subject of the corporate credit review, a parent, affiliate, or subsidiary thereof, and/or the operator is not the subject of an ongoing investigation or judicial or administrative action involving any Federal, State, municipal and/or other regulatory authority, which may have a detrimental impact on the financial condition or jeopardizes any facility's license and/or the provider agreements. Further, the

lender will be required to certify at the time of closing that from the date of the portfolio acceptance letter through the date of final closing there have been no material adverse change in the financial or operational position of the portfolio subject owner and/or operator. OGC will evaluate any active investigations or litigation to determine whether or not they pose a serious risk to the portfolio such that processing should be discontinued or placed on hold.

IX. HUD Documentation to be Submitted for a Portfolio Corporate Credit Review

For those portfolios requiring a portfolio corporate credit review, the submission package must contain the following items in addition to the information required in Section VIII above. Please ensure that all hardcopy materials are labeled, tabbed, and following this format. Submit this package to the Director of ORCF.

1. The Certifications of Multiple Projects as described in Section VI.
2. Portfolio corporate credit review and all supporting documentation as described in Section VIII.
3. HUD Previous Participation (Form HUD 2530 or electronic APPS submission) on the owner, the operator and their affiliates.
4. Explanation of any intent to reallocate base rent. (Owner may reallocate base rent allocated to each real property covered by a master lease so long as the total aggregate amount of base rent for all the leased premises is not increased.)
5. Master lease submission for facilities in a portfolio transaction (if available). The current master lease provisions are described below beginning with Section X.
6. Information demonstrating compliance with liability and property insurance requirements. PLI must be in compliance with HUD Housing Notice H 04-15 or its successor. (The PLI review occurs with the portfolio corporate credit review.)
7. Information demonstrating that AR financing complies with HUD requirements. (The AR financing review occurs with the portfolio corporate credit review.)
8. Certification that all proposed projects shall meet the Single Asset Borrower Entity standard.
9. Financial Statement Certification.

The submission must clearly identify all proposed portfolio projects, including project name, location, FHA number and mortgage amount to be requested, if known. ORCF understands that such a list may be preliminary and subject to change. Also, for ORCF planning purposes, the lender should provide a preliminary schedule and timing of individual application submissions.

X. Master Leases: HUD Policies and Guidance

A. Purpose of Master Lease

FHA approves mortgages for individual properties. However, more and more mortgages approved by FHA have a common or corporate ownership structure which significantly increases the concentration risk for FHA should the parent ownership entities encounter significant financial, market or legal risks. In order to counteract the additional risks, ORCF has determined that owners of multiple properties must provide additional support in the form of a master lease.

The purpose of utilizing a master lease structure is twofold:

1. To provide a mechanism for a master tenant to access available profit from any of the other facilities that are a party to the master lease in order to assist an individual property that may be experiencing inadequate cash flow to meet its financial obligations.
2. The master lease is also a tool to ensure that in the event of a bankruptcy that all project obligations are utilized to maximize HUD's recovery.

A master lease is not a traditional cross collateralization of all project collateral (which would be an accepted practice for a bank loan, a Commercial Mortgage Backed Securities (CMBS) or a bond financed facility). For FHA-insured projects, the master lease is a cross default of only the individual subtenants. A master lease reduces the risk of "cherry picking" – a practice in which the subtenants of multiple FHA-insured facilities maintain the lease in financially successful projects while rejecting the leases of poorly performing projects. . A master lease can prevent "cherry picking" in that the master lease is an indivisible lease which requires a debtor in bankruptcy to accept all leases or reject all leases included within a master lease.

B. Description of the Master Lease

A master lease is a primary lease that controls subsequent leases. The master tenant will sublease its interest to a subtenant operator. All subtenant operators are bound by the master lease. A master lease essentially ties together multiple facilities with the same ownership.

Under each sublease, the operator will be obligated to pay to the master tenant a minimum of base rent plus reserves and escrows owed by the borrower on the FHA-insured loan. Each operator will sign a Cross-Default Guaranty of Subtenants, pursuant to which each operator guarantees to the master tenant the performance of the obligations of the other subtenants under their collective subleases. If any subtenant defaults on any single sublease, that default would trigger a default on the master lease and all subtenants.

It is not in FHA's interest for a default to occur for all subtenants, so it has provided a mechanism to provide a reasonable timeframe for the master tenant and the parent operator to correct any deficiencies and or cure a default to the project as long as there is not a substantial

and imminent risk of a revocation or termination of the license or other necessary permits or approvals.

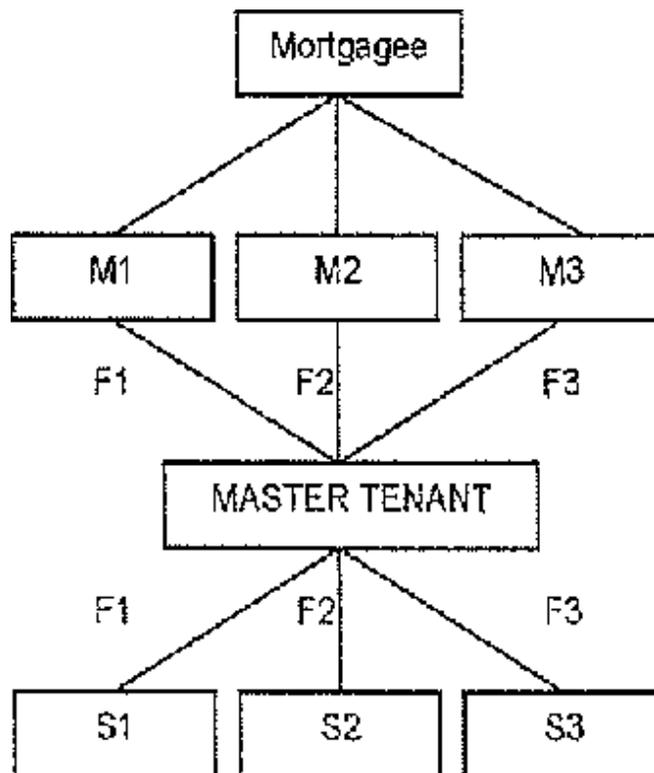
C. Underwriting of Projects included in a Master Lease

Each mortgage insurance application must meet FHA’s underwriting standards on its own merit. HUD does not permit a master lease structure to be used to justify the approval of applications for mortgage insurance for fundamentally weak projects, and HUD will not accept the premise that “the strong projects will take care of the weak projects.” As with all FHA projects, each loan will have a separate note for each borrower and each note will be secured by its own security instrument. FHA does not cross collateralize the real estate of projects included in a master lease structure.

D. Master Lease Structure

Under the master lease arrangement, the borrower for each property included in the master lease is collectively known as the landlord. The landlord enters into a master lease with the master tenant. The master tenant will enter into a separate operating sublease with each healthcare project operator entity. Each sublease will be included in the master lease. Each subtenant operator therefore enters into a separate lease agreement with the entity that owns the facility (i.e. the landlord).

Master Lease Structural Map:



The chart above describes the master lease structure. The chart demonstrates that the mortgagee issues a note and provides a mortgage for each individual standalone project (M1, M2 M3). The master tenant leases all of the facilities and enters into subleases (F1, F2, F3) for each subtenant (S1, S2, S3).

The master lease and the related subleases are subordinate to the FHA-insured mortgage. The master lease should be structured so that additional properties may be added later to the master lease in connection with future FHA-insured loan transactions upon approval by HUD.

Note: Portfolios financed through a CMBS often have provisions that allow projects to be removed from their master lease into one with an FHA-insured mortgage.

E. Alternative Forms of Project Structures and Variations in Master Lease Structures

The basic master lease structure described above may not always be appropriate due to other factors, such as follows:

- Multiple Minority Owners
- Multiple Operators
- Multiple Lenders
- Legal Restrictions
- Contractual Restrictions

1. Multiple Minority Owners

For projects that have majority common owners but have a limited number of minority owners, the master lease structure will be used but with minor modifications. The master lease project cash flows may be segmented so that minority partners do not need to share their minority profit with other projects where they do not have an ownership interest. However, the majority owners' profit will be pledged to all projects in the master lease. If there is more than one master lease, the majority owners will pledge their profit to support all master leases.

If the minority ownership interests are different between projects or there is more than one non-related minority partner, the carve-out amounts shall be proportionally determined. The master lease should have a provision that if the minority ownership position is purchased or obtained by the majority owners, the master lease will be changed to reflect that the interests of the majority partners is 100% or whatever the ownership position is determined to be. Any related party to the minority party after the buyout shall be considered the common majority owner.

HUD understands that the ownership interests of multiple facilities can vary due to the inclusion of minority interests in differing ownership entities. ORCF has structured

master lease transactions with unique and atypical circumstances. HUD has been able to achieve creative solutions in consultation with lenders and OGC to structure master lease documents that protect HUD's interest while not interfering in the legal rights of or fairness to minority ownership interests.

See the Pledge of Cash Flow Model in the Appendix for a sample diagram.

2. Multiple Operators

For projects that have multiple third party operators, such as REITS, a master lease can be constructed for only those units that are leased to one operator. HUD recognizes that one operator cannot and should not be liable for the financial obligations of another unrelated third party operator. However, the owner is not excused from its obligation to provide financial support to all troubled projects. If there is more than one master lease for a common ownership group due to different operators, the majority ownership group will pledge their profit from all master leases constructed with different operator entities to support all of the projects that are subject to each of all master leases. This may be accomplished through a master landlord.

See the Master Landlord Structure in the Appendix for a sample diagram.

3. Multiple Lenders

If the same borrower uses multiple lenders for its financing, the borrower will be allowed to enter into a separate master lease with each lender. The duties and obligations of each lender may conflict if projects within one master lease have differing requirements or need to utilize funds or obligations under the control of a different lender. HUD does not support allowing one lender to interfere with another lender's master lease in a manner that could jeopardize the viability of another lender's projects that are performing under a separate master lease for a different lender that is meeting all of its performance obligations.

In such situations, a master lease for each lender with subordinate cross default guarantee agreements may be a suitable alternative.

See Multiple Lender Master Lease Alternative diagram in Appendix.

Also, the master leases from different lenders may contain a provision that a default under one master lease may constitute a default under all master leases if HUD, in consultation with all lenders, determines that a cross default provision should be exercised.

4. Legal Restrictions

HUD understands that there may be a limited number of situations where a master lease is not feasible due to external factors such as jurisdictions where a master lease would be inconsistent with State law or would be subject to onerous asset transfer taxes. In those cases, HUD will impose alternative risk mitigation requirements.

If there are legal restrictions or other legal provisions that effectively negate the advantages of the master lease structure, the lender and HUD must seek comparable remedies that offer the utmost protection to HUD's interest by ensuring that provisions are adopted in the form of guarantees that provide a means by which profit from projects performing successfully to be utilized to support projects that are unable to meet their financial obligations. If comparable protections are not available, HUD reserves the option not to approve the portfolio. HUD may compensate for the loss of protection normally achieved by master leases by requiring, without limitation, cross guarantees, corporate guarantees, increased debt service reserves, more stringent underwriting criteria for debt service coverage and loan to value, and/or restrictions on surplus cash distributions.

In the event that the lender has additional issues or restrictions that interfere with executing a standard master lease, the lender should contact the Director of ORCF to work with the lender and OGC to try to structure reasonable modifications that will permit HUD's objectives to be met while accommodating any unique needs of the portfolio.

5. Contractual Restrictions

In the event that existing contractual arrangements, such as credit facilities, do not permit a traditional master lease structure, a HUD-acceptable alternative will be required. HUD may consider alternative structures that will provide equivalent protection. If HUD determines that the proposed alternative mechanism is satisfactory, then HUD may accept the projects for mortgage insurance.

XI. Master Lease Criteria

The master lease procedures that are applicable to for-profit and non-profit owners and operators of residential care facilities are stated below.

A master lease will be required where there is:

1. An application for mortgage insurance for purchase or refinance of an existing facility pursuant to Section 223(f);
2. An application for mortgage insurance involving new construction or substantial rehabilitation pursuant to Section 232 NC/SR;

3. An application for mortgage insurance for refinance of an existing FHA-insured facility pursuant to Section 223(a)(7);
4. A transfer of physical assets (TPA); or
5. A change in control of facility operator This will generally be a change in the lessee of a facility, a change in the operating license holder, or a change in the operating entity that provides patient care to residents (a management agent in some circumstances).

A master lease and/or an addendum to a master lease will also be required when:

1. A transaction includes three or more properties and/or \$15 million or more in aggregate mortgage amount (meeting either threshold is sufficient);
2. The borrowers will either be under same ownership or a majority ownership individual or group will control the properties;
3. The operators of each property will be a lessee with the same ownership; and
4. Subsequent application received within 18 months from the last project with the same ownership and operating structure as an existing FHA-insured portfolio with a master lease in place, that property must be added to the existing master lease. In cases where there are different minority owners, different operators or different lenders, refer to the guidance in the above **Section X.E. Alternative Forms of Project Structures and Variations in Master Lease Structures.**

The master lease must be in place at closing for all projects that meet any of the above criteria. The master lease is required regardless of whether the borrower and operator are either identity-of-interest or independent or third party entities.

The master lease requirement applies to newly insured facilities and TPAs. HUD will not reach back and require that existing FHA-insured facilities be placed in a new master lease except when they are within a portfolio of properties submitted for financing or refinancing within the open window, or if credit considerations on a new transaction would otherwise warrant a master lease requirement being imposed as a risk mitigant.

XII. Term of Master Lease and Subleases

The master lease is meant to mitigate the concentration of risk for the term of the mortgages to which the master lease applies. Accordingly, it is expected that the master lease shall run at least as long as the mortgage having the longest remaining term.

HUD recognizes that in some situations such an initial term may not be feasible, such as where, for example, the operator entities and ownership entities are unrelated parties, or where state law would prohibit or impose substantial negative financial consequences on such a long-term lease.

In such situations, the lender must provide the basis for that determination and propose an alternative terms that addresses HUD's long-term intent. Any proposed alternative structure shall, at a minimum, specify that:

1. Unless HUD approves otherwise, the subleases shall each be, and remain, coterminous with one another, and
2. Each borrower's Regulatory Agreement will include an addendum to be approved by HUD requiring that in the event the master lease will terminate prior to the maturity date of the FHA-insured mortgage, the borrower shall enter into a new master lease with another party acceptable to HUD covering all subject properties prior to the expiration of the existing master lease.

The master lease shall only include facilities insured by FHA under the Section 232 program. Projects with affiliated ownership that are not insured under Section 232 shall not be included in a HUD master lease.

XIII. Master Lease Review Package

HUD has developed a series of approved legal documents that are required to be utilized for master lease transactions.

The legal documents are as follows and are available on the hud.gov website.

1. Cross-Default Guaranty of Subtenants
2. Guide for Opinion of Master Tenant's Counsel
3. Healthcare Regulatory Agreement - Master Tenant
4. Master Lease SNDA
5. Master Lease Addendum
6. Master Lease Estoppel Agreement
7. Master Tenant Security Agreement

For each midsize and large portfolio, HUD requires a Master Lease Review Package that must include the items listed below. For midsize and large portfolios, the master lease documents must be in final form prior to any applications being submitted to the queue. To that end, both OGC and ORCF will review the information to insure that it meets HUD's requirements prior to the application being submitted to the queue.

For small portfolios, prior to the ORCF Loan Committee and the issuance of a Firm Commitment, both the OGC closing attorney and ORCF underwriter will review the information to ensure that it meets HUD's requirements.

Notwithstanding the above, the lender and the borrower are responsible for ensuring that all HUD requirements are met. Please label and tab all hardcopy materials following this outline, and submit these documents to ORCF. **HUD's review of documents can be expedited by indicating if the HUD master lease form documents are being used without any requested revisions.**

1. Lender shall provide a narrative which describes the following:
 - a. The terms and conditions of the master lease;
 - b. Any waiver or other requests for modifications to the master lease regime that deviate from the standard requirements specified in the HUD forms, policies or practices for master leases;
 - c. Any proposed payments (fees, income, etc.) to or from the master tenant;
 - d. The lease agreements between borrower and the master tenant, and the lease agreements between the master tenant and the subtenants;
 - e. The collection and flow of funds from the subtenants to the master tenant and from the master tenant to the borrower. Include the involvement of funds flow with the AR lender if an AR lender is providing AR loans to the project; and
 - f. A diagram or other visual depiction of the flow of funds from each operator to the master tenant to the borrower. Specify the depositories for each individual project funds, as well as for the master tenant as applicable.

2. Lender shall provide a spreadsheet with the following:
 - a. The names of the facilities to be included under the master lease;
 - b. The proposed mortgage amount for each facility;
 - c. The recommended appraised value of each facility;
 - d. The proposed debt service coverage ratio for each facility including the mortgage insurance payment;
 - e. The number of beds at each facility;
 - f. The CMS Star Rating at each facility, if applicable;
 - g. The current balance of each facility's replacement reserve account; and
 - h. Any other reserve funds that will be available to the owner/operator to fund project costs.

3. Description of the Legal Structure: A narrative shall be provided describing the legal structure of the borrower or master landlord entity, the master tenant, and the operating entity/subtenant. The legal structure must disclose all tiers of ownership. If the borrower or operator has multiple tiers of ownership, the narrative shall include a diagram or chart identifying all parties and their relationship to one another and any conflicts of interest between the parties.

4. ORCF Review: ORCF, in cooperation with OGC, will review the following items to ensure agreement with the contents of the lender's application:

- a. Master Lease and Subleases
- b. Base rent amount
- c. Escrow amounts (for example, taxes, MIP, property insurance, etc.)
- d. Term of the master lease
- e. HUD mandated immediate and/or critical repairs
- f. HUD required replacement reserves
- g. Any other required reserves

XIV. Information Collection

Information collection requirements contained in this document have been approved by the Office of Management and Budget (OMB) under the Paperwork Reduction Act of 1995 (44 U.S.C. § 3501-3520) and assigned OMB Control Numbers 2502-0605.

In accordance with the Paperwork Reduction Act, HUD may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection displays a currently valid OMB Control Number.

Carol J. Galante
Assistant Secretary for Housing-Federal Housing
Commissioner

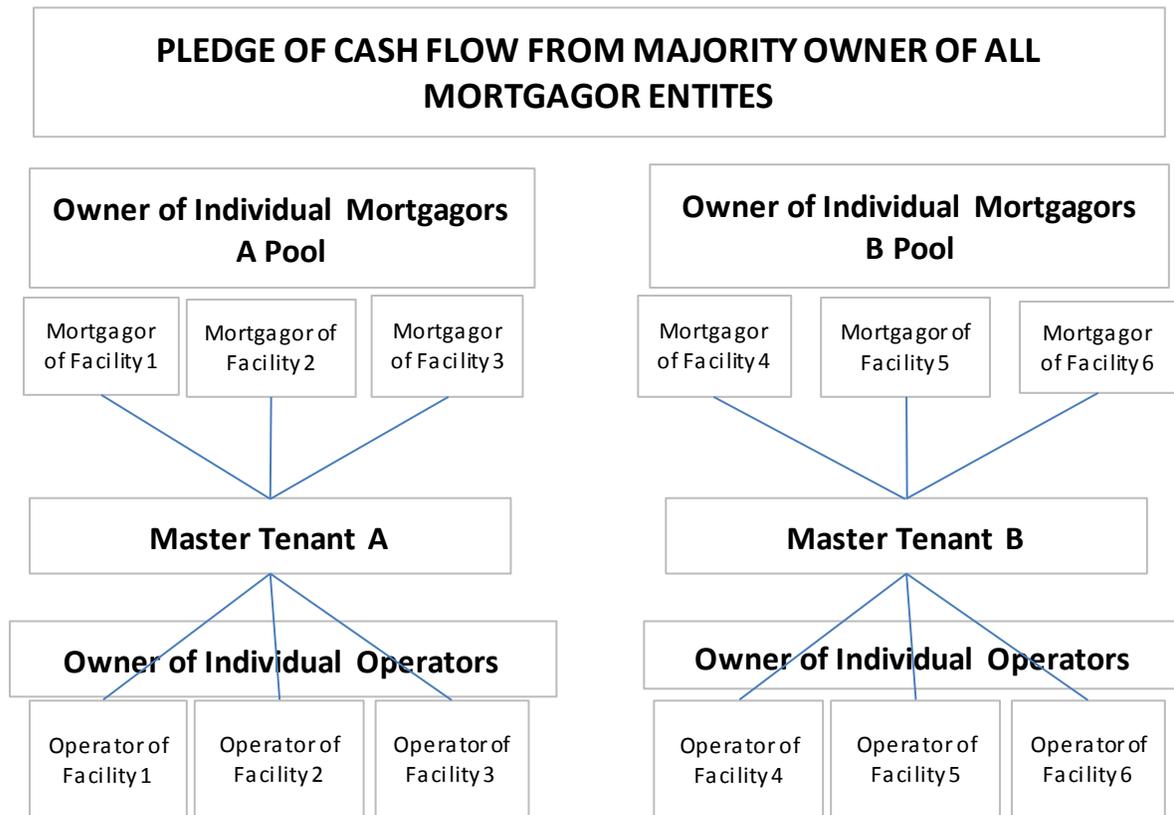
APPENDIX

Pledge of Cash Flow Model

Pledge of Cash Flow Model

All Borrower Entities are NOT the Same - BUT WITH A CLEAR MAJORITY PARTICIPANT AMONG ALL BORROWER ENTITIES

All Operator Entities are the Same in Each Pool

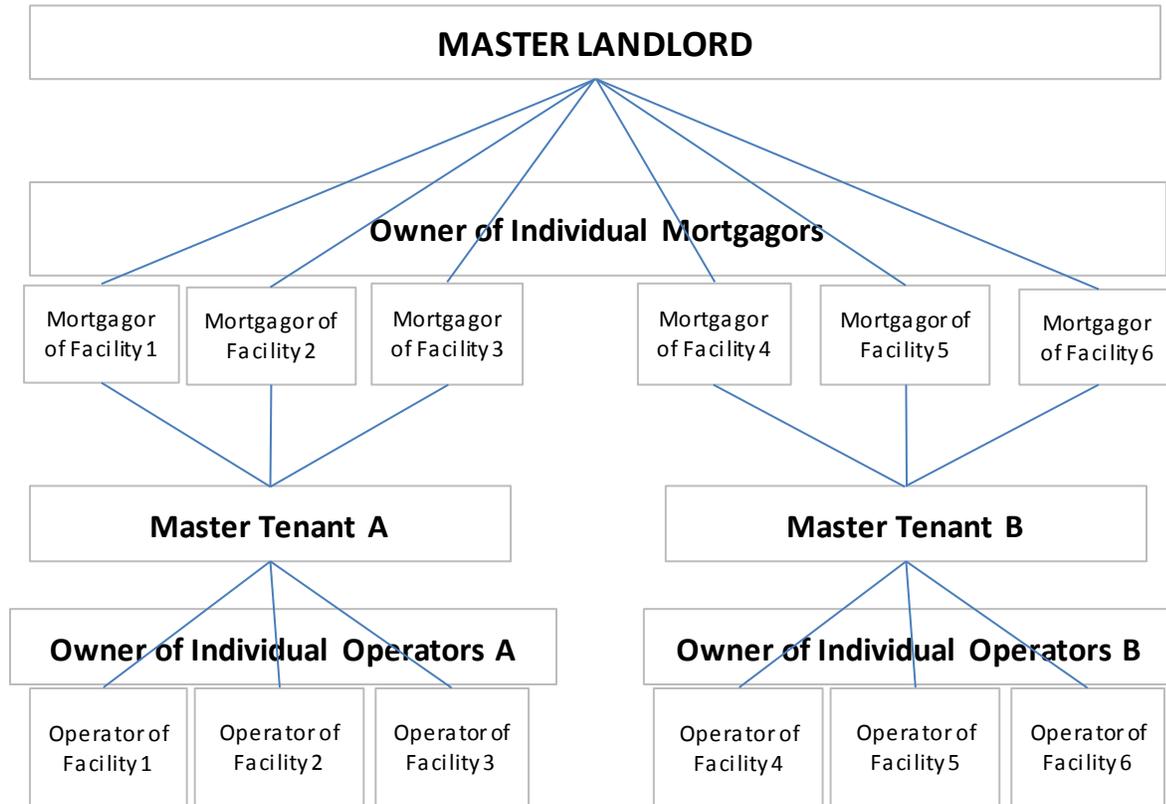


Master Landlord Structure

Master Landlord Structure

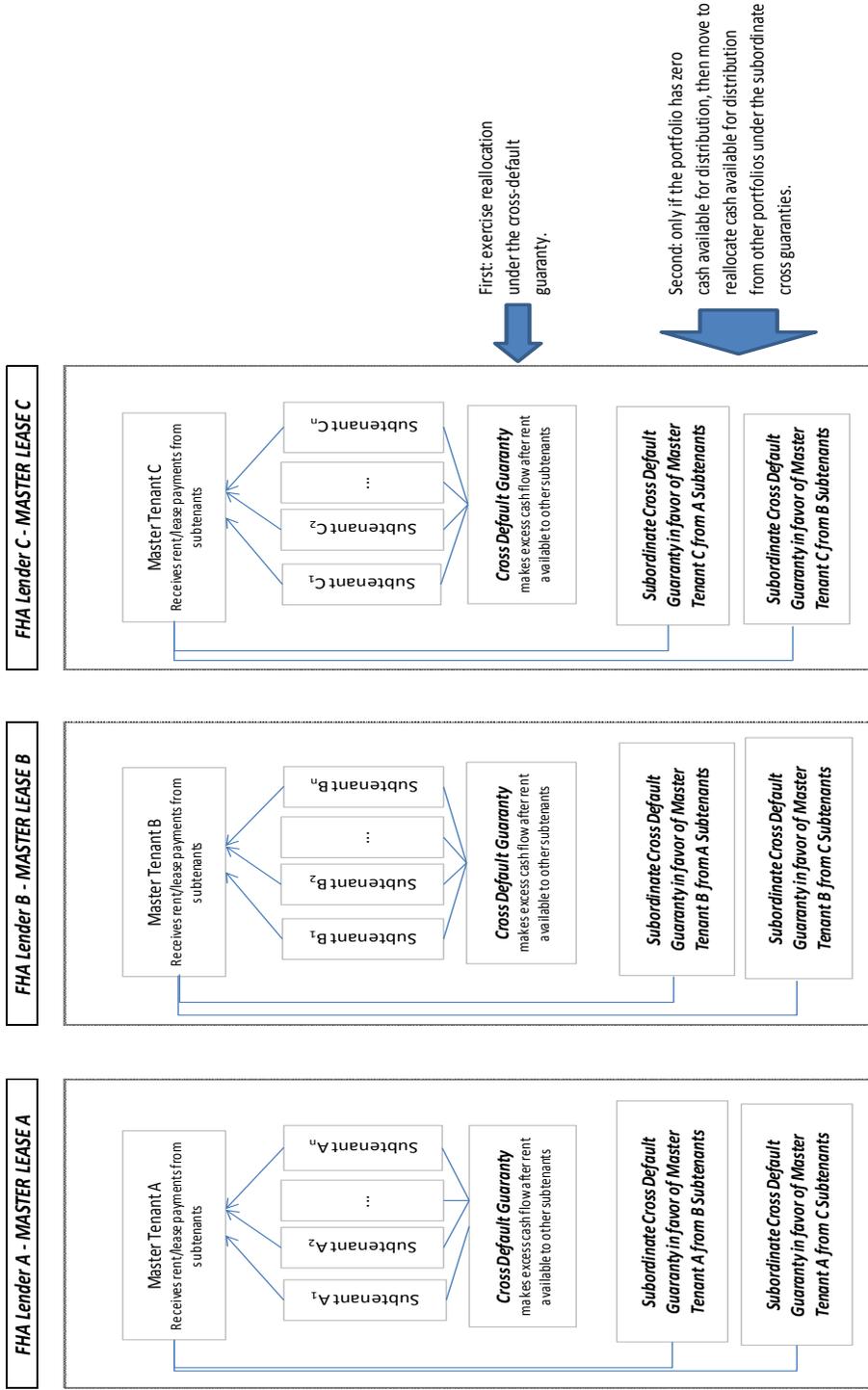
All Borrower Entities are the Same

All Operator Entities are NOT the Same - Separate and Unaffiliated from Each Other



Alternative to Multiple Lender Master Lease

Alternative to Multiple Lender Master Lease



The Subordinate Cross Default Guaranties are unsecured. With HUD Approval, a Master Tenant can make demands on any Subtenant under a Subordinate Cross-Guaranty to the extent of cash available for distributions under the applicable Operator Regulatory Agreement.