4232.1 REV-1

HEALTHCARE MORTGAGE INSURANCE PROGRAM
SECTION 232 OF THE NATIONAL HOUSING ACT

A HUD HANDBOOK

For Program Participants and HUD Staff

Issued January 12, 2017

Effective January 19, 2017

Federal Housing Administration
U. S. Department of Housing and Urban Development
Washington, DC 20410

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Section I
Handbook Introduction

Chapter 1
Introduction

1.1 Purpose of the Section 232 Handbook

The Section 232 Program is a Federal Housing Administration (FHA) mortgage insurance program that insures HUD-approved Lenders against financial loss from mortgage defaults. This Handbook establishes uniform national standards for applying, underwriting, submitting for approval, closing, managing and servicing mortgages insured or held pursuant to Section 232 of the National Housing Act. Section 232 mortgage insurance is available on mortgages that finance residential healthcare facilities, such as, nursing homes, assisted living facilities and board and care facilities. Eligible mortgages can be for the purchase, refinance, new construction, or substantial rehabilitation – or for a combination of these. Section 232 may also be used to insure mortgages to install fire safety equipment in such properties.

HUD's Office of Healthcare Programs (OHP), and specifically the Office of Residential Care Facilities (ORCF) within OHP, has responsibility for administering the Section 232 mortgage insurance program.

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1.2 Handbook Sections

In addition to this introductory section (consisting of this chapter and a chapter on Lender Relations), there are two primary sections of this Handbook. Those are the Production section and the Asset Management section.

A. **Production**. The Section 232 Production section provides mortgage insurance program descriptions, Borrower and Lender eligibility requirements, application requirements, underwriting standards and construction loan administration requirements. It also provides

approved Lenders the instructions to prepare, process and submit loan applications for residential healthcare facilities financed for FHA mortgage insurance.

B. **Asset Management**. The Section 232 Asset Management section is designed to establish national standards for the servicing and risk management of Section 232 FHA-insured mortgages. The section also describes how each Account Executive (AE) works in partnership with the Borrower and Lender to ensure each FHA-Insured 232 mortgage is financially and operationally strong, that each property provides a safe, quality place of residence, and that the loan remains viable for the term of the mortgage.

1.3 Legal Authority

A. **Section 232:** The Section 232 Program is authorized by Section 232 of the National Housing Act (12 U.S.C. 1715w), (12 U.S.C. 1715(b)) and 42 U.S.C. 3535. Statutory authority for the implementation of the Section 232 programs is contained in the basic insuring authority for each of the Section 232 programs. See the National Housing Act, Sections 223(a)(7), 232, 223(d), 232/223(f), and 241. Additionally, Section 211 of the National Housing Act authorizes and directs the Secretary to make such rules and regulations as may be necessary to carry out the provisions of the Act. Regulatory authority includes 24 CFR Parts 200, 232 and Section 5.801.

B. **Section 232/223(f):** Section 223(f) of the National Housing Act was added by Section 311(a) of the Housing and Community Development Act of 1974 and is codified at 12 U.S.C. 1715n(f). The program regulations are found in 24 CFR, Parts 200 and 232.

C. **Section 232/223(a)(7):** The Section 232/223(a)(7) program is authorized by the National Housing Act (12 USC 1715n(a)(7)).

D. **Section 232/241(a):** The Section 232/241(a) program is authorized under the National Housing Act, as amended, Section 241, Public Law 90-448 (12 U.S.C. 1715) and Public Law 94-375 (12 U.S.C. 1715z-6(a)). The program regulations are found in 24 CFR Parts 200 and 241.

E. **Section 223(d):** The Section 223(d) Operating Loss Loan program is authorized by Section 223(d) (12 U.S.C. 1715n(d)) of the National Housing Act 1937, as amended; Public Law 90-448, as amended; and Public Law 91-152, 12 U.S.C. 1715x. The program regulations are found in 24 CFR 207.

F. **Section 232(i):** The Section 232(i) program is authorized under the National Housing Act (12 U.S.C. 1715w(i)) as amended; Section 203(i) Public Law 93-204. The program regulations are found in 24 CFR Part 232 Subpart C.

1.4 Relation of Section 232 Handbook to Other Guidance

This Handbook is intended as a comprehensive guide to the Section 232 Program, and supersedes prior handbook or other guidance specifically on the Section 232 Program, consistent with statutory and regulatory requirements. Handbook chapters may include appendices which list the most recently published transactional documents, but the Handbook also covers transactions for which earlier versions of the documents were used and are in force. There may also be instances where existing guidance (particularly related to Borrower audited financial statement matters), references "Multifamily Housing", because the guidance was issued at a time when the Section 232 Program was a part of the Office of Multifamily Housing, and thus is still applicable to Section 232 Projects. If a particular Section 232 program matter is not addressed in this Handbook, and appears in other guidance, questions regarding applicability may be raised with ORCF.

This Handbook is part of "Program Obligations," a term used in multiple controlling documents and also at various places in this Handbook. "Program Obligations" means (1) all applicable statutes and any regulations issued by HUD pursuant thereto that apply to the Project, including all amendments to such statutes and regulations, as they become effective, except that changes subject to notice and comment rulemaking shall become effective only upon completion of the rulemaking process, and (2) all current requirements in HUD handbooks and guides, notices, and mortgagee letters that apply to the Project, and all future updates, changes and amendments thereto, as they become effective, except that changes subject to notice and comment rulemaking shall become effective only upon completion of the rulemaking process, and provided that such future updates, changes and amendments shall be applicable to the Project only to the extent that they interpret, clarify and implement terms in this Agreement rather than add or delete provisions from such document. Handbooks, guides, notices, and mortgagee letters are available on HUD's official website:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips or a successor location to that site.

1.5 Waivers of the Section 232 Handbook

This Handbook provides instructions to Lenders on how to apply, underwrite, close and service 232 insured mortgages consistent with program-related regulatory requirements and other directives. However, there are situations where Lenders are fully aware of ORCF's program requirements, but have legitimate business reasons for seeking loans for projects that do not fully meet ORCF's published guidelines. In those circumstances, the Lender must apply for a waiver of the program requirement, in advance of the transaction's approval. During the course of ORCF's review of a Lender's application, it may also be determined that a waiver is needed to obtain or maintain section 232 insurance. In either case, ORCF sets a high standard to approve program waivers.

There are two types of waiver requests: Regulatory waivers and Housing Directive waivers. Regulatory waivers are issued to waive a rule that is published in Title 24 of the Code of Federal Regulations. Generally, rules are established pursuant to statutory authority or by publication in the Federal Register for notice and comment. Regulatory waivers can only be approved by the FHA Commissioner. Housing Directive waivers are issued to waive handbook provisions, Mortgagee Letters and other directives issued by the program office. Housing Directive waivers are approved by OHP management under provisions determined by HUD.

Waiver requests are project specific. A Lender must follow the waiver provisions that are prescribed in its application process. If the waiver request is not associated with an application or not prescribed, the Lender should send the following information to the HUD Underwriter or Account Executive assigned to the project:

A. Project Name,
B. Project Address,
C. FHA Number,
D. Type of Facility,
E. Number of beds,
F. Number of units, and
G. Full explanation and supporting documentation on why the project cannot meet the program requirements.

It is also important to remember that statutory provisions may not be waived unless expressly permitted by statute. Generally, statutory requirements in the areas of fair housing, civil rights, environmental protection, and labor standards may not be waived.

1.6 Identity of Interest (IOI)

In processing and reviewing applications for FHA-insured mortgages, and in ensuring the long-term viability and ongoing programmatic compliance of FHA-insured projects and their members of the development team, operators, and investors pursuant to Section 232 of the National Housing Act, ORCF analyzes the relationship between and among entities. ORCF analyzes relationships in order to determine if one entity *could* significantly influence another entity to an extent that one or more of the entities party to a project-related transaction might be prevented from fully pursuing its own separate interests. In its analysis of the relationships between and among entities, HUD will determine whether any relationship would reasonably give rise to a presumption that the parties may not operate at arm's length. When it is determined that a relationship between or among the proposed parties constitutes an identity of interest, additional requirements and/or certain restrictions will apply.

A. Definition. An **"Identity of Interest"** (whether or not such term is capitalized) is any relationship based on family ties or financial interests between or among two or more entities involved in a project-related transaction which reasonably gives rise to a presumption that the entities may not operate at arms-length. These project-related transactions include, but are not limited to:

1. Establishing the purchase price of the property,
2. Establishing the cost of the design, rehabilitation or construction (or influencing the performance of entities charged with carrying out such work),
3. Establishing the terms of the financing,
4. Controlling the funds, or
5. Providing legal, consulting or management services.

B. Application. An identity of interest shall be deemed to exist between two entities if:

1. An entity, or any Owner of any direct or indirect ownership interest of such entity, or any family member of any such Owner, is:
    a. an Owner of any direct or indirect interest in the other party, or
    b. an officer, director, stockholder, partner, trustee, manager or member of such other party; or

2. Any officer, director, stockholder, partner, trustee, manager, member, principal staff, contract employee or consultant of an entity, or any family member of any such officer, director, trustee, stockholder, partner, trustee, manager, principal staff, contract employee or consultant, is:
    a. an Owner of any direct or indirect interest in the other party, or
    b. an officer, director, stockholder, partner, trustee, manager or member of such other party.

3. A "family member," as used herein, means, with respect to any person, his/her spouse, parents, siblings, children, grandparents, grandchildren, aunts, uncles, mother-in-law, father-in-law, brothers-in-law and sisters-in-law.

C. Determinations. The definition of "identity of interest" is generally applicable to HUD's determination of the appropriateness of relationships between and among parties involved in the financing, development and operation, management and ownership of the project. HUD concerns itself with the relationship between and among entities involved in project-related transactions throughout the development and asset management processes. Due to the inherent complexity of identity of interest determinations, additional guidance on the determinations made and what additional requirements or restrictions are applicable when involving various types of entities is provided in the appropriate chapters.

1. **Identities of interest addressed in this Handbook**. Identities of interest involving the following parties are addressed in this Handbook:
    a. Lenders (FHA Lender) (see Introduction, Chapter 2),
    b. Lenders (Existing Lender, Bridge Lender, and Mezzanine Lender) (see Production, Chapter 3)
    c. Borrowers, Buyers and Sellers (see Production, Chapter 3)
    d. Accounts Receivable Lenders (see Production, Chapter 15)
    e. Architects (see Production, Chapters 10 and 11)

f. Contractors (General Contractors, Subcontractors, Suppliers) (see Production, Chapters 10 and 11)
g. Operators and Management Agents (see Production, Chapter 8 and Asset Management, Chapter 8)

2. **Establishing the purchase price of the property**. HUD defines an identity of interest purchase as a transaction in which there is a relationship of any degree between the seller and purchaser (or any affiliates or principals of any such entities) that survives the transaction and could be construed to not be arms-length. These transactions include instances where a partner is being bought out, but may not necessarily include sale-leaseback transactions (see Production, Chapter 2 & 3).

3. **Establishing the cost of the design, rehabilitation or construction (or influencing the performance of entities charged with carrying out such work)**.
   a. Relationships between the architect and the Borrower, general contractor or subcontractor are discussed in Production, Chapter 11.
   b. Rules pertaining to Cost Certification (see Production, Chapter 11) are impacted when there is an identity of interest between or among:
      i. The Borrower and the general contractor, or
      ii. The Subcontractor and the Borrower, general contractor, another subcontractor, equipment lessor or material supplier
   c. HUD requires the FHA Lender (Lender) to assess a Borrower's previous use of a contractor when an identity of interest is involved (see Production, Chapter 10).

4. **Establishing the terms of the financing**.
   a. The Lender (and any affiliates or principals) cannot have an identity of interest with the Borrower (and any affiliates or principals). The Lender (and any affiliates or principals) also cannot have an identity of interest with a sponsor, general contractor, subcontractor or the seller of a particular transaction (see Introduction, Chapter 2).
   b. See Production, Chapter 12.2.E for guidance on how to process applications involving an identity of interest between the Lender and a tax credit equity syndicator or an investor.
   c. HUD also examines relationships between and among other Lenders involved in various aspects of the project:
      i. In the case of existing indebtedness created with an identity of interest between the Borrower and the current Lender in a banking relationship, where a third party lender submits the firm application, a Debt Investigation is always required (See Production, Chapter 3).
      ii. Bridge Lenders may have an identity of interest with the Lender, and an existing Lender may engage an identity of interest Lender in taking out a bridge loan of this debt. However, in both instances, HUD will require the Lender to disclose the relationship and to carefully justify the concluded valuation (see Production, Chapter 3).

iii. Mezzanine Lenders may not have an identity of interest with the principals of Borrower, but may have an identity of interest with the existing Lender, subject to the same scrutiny as Bridge Lenders (see Production, Chapter 3).

iv. In the case of bond financed transactions, a financing fee beyond 3.5% will not be recognized where an identity of interest is involved between the sponsor or Borrower and a Lender (see Production, Chapter 3).

5. **Controlling the funds**.
   a. When accounts receivable (AR) financing is involved, any identity of interest involving the AR Lender must be disclosed, analyzed and mitigated if it is determined that a potential conflict of interest is present (see Production, Chapter 15).
   b. Additional requirements and restrictions may apply when various other identities of interest exist (e.g. between the Borrower and the Operator, Management Agent and/or Lessee/Tenant).

6. **Providing legal, consulting or management services.**
   a. In the Opinions of Borrower's and Operator's Counsel (Form HUD-91275-INST), an attorney signing the Opinion cannot have any identity of interest with any party to the transaction. If another member of the firm has an interest in any entity involved in the transaction, such a relationship must be disclosed. Additionally, attorneys that represent both the Borrower and the Operator must disclose to both parties the inherent conflicts of interest involved.
   b. Fees arising from pre-opening management services provided are not included as a mortgageable cost if an identity of interest exists between the Borrower and the service provider (See Production, Chapter 2).
   c. Any identity of interest between a prospective risk management provider and the Borrower, Lessee or Lender must be disclosed and analyzed (see Asset Management, Chapter 5).

D. Conflict of Interest. HUD Regulations for general lender approval (24 CFR §202.5(l) include the following prohibition of conflicts of interest:

> *Conflict of interest and responsibility.* A mortgagee (Lender) may not pay anything of value, directly or indirectly, in connection with any insured mortgage transaction or transactions to any person or entity if such person or entity has received any other consideration from the mortgagor, seller, builder, or any other person for services related to such transactions or related to the purchase or sale of the mortgaged property, except that consideration, approved by the Secretary, may be paid for services actually performed. The mortgagee shall not pay a referral fee to any person or organization.

In its analysis of relationships between and among parties to project-related transactions and Lenders, HUD will examine identities of interest, in part, to determine if they result in a conflict of interest. When a conflict of interest is determined to exist, certain prohibitions or additional risk mitigation may be required.

[NOTE: See Introduction and Production Chapter 15, for specific discussions of conflicts of interest involving Lenders and AR financing situations.]

E. For publicly-traded lenders (or lenders owned by publicly-traded companies), the Borrower must provide to the Lender and HUD a certification that there is no identity of interest between Borrower (and any affiliates or principals) and the Lender (and any affiliates or principals), For purposes of complying with the IOI requirements of this handbook, publicly-traded Lenders (or lenders owned by publicly-traded companies) may rely on such Borrower certification in determining its satisfaction with said IOI requirements

Section I
Handbook Introduction

Chapter 2
Lender Relations, Approvals and Monitoring Requirements

2.1 Introduction

A. The Office of Residential Care Facilities (ORCF) within the Office of Healthcare Programs (OHP) actively partners with Section 232 approved lenders as an ongoing part of providing accessible and affordable housing in FHA-insured residential care facilities. In that regard, ORCF provides periodic training sessions and Kaizens, to promote effective dialogue between ORCF and the lending community in administering the Section 232 Program. In its review and monitoring, ORCF strives to provide feedback to lenders on their performance in order to enhance the quality of Lender activity, from underwriting through servicing. Lender Relations is an integral part of ORCF's way of achieving continuous improvement and productivity while reducing risk to the FHA Insurance Fund.

B. In order to participate in the Section 232 Program, Lenders are required to have staff skilled in underwriting, closing and servicing residential healthcare facility loans, and in preparing applications for Section 232 mortgage insurance. To that end, the Section 232 Program requires three levels of approval for participation.

   1. Approval in accordance with 24 CFR Part 202 and HUD Handbook 4000.1 (FHA Single Family Housing Policy Handbook).

   2. Approval as a Multifamily Accelerated Processing (MAP) Lender in accordance with published MAP guidelines. See MAP Guide for the standards required for qualification. Traditional Application Processing will not be accepted.

   3. Approval by ORCF as a Section 232 Program Lender and approval of individual Section 232 underwriters in accordance with requirements set forth in the MAP Guide and prescribed in Section 2.2 below.

C. Approval as a Section 232 Lender by ORCF is on a nationwide basis. Therefore, the Section 232 Program Lender may process Section 232 loans regardless of where the property is located.

2.2 Lender Approval Requirements

A. Once a Lender has met the MAP approval requirements under section 2.1.B.1 and B.2, the Lender must submit the following information, in the following format to ORCF to obtain Section 232 approval as described in section 2.1.B.3:

1. **Cover Letter.**

2. **Exhibit A**. Name of applicant, address, employer identification number, contact person or persons, telephone and fax number, e-mail address, branch offices for residential healthcare facility business with address, telephone and e-mail address, and the FHA Mortgagee ID Number.

3. **Exhibit B**. Evidence of approval from FHA's Multifamily Asset Counterparty Oversight Division (MACOD) or appropriate FHA-designated entity in accordance with 24 CFR Part 202 and the Mortgagee Approval Handbook, including the most recent recertification, if any.

4. **Exhibit C**. Evidence of MAP Approval

5. **Exhibit D**. A lender certification that the lender will only use underwriters for Section 232 mortgages that have already been approved as Section 232 Healthcare Underwriters or who obtain approval as set forth in Section 2.3 below.

B. A Lender must submit two copies of its application to:

Multifamily Asset Counterparty Oversight Division
ATTN: OHP Section 232 Approvals
Room 6158
HUD Building, 451 Seventh Street, SW
Washington, DC 20410

Review and approval or disapproval will take approximately 30 to 45 days from the date an application is received. The applicant will be informed in writing of the decision.

2.3 Approval Requirements for Section 232 Healthcare Underwriters

A. **Approval of Lender Underwriters.** The Lender's 232 Healthcare Underwriter(s) must be approved according to this section. Lender Underwriters heretofore have been approved by FHA's Multifamily Asset and Counterparty Oversight Division with final review by the Office of Residential Healthcare Facilities. The approval requirements are as follows, with exceptions to prior Lean approval effective prior to the issuance of this Handbook and Underwriter Approval Delegation as described in 2.3.C below:

1. **Cover Letter.**

2. **Exhibit A**. Include a resume for healthcare underwriter that supports experience in underwriting residential healthcare facilities within the previous five years. The resume should highlight(a) any experience that evidences satisfaction of training requirements for MAP Approval, and (b) any emphasis or training provided in-house or by industry experts in healthcare underwriting, finance and appraisals.

3. **Exhibit B**. Evidence of approval as a MAP-approved underwriter. In lieu of MAP deals that have been approved, an applicant seeking Section 232 underwriter approval can provide evidence of having completed ORCF's Section 232 Underwriter Training and also having underwritten, as a trainee, three additional Section 232 (New Construction/Substantial Rehabilitation, 223(f), or 241(a) loans) loans that have closed beyond what is provided in response to item 4 immediately below.

4. **Exhibit C**. Evidence that the healthcare underwriter: (a) has underwritten, as a trainee, three Section 232 (New Construction/Substantial Rehabilitation, 223(f)) or 241(a)) loans that have closed and (b) unless at least two of those loans are Section 232 Lean loans that have closed, has also participated in ORCF's Underwriter training. For all healthcare deals, the underwriter trainee must have clearly been involved in all aspects of the underwriting, including but not limited to financial calculations, underwriting analysis, quality completion of paperwork, readily communicating with and responsive to ORCF staff, all under the mentorship and guidance of the lender's Section 232 approved chief or lead underwriter and where appropriate, involved in responding to any issue arising in closing the loan. While trainees are encouraged work with ORCF approved underwriters in underwriting 223(a)(7) loans, for purposes of underwriter approval as described herein, Section 232/223(a)(7) loans do not count for underwriter approval under this exhibit.
    a. The Lender requesting approval of an underwriter trainee as a Section 232 Underwriter shall have direct experience in working with the trainee on healthcare deals.
    b. The Lender is to provide to HUD the Lender Narrative and Maximum Insurable Loan Calculation ("MILC") (Form HUD-92264A-ORCF) for the transactions underwritten by the Healthcare Underwriter. The Lender is also to provide a copy of the Healthcare Underwriter's attendance letter from ORCF Underwriter training, if applicable.

B. **Address for Submission of Applications.** A lender must submit two copies of its application to:

Multifamily Asset Counterparty Oversight Division
ATTN: OHP Section 232 Approvals
Room 6158
HUD Building, 451 Seventh Street, SW
Washington, DC 20410

Review and approval or disapproval will take approximately 30 to 45 days from the date the application is received. The applicant will be informed in writing of the decision.

C. **Underwriter Approval Delegation**. In accordance with Housing Notice H-2015-08 and Mortgagee Letter 2015-16, and until such further notice, FHA's MACOD requires eligible Section 232 Lenders to designate qualified individuals as "Chief Underwriter" and "Deputy Chief Underwriter."

1. Through the Chief Underwriter the Lender designates and approves Section 232 underwriters on their staff.

2. Depending on the volume of a Lender's firm commitments, as prescribed by the above referenced notice and mortgagee letter, the Lender either participates in Underwriter Approval Delegation or, for certain low volume lenders, may opt to continue to obtain underwriter approval from HUD as described in 2.3.A and B, above. All newly approved Section 232 Lenders must comply with Underwriter Approval Delegation.

3. All approval requirements for Section 232 Lenders, Chief Underwriter and Deputy Chief Underwriters are set forth by MACOD in accordance with the aforementioned Notice and Mortgagee Letter.

4. FHA's MACOD will continue to review and approve underwriters with suspension or termination enforcement actions within the previous 18 months.

2.4 Electronic Capability and Internet Access

ORCF will post information on its web site and will transmit messages to Lenders and to the lending community by electronic mail, or alternative secure methods, often with attached documents. This is the only format in which the lenders will receive this information. Much of the information required by ORCF must be submitted electronically, in a format determined by HUD to be acceptable.

2.5 Identity of Interest

A. **Section 232 Lenders**. An "Identity of Interest" is defined in Program Introduction, Chapter 1.6. Any identity of interest (IOI) between:

1. An officer, director, partner or the principal staff of the Section 232 Lender, or any of their family members, or contract employees of the Section 232 Lender working on a particular application, and

2. An officer, director, partner or family member of the sponsor, the Borrower, the principal of the Borrower, the general contractor, subcontractor, seller of the land or seller of the property is not permitted.

Transactions that involve an IOI between any persons described in subsections 1 and 2, above, are not allowed under the Section 232 program.

B. **Counsel to the Borrower**. An IOI shall be deemed to exist between the Section 232 Lender and Counsel to the Borrower (whether a law firm or an individual attorney), if:

1. Counsel to the Borrower, or any attorney who is a partner, member or employee of the law firm that is counsel to the Borrower, or any of their family members, is:
   a. An owner of any direct or indirect ownership interest in the Section 232 Lender, or
   b. An employee of the Section 232 Lender.

2. Any such identity of interest must be disclosed so that the relationship can be analyzed for potential impermissible conflicts of interest.

C. **Consultants**. It has long been common practice for lenders to use consultants, individuals and companies, to increase market share. The term consultant, as used here, applies to a mortgage broker, loan correspondent and packager. The consultant's sole purpose is to refer new business to the Section 232 Lender including information supplied by a proposed Borrower. HUD prohibits identities of interest between the consultant (as defined herein) and the Section 232 borrower, operator, or management agent, or any principals of or entities affiliated with those participants.

[NOTE: See Production, Chapter 12.2.E for a discussion of how to treat identities of interest between the Section 232 Lender and a tax credit equity syndicator or an investor.]

2.6 Limitation on Requirements

A. There are no additional capital requirements for Section 232 Lenders beyond HUD's minimum net worth and liquidity requirements in 24 CFR Part 202.

B. There is no additional fee required by HUD for qualifying as a Section 232 Lender.

C. Section 232 Lenders must notify FHA's MACOD, or designated entity, if there has been a change of address of the home office for residential healthcare facility business, electronic mail address, telephone number, ownership or if the Lender has a material change in its way of doing business. Lenders must also notify MACOD, or designated entity, if they withdraw as a Section 232 Lender, even if temporarily. These notification requirements are in addition to the requirements of FHA's MACOD, or designated entity, and MAP.

D. Section 232 Lenders must notify ORCF if they lose their MAP or FHA approval. The loss of either of those approvals also constitutes a loss of the Section 232 approval.

E. Section 232 Lenders are expected to maintain and improve the level of experience and the number of experienced staff members. ORCF expects the Section 232 Lenders to be certain that their staff meet the qualifications prescribed by the ORCF.

2.7 Agreement to Accept Monitoring

By accepting approval, the applicant for 232 Lender approval agrees that it will make its files, records and offices available to HUD or HUD's authorized contractors or agents for such monitoring of 232 loans as HUD determines. The Lender shall retain the origination and underwriting files for ten years from final closing even if the loan has been sold. The servicing file shall be maintained for the life of the loan plus 3 years.

2.8 Monitoring by HUD

The 232 Lender collects, prepares, and reviews the documentation for a firm application submission for mortgage insurance. Consequently, HUD will rely on the accuracy and validity of the documentation and data the Lender collected or created in order to obtain HUD's approval. HUD further requires that Lenders exercise integrity and competence in the origination of loans for FHA insurance. The 232 Lender will have the affirmative duty to report underwriting risks and provide for mitigation. HUD and Section 232 Lenders have a mutual interest in ensuring consistent Lender competence and compliance with this Section 232 Handbook and other relevant guidance and handbooks. If in the process of performing this work, the Lender fails to maintain such compliance and/or thereby places HUD at a risk level not fully disclosed, then HUD may pursue administrative action or other actions against the Lender.

A. Section 232 Lenders are subject to monitoring and periodic on-site reviews by HUD or its designee to verify that:

    1. The Lender's underwriting, closing, servicing, loss mitigation and asset management decisions are consistent with and adhere to any and all statutory requirements, regulatory requirements, Section 232 Handbook requirements, Mortgagee Letters, Notices, and other directives issued by HUD.

    2. The Lender's technical processing is consistent with the requirements of the Section 232 Handbook.

    3. Each of the Lender's loan applications is clear, complete, and organized in a manner that facilitates efficient review and processing.

4. The Lender has complied with the conditions of the Firm Commitment and the requirements for Initial or Final Closing.

5. The Lender has complied with the requirements for construction loan administration in the Section 232 Handbook.

B. HUD will not begin reviews of origination and underwriting documentation until after the Lender's first Section 232 Program Firm Commitment has been issued. Any origination loan may be reviewed by ORCF for up to ten years after Initial or Final Closing. Servicing loans may be reviewed for as long as HUD's Contract of Insurance is in effect plus three years.

C. If there has been fraud or misrepresentation by the Lender, HUD reserves its right to take action against the Lender under the contract of mortgage insurance and/or Mortgagee Review Board requirements. Instances of fraud are also referred to the Office of the Inspector General.

D. This review by HUD is not a substitute for other periodic audits and reviews by HUD, or any other authorized entity (e.g., Office of Inspector General or General Accounting Office) including a financial management review and a review of the Lender's Quality Control Plan as required by 24 CFR Part 202.5(h) and the Mortgagee Approval Handbook.

2.9 Quality Control Plans and Reviews

A. **Quality Control Plans**.

1. As with Lenders under Multifamily Accelerated Processing (MAP), Lenders under the Section 232 Healthcare Program must have and maintain a Quality Control Plan (QC Plan) for underwriting and construction loan administration, if applicable, of their FHA-insured mortgages. Objectives and guidance on requirements of Quality Control Plans is promulgated by MACOD, which is responsible for the approval of the QC Plan and for monitoring of the Section 232 Lender's performance in accordance with the QC Plan.

2. The QC Plan must clearly describe the requirements for the Section 232 loan origination, underwriting and construction loan administration. The QC Plan must also state the actions the Lender will take to assure acceptable management and comprehensive risk reduction in the lending process.

3. The Lender may submit the Section 232 QC Plan as part of an overall QC Plan that also incorporates the QC Plan for MAP activity, since by definition, a Section 232 Lender is also a MAP-Approved Lender. Regardless, the Section 232 QC Plan follows the same format and requirements required of the MAP QC Plan and MAP required QC Reviews, in accordance with MACOD requirements. Accordingly,

MACOD monitors and assesses lender compliance and risk for Section 232 Lenders, consistent with the requirements for MAP Approved Lenders.

B. **Quality Control Reviews**.

Quality Control Reviews (QC Reviews) of the Lender's Section 232 operations are to be part of the overall QC Review performed annually, in accordance with and set forth by MACOD guidance consistent for MAP Approved Lenders. For lenders participating in Underwriter Approval Delegation (see 2.3.C of this section), QC reviews must confirm that the Chief Underwriter and designated underwriters are approved and have satisfactorily completed all designation criteria including the Lender's approved training and approval requirements. The review will insure that each loan reviewed was underwritten by an approved and designated underwriter and if the underwriter was approved within the previous four years, the QC review should include a review of the underwriter's approval package. Additionally, Lenders opting to participate in Delegated Lender Processing for Reserve for Replacements and Non-critical Repair Escrows must address the appendix to the QC Plan reviewing the procedures, staff and recordkeeping for lender processing in accordance with Chapter 3 of the Asset Management portion of the Handbook.

1. In general, the Annual QC Review shall:
    a. Track all Section 232 loans presented by individual loan originators and underwriters.
    b. Evaluate the Lender's overall QC plan for adequacy and the Lender's operation for compliance with the QC plan.
    c. Perform audits of Section 232 Individual Loan Commitments. For Lenders with total commitments on 20 or more Section 232 loans in the applicable year of review, QC reviews will be completed for 5% of all closed loans. The maximum number of required reviews will be the lesser of 5% of all closed Section 232 loans or three reviews. Lenders with fewer than 20 commitments in the applicable year of review will be required to perform one QC review.

C. **Additional Reviews**.

1. Audit Reviews of Problem Loans. The originating Section 232 Lender must also undertake a comprehensive review and reexamination of any loan it underwrote that goes into claim either during construction or within ***three years*** after final endorsement. This must be done in all cases including those in which the Lender no longer has the loan in its portfolio.

2. Loans Purchased/Transferred from Another Section 232 Lender.

While not required, Section 232 Lenders are encouraged to perform a basic due diligence QC Review on any loan purchased from another Section 232 Lender.

D. **Independent Third Party Reviews**.

The Quality Control function, which must be independent of the origination and servicing functions, may be conducted by either of the following:

1. **In-house staff.** Lenders may establish a unit that is dedicated solely to Quality Control. Staff performing Quality Control must not be involved in the day-to-day processes that they are reviewing.

2. **Outside firms.** Lenders may use knowledgeable outside independent firms to assist in the performance of the QC Reviews. The outside source must use the Lender's QC Plan in completion of the annual QC review. Lenders seeking to use an outside firm should consult with MACOD on specific mandates pertaining to qualifications and acceptability of outside sources.

2.10 Other Monitoring Reviews

Generally, lenders and program participants are subject to several types of monitoring by HUD staff or other entities designated by HUD, which are described below.

A. **Desk Reviews**. The purpose of a desk review is to determine the level of compliance with HUD's loan origination, underwriting, closing, servicing, loss mitigation and/or asset management requirements. The review examines the policies, procedures, and practices as they relate to FHA-insured loans, to determine that they are timely, proper, and effective in mitigating unnecessary losses to HUD's insurance fund. Desk reviews may also be used as a tool to assess the effectiveness of training provided to Lenders.

B. **On-site Reviews**. These reviews, conducted at mortgagees' offices, consist of an opening conference; interviews with mortgagee officials and their employees; reviews of individual case files, logs and computer records; reviews of the mortgagees policies, procedures, and Quality Control Program; and an exit conference; followed, as appropriate, by selected re-verifications, such as interviews with Borrowers. Generally, Lenders are given 30 days' notice prior to a review and will be contacted in writing. Mortgagees are expected to have files requested by FHA monitors available for their review.

C. **Communication with Lenders regarding monitoring for Desk Reviews**.

1. **Initial Letter Following the Desk Review**. HUD will issue a letter to the Lender based on the findings of the desk review(s). The letter will identify and describe items of concern and require the Lender to reconcile with its Quality Control Plan to assure compliance with HUD requirements. Within 30 days of the date of the letter, the Lender is to provide HUD a full explanation for each finding with documentation, and a statement of corrective actions taken to prevent recurrence of each violation and cure the original finding.

2. **Final Letter**. After the Lender's response letter is reviewed by HUD, a final letter

will be sent to the Lender. The final letter indicates that the Corrective Actions were reviewed and states whether those Corrective Actions are considered appropriate to satisfy the desk review findings. Lenders have a responsibility and an obligation to use reasonable diligence in assuring that all requirements of the Section 232 Program are followed. If the findings are major, the actions prescribed in Sections 2.13 and 2.15 – 2.18 below will be followed.

D. **Communication with Lenders for On-site Reviews.**

1. **Exit Conference.** Upon completion of the on-site review, an exit conference is held to discuss problems and deficiencies in loan files and in the Lender's operations. Minor findings, which have been resolved by the Lender, may be closed out at the exit conference.

2. **Initial Letter Following the On-site Review.** HUD will issue a letter to the lender based on the findings of the on-site review(s). The letter will identify and describe items of concern and encourage the lender to reconcile with its Quality Control Plan to assure compliance with HUD requirements. Within 30 days of the date of the letter, the lender is to provide HUD with the following:

    a. Full explanation for each finding with documentation, and
    b. Statement of corrective actions taken to prevent recurrence of each violation.

3. **Final Letter.** After the Lender's response letter is reviewed by HUD, a final letter will be sent to the Lender. The final letter indicates that the Corrective Actions were reviewed and states whether those Corrective Actions are considered appropriate to satisfy the on-site review findings. Lenders have a responsibility and an obligation to use reasonable diligence in assuring that all requirements of the 232 Program are followed. If the findings are major, the actions prescribed in Sections 2.11 – 2.14 below will be followed.

2.11 Section 232 Program Authority to Issue Sanctions

A. **General.**

1. At any time, the ORCF Director may initiate discussions with a Section 232 Lender regarding any concerns HUD has with respect to any of the Lender's actions or personnel, or any changes the Lender should make in using its Section 232 Program authority.

2. If there are concerns about the Lender's underwriting and/or construction loan administration, the ORCF Director may take certain actions listed below without limitation.

3. Every ORCF employee must refer any possible instances of fraud or other criminal violations to the Office of the Inspector General.

B. **The ORCF Director may:**

1. Issue a Warning Letter (see Section 2.11 below) to the Section 232 Section Lender.

2. Temporarily suspend a Section 232 Lender's approval status (see Section 2.12 below). (This action must be taken in conjunction with steps 3, 4, 5 or 6 immediately below).

3. Initiate the issuance of a Limited Denial of Participation (LDP) to an individual or firm involved in a "covered transaction" as defined in 2 CFR 180.220 and 2 CFR 2424.220.

4. Make a referral to the Department's Mortgagee Review Board in accordance with procedures in Section 2.16 below.

5. Make a referral to FHA's MACOD.

6. For non-Lenders, those program participants who are not FHA-approved Mortgagees involved in the lending transaction, make a referral to the Departmental Enforcement Center (DEC) for appropriate action.

7. Make a referral to the HUD Office of Inspector General (OIG).

C. All referrals in Section 2.10 B above shall be in writing, and shall include an administrative record described in Section 2.13 below.

2.12 Basis for Issuance of Warning Letter from the ORFC Director

A. A Section 232 Lender's improper, inaccurate or inadequate origination, underwriting, construction loan administration, servicing, loss mitigation or asset management may lead to HUD issuing a Warning Letter or other sanction. Offenses that may be the basis for a Warning Letter include, *but are not limited to*:

1. Failure to provide required exhibits or the submission of incomplete or inaccurate exhibits. Although a Section 232 Lender will be permitted to correct minor errors or provide additional information, substantial inaccuracies or lack of significant information will result in the return of the application and retention of any fees collected. Moreover, even minor errors or the initial failure to provide full and complete information lead to loss of efficiency, avoidable delays and unnecessary use of staff time, and are thus significant.

2. Preparation of a Lender Narrative that is not supported by the appropriate documentation and analysis.

3. Failure to notify the HUD processing office promptly of changes in the mortgage loan application for a Firm Commitment that has been submitted, such as changes in rents, numbers of units or gross project area.

4. Failure to meet Section 232 closing requirements or construction loan administration requirements.

5. Failure to meet the Section 232 servicing, loss mitigation, or asset management requirements.

6. Business practices that do not conform to those generally adopted by prudent Lenders.

B. **The Warning Letter.**

1. May require a meeting with the Director of ORCF or designee's office with principal owners of, and/or officers of a Section 232 Lender to discuss the problem(s) and possible corrective action(s).

2. Shall specify the violation(s) for which the Warning Letter is issued.

3. Shall direct the taking of a corrective action by Lender and the Warning Letter will include the timeframe for corrective action.

C. The Warning Letter does not suspend a Lender's Section 232 privileges, but may impose a higher level of review of the Lender's underwriting, closing, servicing, loss mitigation or asset management. The Warning Letter must clearly state that it is a Warning Letter issued pursuant to the Section 232 Program requirement violated. The letter will be mailed to the Section 232 Lender's contact person as listed on the Section 232 Program website. The website is maintained by HUD, but the Lender is responsible for notifying HUD of any changes or updates to its contact information.

D. The Lender must be sent, along with each Warning Letter, a copy of the administrative record prepared with respect to that letter.

2.13 Basis for Suspending a Lender's 232 Program Approval

The ORCF Director may suspend the approval authority for a Section 232 Lender with the simultaneous referral to any of the entities listed in Section 2.15 below. Major offenses that might be the basis for suspending Section 232 Program Approval authority include, *but are*

not limited to:

A. Receipt of two or more Warning Letters over any twelve consecutive month period. In determining which sanctions to pursue as a result of prior warning letters, HUD will consider the circumstances surrounding those warning letters and any corrective actions undertaken by the Lender.

B. Fraud or material misrepresentation in the Lender's participation in the Section 232 program.

C. Lender collusion with or influence upon third party contractors to modify reports prepared by the contractor that cause the contractor's report to misrepresent a material fact to HUD, cause the HUD loan amount to be improperly increased, or otherwise be misleading or inaccurate.

D. A violation of Section 232 procedures by a third party contractor, which the Section 232 Lender knew, or should have known, was occurring and which, if performed by the Section 232 Lender itself, would constitute a ground for a sanction under this chapter.

E. Adequate evidence that a Lender's improper, inadequate or inaccurate underwriting, servicing, loss mitigation or asset management was a cause for assignment of an insured mortgage.

F. Identity-of-interest violations under Section 2.5 above.

G. Payment by or receipt of a payment by a Section 232 Lender of any kickback or other consideration, directly or indirectly, from the sponsor or from any other participant in the transaction, which would affect the Lender's independent evaluation, or represent a conflict of interest, in connection with any insured mortgage transaction.

H. Failure to comply with any agreement, certification, undertaking, or condition of approval listed in a Section 232 Lender's application for approval.

I. Noncompliance with any written requirement or directive of the ORCF Director.

J. Violation of the requirements of any contract with HUD or violation of the requirements in any statute, regulation, handbook, notice, mortgagee letter, or other written rule or instruction including the Section 232 Handbook.

K. Submission of false information or a false certification to HUD in connection with any Section 232 mortgage transaction.

L. Failure of a Section 232 Lender to respond in a timely manner to inquiries from the ORCF Director.

M. Indictment or conviction of a Section 232 Lender or any of its officers, directors, principals or employees for an offense that reflects on the responsibility, integrity or ability of the Lender to participate in Section 232 Program.

N. Employing or retaining an officer, partner, director or principal at the time when the person was suspended, debarred, ineligible or subject to a LDP, or otherwise prohibited from participation in HUD Programs, when the Section 232 Lender knew or should have known of the prohibition.

O. Employing or retaining an employee who is not an officer, partner, director or principal, and who is or will be working on HUD-FHA Program matters, at a time when that person was suspended, debarred, ineligible, or subject to a LDP or otherwise prohibited from participation in HUD Programs, when the Section 232 Lender knew or should have known of the prohibition.

P. Failure to cooperate with an audit or investigation by the HUD OIG or an inquiry by HUD into the conduct of the Section 232 Lender.

Q. Failure to fund insured mortgage loans or any misuse of mortgage loan proceeds.

R. Failure to cooperate with a monitoring review.

2.14 Administrative Record

When any final action is taken against a Section 232 Lender, an administrative record must be prepared, which includes all materials that were considered, reviewed and relied upon in the final decision. Although not intended to be an exhaustive listing, examples of material that should be included in the record are:

A. Correspondence between the Lender and HUD or the Lender and any third party contractors that was provided as documentation in support of the Firm Commitment application;

B. E-mails or other electronic transmissions (e.g., SMS text messages), if relied on in the decision process;

C. Faxes including the FAX cover sheet and the FAX confirmation sheet;

D. Application and underwriting submissions;

E. Copies of appropriate sections of notices, guidance including Frequently Asked Questions (FAQs) posted on the ORCF web site, handbooks, regulations and statutes;

F. Notes from meetings and telephone conversations; and

G. Work product and recommendations from subordinates.

[NOTE: Intra-agency memoranda and other such records should be included, but will not be released if privileged. The administrative record in its final form as described in this Section

relates to and supports HUD's final action and is not to be released to any person outside of HUD until it has been reviewed by HUD's Office of General Counsel.]

2.15 Appeals

A. **Request for an Appeal Conference.**

1. Whenever the ORCF Director imposes a sanction of suspension against a Section 232 Lender, the Lender may request in writing within 10 business days of receiving the sanction letter, an appeal conference before the Appeals Official.

2. The appeal conference before the Appeals Official regarding the ORCF Director's action will be held within 30 business days of HUD receiving the Section 232 Lender's appeal request. A Section 232 Lender may voluntarily request and the Appeals Official may agree to have an appeal conference held more than 10 business days but not more than 30 business days after the date of the lender's request for an appeal.

B. **Appeals Official**.

1. The Appeals Official must be an individual who was not previously involved with the proceedings or settlement discussions up to this point. Generally, the appeal will be made to the OHP Deputy Assistant Secretary or designee.

2. The ORCF Director provides the administrative record to the Appeals Official and points out the evidence on which the decision was made.

C. **Appeal Conference**.

1. The Section 232 Lender may provide oral arguments in support of its position and the evidence previously submitted. No new evidence may be submitted to the Appeals Official at this point.

2. Oral statements made by any participant at this meeting are not considered as evidence on any matter under consideration, except that the Appeals Official may consider voluntary admissions against interest as an admission by a representative of the Lender of any element of the violation charged.

   No transcript of the appeal conference will be made, unless the Lender elects to have a transcript made by a certified court reporter at its own expense. If the Lender elects to have a transcript made, it must provide three copies to the Appeals Official.

2.16 Results and Referrals

Major findings from any desk review or on-site review may result in a referral. Referrals may be made to:

A. Mortgagee Review Board;

B. FHA's MACOD;

C. HUD's DEC (suspension or debarment actions);

D. Office of Fair Housing and Equal Opportunity (FHEO) (fair lending issues);

E. HUD Office of General Counsel Office of Program Enforcement;

F. HUD OIG; and

G. State licensing agencies (e.g., Secretary of State, Real Estate Commissioner, Appraisal Review Board, Department of Banking, Bar Association).

2.17 Administrative Sanctions and Mortgagee Review Board (MRB) Actions

HUD may take an administrative action against individuals, companies and lenders for actions or omissions in connection with FHA mortgage insurance programs, including but not limited to:

A. **Limited Denial of Participation (LDP)**. Major isolated violations of FHA requirements may lead to an LDP of an individual or company (other than an approved Lender) by the Deputy Assistant Secretary. The LDP precludes the party from participating in the HUD Programs specified, within the jurisdiction of the HUD official taking the action, for up to one year (see 2 CFR 2424 Subpart J).

B. **Debarment or Suspension**. Violations of statutes or major or repeated violations of FHA requirements may lead to a debarment or suspension of an individual, a company, or with approval of the MRB, a lender, by the DEC or an Assistant Secretary. These actions preclude the party from participating in most Federal Domestic Programs (see 2 CFR Parts 180 and 2424).

C. **Mortgagee Review Board (MRB) Action**. HUD's Mortgagee Review Board (MRB) is authorized to impose civil money penalties on a Lender or other party, and to take administrative action against any approved Lender that does not comply with FHA requirements or the non-discrimination requirements of the Equal Credit Opportunity Act, the Fair Housing Act, or Executive Order 11063. The Department's regulations on the Mortgagee Review Board and civil money penalties are in 24 CFR Parts 25 and 30.

1. **Administrative Actions**. The Board may issue a letter of reprimand, place a Lender on probation, suspend or withdraw a Lender's approval, or enter into a Settlement Agreement. The Board may also issue a cease and desist order where there is reasonable cause to believe that a Lender is violating, or has violated, the Department's requirements. The nature and extent of the violation(s) determine the type of administrative action that the Board may take.

2. **Civil Money Penalties**. The Board is authorized to impose a civil money penalty pursuant to 24 CFR Section 30.35, against a party that knowingly and materially violates FHA Program regulations or requirements. A civil money penalty may be imposed against a Lender in addition to any other administrative action taken by the Board.

2.18 Enforcement Authority

Lenders and program participants shall review the enforcement authority applicable below.

Action/Entity	Citation	Enforcement	Official	Applies to:
Mortgagee Review Board (MRB)	24 CFR Part 25	Letter of reprimand, probation, suspension, withdrawal	MRB	Lenders
Limited Denial of Participation (LDP)	2 CFR Part 2424 Subpart J	Limits participation in specific Program activity and within a specific jurisdiction	Official Designated by Secretary	All Parties to the transactions (excluding Lenders)
Civil Money Penalty	24 CFR Part 30	Civil Money Penalty	Departmental Enforcement Center (DEC)	All Parties to the transactions
Suspension	2 CFR Part 180 and 2424	Suspends participation	DEC	All Parties to the transactions
Debarment	2 CFR Part 180 and 2424	Bars participation	DEC	All Parties to the transactions
Program Fraud Civil Remedies Act	24 CFR Part 28	Civil Penalties and/or assessments	HUD OIG and Office of Program Enforcement	All Parties to the transactions

Section I
Handbook Introduction

Appendix 2.1
Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care

Link to HUD Handbook 4060.1 REV-2 (FHA Title II Mortgagee Approval Handbook):
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/handbooks/hsgh/4060.1

Link to Multifamily Housing – Multifamily Accelerated Processing (MAP) homepage:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/mfh/map/maphome

Form Number	Form Name
HUD-92264A-ORCF	Maximum Insurable Loan Calculation (“MILC”)

Section II
Production

Chapter 1
Introduction and Application Processing

1.1 Introduction

The Production section of the Office of Residential Care Facilities reviews and approves applications for new Section 232 loans. ORCF has standardized submission and review requirements for all Section 232 applications. This portion of the handbook details the process for application submission, review, construction administration and closing.

1.2 Section 232 Approved Lenders

Only an approved Section 232 Lender and underwriter may submit an application for mortgage insurance for Section 232 projects. As the Section 232 approved Lender is the key player in the process, potential borrowers are encouraged to contact a Lender as early in the process as possible. The Lender will explain the process from initial discussions to underwriting and submittal of the application to the closing of the loan. The approved Lender list can be found at: http://portal.hud.gov/hudportal/documents/huddoc?id=aprvlend.pdf. Those Lenders marked with an asterisk can originate Section 232 loans.

1.3 Application Requirements

Application checklists for all of the Section 232 programs are located on the Section 232 program website. All exhibits on each application checklist are required, as applicable.

It is the Lender's responsibility to diligently review every exhibit to assure that it is complete and accurate prior to submitting the application to ORCF. The Lender is to submit an electronic version of the entire application. ORCF retains the right to request a hard copy of any application exhibits that facilitate the underwriting review process, e.g. documents with original signatures, documents illegible in electronic format, or large exhibits such as third party reports. Lenders are required to maintain a copy of the application in their files for monitoring.

The submission of computerized forms generated by a Lender is acceptable, as long as the retyped form has the Office Management and Budget (OMB) number, expiration date, form title, form number, is identical in content and in the order of the line items on the ORCF Form. The retyped form must be completed subject to that form's instructions.

1.4 Application Process

Under ORCF processing procedures, the Lender submits an application for a Firm Commitment. In the application, the Lender completes a full underwriting analysis of the transaction and must present its recommendation to ORCF in the Lender Narrative. The Lender Narrative provides a summary of the Lender's analysis as it relates to each of the exhibits in the application.

There are two application processes, Direct-to-Firm and the Two-Stage Process. Projects under Section 232/223(f), Section 232/241(a), 232/223(a)(7), 223(d), and 232(i) may only submit a Direct-to-Firm application. For New Construction and Substantial Rehabilitation projects the Lender may choose whether to submit the application Direct-to-Firm or via the Two-Stage process.

A. **Direct-to-Firm Application Process.** The Lender submits the entire Firm Application at one time for review by ORCF. ORCF will either issue a Firm Commitment or will reject the application. In either instance, HUD will retain the application fee.

B. **Two-Stage Application Process.** The Lender submits exhibits for the Initial Submission review by HUD. HUD's Initial Submission review includes the Underwriting Review, Appraisal and Market Study Review, Part 1 Legal Review, Title/Survey Review and Environmental Review. ORCF will either issue an Initial Submission Firm Commitment or a rejection letter. This differs from the Multifamily Firm Invitation process in that a Firm Commitment can be issued at the initial review phase. Once an Initial Submission Firm Commitment is issued, the Lender has 120 days to submit the Final Submission application. HUD will review the Final Submission application, which includes architecture, cost, professional liability insurance, labor relations and satisfaction of any conditions from the Initial Submission Firm Commitment. ORCF will confirm that there are no material changes to the application prior to issuing an Amended and Restated Firm Commitment. Mortgage increases of 5% or more will be re-evaluated by the ORCF Loan Committee. If an Amended and Restated Firm Commitment is issued, the project may proceed to closing.

   The HUD application fee is paid at the Initial Submission stage. If the Initial Submission stage does not result in a Firm Commitment being issued, the Lender may request a refund of 50% of the HUD application fee.

C. **Deficiencies.** When an application is received, the ORCF underwriter will advise the Lender of any defects or deficiencies. The Lender will have 10 business days, or such other brief timeframe as specified by ORCF, to cure the defects or deficiencies. Other applications pulled for review while the application is on hold awaiting Lender revision will take

precedence over the hold application. If not cured, the ORCF underwriter may take the project to Loan Committee as is, which could result in rejection of the application.

D. Lenders are encouraged to contact ORCF at LEANThinking@hud.gov during assembly of their applications in the following instances or with any other questions that impact the underwriting of the application:

1. **Waivers.** When the approval or denial of a waiver impacts the feasibility of a project, ORCF may review waiver requests in advance of the application submission.

2. **Environmental Concerns.** Where single item environmental concerns warrant consultation in order to avoid wasted time and effort, ORCF may review the issue prior to application submission. Examples of items that may merit early consultation include:
    a. **Unusual Site Conditions**, such as soil contamination, explosive hazards, unacceptable noise levels, fall hazards, etc.;
    b. **Flood Hazards or Wetlands:** If the site contains flood hazards or wetlands, an 8-step process can be initiated prior to application;
    c. **State Historic Preservation, US Fish and Wildlife:** In cases where HUD involvement is required to contact the State or regional office, Lenders can request that ORCF initiate the consultation process. The Lender must provide the research necessary for HUD to make a recommendation.

3. **Davis Bacon.** When the Lender is unsure whether Davis Bacon prevailing wage requirements apply, or which wage decision will be required, ORCF will work with HUD Labor Relations staff, as necessary, to provide an initial determination.

1.5 Loan Committee

Once the ORCF underwriter has reviewed the application and the Lender's conclusions, the ORCF underwriter will make a recommendation of approval or rejection to the ORCF Loan Committee. The Loan Committee will review the application and will either approve or reject it. If the Loan Committee approves of the application, a Firm Commitment will be issued. If the Loan Committee does not approve the application, a rejection letter will be issued and HUD will retain the application fee. In some instances, the Loan Committee may approve an application with special conditions or added risk mitigation so the project will be an acceptable risk to the FHA insurance fund.

1.6 Closing Process

After a Firm Commitment is issued for a project, the Lender and the Lender's attorney must begin compiling the required closing documents. The Lender must work directly with the ORCF closing coordinator, and the Lender's attorney must work directly with the assigned HUD

closing attorney. A closing date will be scheduled between the HUD closing attorney and the ORCF closing coordinator. The Lender must inform the HUD closing attorney and ORCF closing coordinator of any deadlines that must be met. While ORCF is unable to guarantee a specific closing date, the HUD closing attorney and ORCF closing coordinator will make every effort to accommodate deadlines whenever possible.

ORCF encourages Lenders to make every effort possible to accomplish the closing within this prescribed effective date of the firm commitment. In the event of extenuating circumstances, the Lender may request an extension. The extension request must provide justification acceptable to ORCF to support why extension of the Firm Commitment is warranted and necessary. See Production, Chapter 9.3 for more information.

To the extent Amendments to the Firm Commitment are required during the closing process, the Lender is encouraged to consolidate these requests to minimize the number of amendments requiring review and processing.

See Production, Chapter 9 for more details on closing requirements and the closing process.

Section II
Production

Chapter 2
Eligible Section 232 Mortgage Insurance Programs

2.1 Introduction

This chapter contains the basic program requirements for the Section 232 Residential Healthcare Facilities mortgage insurance programs for which Lenders can submit applications.

2.2 Eligible Projects

A. **Nursing Home:**

1. A public project, proprietary project, or project of a private nonprofit corporation or association, which consists of at least 20 beds and is licensed or regulated by the State (or, if there is no State law providing for such licensing and regulation by the State, by the municipality or other political subdivision in which the project is located).

2. Provides for the accommodation of convalescents or other persons who are not acutely ill and not in need of hospital care but who require skilled nursing care and related medical services, in which such nursing care and medical services are prescribed by, or are performed under the general direction of, persons licensed to provide such care or services in accordance with the laws of the State where the project is located.

B. **Assisted Living Facility:**

1. A proprietary, public or nonprofit project of at least 20 beds that is designed for frail elderly. Frail elderly means an elderly person of at least 62 years who is unable to perform at least three activities of daily living. Activities of daily living are activities regularly necessary for personal care including bathing, dressing, eating, getting in or out of beds and chairs, walking, going outdoors, using the toilet, preparing meals, shopping for personal items, obtaining and taking medications, managing money, using the telephone or performing light or heavy housework. Residents may make their own arrangements for support

services, such as physical therapy, nursing care, podiatry, etc. Residents may employ their own private staff to provide assistance with activities of daily living or other household/personal needs. A resident may have a contract with a home health agency for nursing and personal care services.

2. Must be licensed or regulated by the State, municipality or other political subdivision in which the project is located.

3. Must provide areas for central dining, kitchen (or preparation area where food is supplied from an offsite location), lounges, recreation, and other projects appropriate for the provision of supportive services to the residents of the project. Where food is provided from an offsite location, the preparation area in the project must be of sufficient size to allow for the installation of a full kitchen if it becomes necessary, or additional land must be available to add kitchen space.

4. Must provide continuous protective oversight that at a minimum includes awareness by management and staff of the residents' condition and location as well as the ability to intervene in a crisis on a 24-hour basis.

5. Must offer three meals per day to each resident.
   a. Residents in accommodations without kitchens must take three meals a day provided by the project.
   b. Residents whose accommodations have a kitchen must take at least one meal a day provided by the project.

6. The assisted living project's admission agreement must state that no dwelling unit in the project will be occupied by more than one person without the consent of the other residents of that unit. The resident who signed the admission agreement must consent before another person(s) may occupy the unit.

7. Not less than one (1) full bathroom must be provided for every four (4) residents and bathroom access from any bedroom or sleeping area must not pass through a public corridor or area.

C. **Intermediate Care Facility:**

1. A proprietary residential project or project of a private nonprofit corporation or association which consists of at least 20 beds and is licensed or regulated by the State, the municipality or other political subdivision in which the project is located.

2. Provides for the accommodation of persons who require minimum but continuous care (24-hour staffing/supervision) but are not in need of continuous medical or nursing services.

3. Corresponds to the Department of Health and Human Services definition of "Intermediate Care Facility" (ICF).

These types of facilities are under heightened scrutiny for deinstitutionalization under Title II of the Americans with Disabilities Act (ADA) and the United States Supreme Court landmark decision in Olmstead v. L.C., 527 U.S. 581 (1999).

D. **Board and Care Home.** Board and Care facilities considered eligible for Section 232 mortgage insurance must meet the following requirements:

1. A proprietary residential project or a residential project owned by a private nonprofit corporation or association which consists of at least 20 accommodations, bedrooms with a maximum of 4 persons for each accommodation, each with a full bath.

2. Must be regulated by the State in accordance with Section 1616(e) of the Social Security Act (Keys Amendment) and meet the State's eligibility requirements. The State also must have certified to the U.S. Department of Health and Human Services that the State is in compliance with the provisions of 1616(e). Specifically, the State must have the legislative authority and regulatory body that enables it to conduct unscheduled inspections of the project.

3. Provides room, board and continuous protective oversight. At a minimum continuous protective oversight includes awareness by management and staff of the residents' condition and location, as well as the ability to intervene in a crisis on a 24-hour basis.

4. Must be a freestanding structure or an identifiable and separate portion of an assisted living project, intermediate care project or nursing home.

5. Must provide areas for central dining, kitchen (or preparation area where food is supplied from an offsite location), lounges, recreation, and other multipurpose rooms. Where food is provided from an offsite location, the preparation area in the project must be of sufficient size to allow for the installation of a full kitchen if it becomes necessary, or additional land must be available to add kitchen space.

6. Must offer three meals per day to each resident.
   a. Residents in accommodations without kitchens must take the three meals a day provided by the project.
   b. Residents whose accommodations have a kitchen must take at least one meal a day provided by the project.

7. Charges may be assessed for providing other services that are in addition to those services included in the basic residential fee. Such services may include housekeeping, laundry, supervision of nutrition or medication and assistance with daily living (bathing, dressing, shopping, and eating).

8. Not less than one (1) full bathroom must be provided for every four (4) residents and bathroom access from any bedroom or sleeping area must not pass through a

public corridor or area.

2.3 Ineligible Projects

The following projects are not eligible for FHA mortgage insurance:

A. Projects with "Founder's Fees," "Life Care Fees," or other similar charges associated with "Buy-in" projects.

B. Projects not meeting program intent such as hospitals, clinics, diagnostic and treatment centers, group practice facilities, and halfway houses. (Residential care projects may include clinics, medical offices and similar related services as commercial space).

C. Projects where the Borrower/former owner, Operator or any of their affiliates, renamed or reformulated companies, filed for or emerged from bankruptcy within the last 5 years. 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.

D. Projects where the Project, Borrower, Operator or any of their affiliates, renamed or reformulated companies, are currently in bankruptcy.

E. Projects not providing the continuous protective oversight or minimum assistance required, such as retirement homes, boarding houses or single room occupancy residences that provide only food and shelter.

F. Projects designated by the Centers for Medicare and Medicaid Services (CMS) as Special Focus Facilities or similar future designation.

G. Projects designated as long-term acute care facilities.

2.4 Loan Types

A. **Section 232 New Construction**. A project qualifies as new construction when all project and construction elements are installed as part of the construction contract and no work has been done prior to the issuance of the HUD Firm Commitment.

B. **Section 232 Substantial Rehabilitation**. A project undergoing substantial repairs or improvements.

C. **Section 232/223(f) Purchase/Refinance**. Loans for projects that do not meet the requirements for substantial rehabilitation are eligible for refinance or purchase under this Section. Existing FHA-insured loans may refinance under Section 223(f).

D. **Section 232/223(a)(7) Refinance**. Streamlined refinance of an existing FHA-insured loan.

E. **Section 232/241(a) Supplemental Loans**. Supplemental loans under Section 241(a) are permitted for existing FHA-insured loans to complete an addition, repairs, replacements (including major movables), energy conservation measures and/or improvements. The purpose of these loans is to provide financing to keep the property competitive, extend its economic life, and provide for replacement of obsolescent equipment.

F. **Section 223(d) Operating Loss Loan (OLL)**. The OLL is a supplemental loan program that provides owners of FHA-insured projects a vehicle for recouping their out-of-pocket expenditures to fund unforeseen operating deficits during the early years of the project's operation.

G. **Section 232(i) Fire Safety Equipment Loan Program.** To be eligible, the loan must be for the purpose of financing the purchase and installation of fire safety equipment, primarily fire sprinkler systems. This includes the cost of structural modifications where necessary to install the equipment. The equipment to be installed must be in compliance with or exceed the requirements approved by Centers for Medicare and Medicare Services (CMS). For non-CMS regulated residential healthcare facilities, the Lender must provide documentation sufficient to ORCF that the fire sprinkler system is in compliance with its State's regulatory authorities.

2.5 General Section 232 Requirements

The following requirements or program features apply to *all* Section 232 mortgage insurance programs:

A. **Regulatory Agreement.** All Borrowers and Operators must execute an ORCF Regulatory Agreement governing the operation of the project in order to comply with Program Obligations, the requirements of the National Housing Act, as amended, and the regulations adopted by HUD. The regulatory agreement will be recorded at Initial Closing and will continue during such period of time as HUD is the owner, holder or insurer of the Note. Borrowers and Operators are responsible for any violations of the Regulatory Agreements and may be subject to adverse actions if violations occur. The Borrower Regulatory Agreement is Form HUD-92466-ORCF and the Operator Regulatory Agreement is Form HUD-92466A-ORCF.

B. **Single Asset Entity Borrower.** Single-asset entities (SAE) may also be referred to as single-purpose entities (SPE). The mortgaged healthcare facility must be the only asset of the Borrower; however, the Borrower entity is permitted to operate the project. ORCF may approve, in very limited circumstance, a non-single asset government-entity Borrower, such as a Public Housing Authority.

C. **Single Asset Entity Operator.** Single-asset entities (SAE) may also be referred to as single-

purpose entities (SPE); it is HUD's intent that the Operator will generally only own assets related to or necessary for the operation of the healthcare project. Unless one of the circumstances below applies, the Operator entity that operates the Section 232 healthcare project shall be a SAE. The Operator entity is not required to be a SAE when any one or more of the following circumstances applies.

1. The entity, although named on the license (in which HUD must obtain a security interest), does not hold or control substantial other project assets.

2. The entity's organizational purpose is limited to operating healthcare facilities, and the entity demonstrates, to HUD's satisfaction, (a) strong overall operational and financial capacity, and (b) that all operator assets of the project are legally protected from expenses or claims arising from the operator's activities outside of the subject Section 232 facility and other facilities covered by the same HUD-approved master lease, or

3. The project is a currently FHA-insured project for which refinance or a Transfer of Physical Assets is being requested and, during the operator's extended tenure at the project, the project's performance has been acceptable to the Lender and HUD.

Operators who are not SAEs must fully document that one of the above enumerated circumstances applies.

D. **Leased Projects.** Section 232 Borrowers are permitted to lease projects to qualified Operators. See Production, Chapter 8 for details on the requirements for leased projects.

E. **Special Use Facilities.** Special use facilities are facilities that serve a niche market (e.g. psychiatric facilities; facilities for the developmentally disabled; drug, alcohol, or eating disorder recovery facilities; hospice facilities). These facilities are likely to have a much higher component of their valuation in the operation, rather than the real estate, therefore posing a correspondingly high level of risk. ORCF has continued to experience extremely high claim rates of such facilities. If the Section 232 Lender decides to submit an application for a Special Use Facility, ORCF would anticipate a very conservatively underwritten application which would address, without limitation, the following where applicable:

1. The extent of the successful experience of the operator in dealing with the contemplated population;

2. How the principals of the project address the higher risks of the project associated with the targeted population (e.g., higher Professional Liability Insurance, etc.);

3. The project's ability to maintain stabilized occupancy over time, including any obsolescence risk;

4. Funding/operational risks related to:

a. continuing efforts to comply with the 1999 U.S. Supreme Court's Olmstead decision emphasizing that persons with disabilities receive services in the most integrated setting appropriate,
b. state initiatives to re-balance Medicaid funding toward home and community-based services, including the impact of the Center for Medicare and Medicaid Services regulatory requirements regarding home and community based settings, and
c. other relevant Medicaid funding threats within the state

F. **Independent Living Units:**

1. ORCF will allow up to 25% of the beds in a Section 232 project to be for Independent Living residents. Residents in Independent Living Units do not need to meet ORCF's definition of frail elderly. The project must offer services to all residents in the project comparable to those found in a skilled nursing project, assisted living project, board and care project or intermediate care project. Independent Living Units do not need to be licensed—they may be licensed or un-licensed. The units must be of a complimentary design and use to the rest of the project.

2. Lenders proposing a project containing a percentage of Independent Living Units exceeding 25% may wish to insure the project under two loans. ORCF has insured loans on projects where a portion of the project was insured under Section 232 and another portion was insured under Section 221(d)(4) or Section 231. Lenders wishing to pursue such a project must contact ORCF and ORCF will need to coordinate with Multifamily staff in the processing of the project – the Section 232 loan would be processed by ORCF and the Section 221(d)(4) or Section 231 loan would be processed by the Office of Multifamily Housing.

G. **Assessment Fees.** Assessment fees are paid upon entry to the project for purposes of covering the cost of assessing a new resident's need for services. Assessment fees that are in line with the prevailing market conditions are permitted.

H. **Scattered Site.** Projects not located on the same contiguous site are eligible for mortgage insurance under Section 232 under certain conditions. HUD generally requires that the two sites are under the same license, but may consider projects involving two different types of facilities, such as a Skilled Nursing Facilities (SNF) and an Assisted Living Facility (ALF), that cannot be under the same license. Additionally, HUD would look for evidence submitted by the Lender that demonstrates the parcels physically comprise a readily marketable real estate entity (e.g., the same immediate neighborhood) and that they are within an area limited enough to allow convenient and efficient management.

I. **Project Design.** Project design must cater to the specialized needs of the residents and be consistent with the market and industry best practices and accessibility requirements.

J. **Commercial Space.** Varies by program.

K. **Non-Resident Adult Day Care.** An eligible Healthcare project may provide nonresidential (outpatient) care for elderly individuals and others (e.g., persons with physical or mental disabilities) who require care during the day. A project that contains *only* a day care component is *not* eligible under Section 232. Non-resident adult day care space may not exceed 20% of the gross floor area of the project and nonresident day care income may not exceed 20% of gross income. The Lender must provide a Certificate of Need or operating license, if applicable, and must demonstrate that the day care space will be self-supporting.

L. **Real Estate requirements.** The mortgage must be on real estate held:

1. In fee simple;

2. Under a ground lease for not less than 99 years which is renewable; or

3. Under a ground lease approved by ORCF with a minimum term of 10 years beyond the loan maturity date.

M. **Environmental Review.** ORCF must comply with various environmental laws and regulations. ORCF imposes submission requirements on Lenders to assist in this review. These requirements are detailed in Production, Chapter 7, Environmental Review.

N. **Lender Site Visit.** The site inspection is an integral part of the overall underwriting process, and it is most appropriate that the Lender's underwriter for that transaction perform that site inspection. In rare circumstances this may be infeasible, in which case either the underwriter trainee assigned to that particular project or another Lean-approved underwriter in that firm may conduct the inspection. If the Lender has an employee who is a licensed appraiser (not a third-party contractor), ORCF will consider approving that individual to do a site inspection on a transaction-by-transaction basis. Requests for such approvals must be submitted to Lean Thinking.

O. **Prior Defaults/Claims.** ORCF does not prohibit applications for mortgage insurance for formerly HUD-held loans. However, ORCF is not obligated to accept any application with a Borrower/principal who has not proven to be a good business partner or for a property which has proven to be unsuccessful in the past. In such cases, the Lender should accept such applications only after they have considered and documented the economic, physical, operational or management factors that led to the specific changes that have occurred which would justify an application for new mortgage insurance.

P. **Non-recourse.** The ORCF Healthcare Project Note (Form HUD-94001-ORCF) contains a non-recourse provision. The non-recourse nature of the loan is not absolute, and can be overridden based on intentional bad acts as described in Section 8 of the Healthcare Project Note, Section 38 of the Healthcare Regulatory Agreement—Borrower, and Section 6 of the Healthcare Security Instrument, Form HUD-94000-ORCF. See Production, Chapter 6.1 E.3 for guidance on identifying those individuals or entities who will be personally liable for certain enumerated matters identified in the Regulatory Agreement.

Q. **Liens/Secondary Financing.** Section 232 of The National Housing Act requires mortgages insured under Section 232(either directly or pursuant to 223(f) or 223(a)(7) to be first liens. Mortgages insured under Section 241, 223(d), or 232i may be subordinate to other loans Secondary liens are permitted, in accordance with requirements for secondary financing described in Production, Chapter 3.

R. **Loan Term.** Varies by program. See individual program sections below for more information.

S. **Amortization plan.** All FHA-insured loans must fully amortize through a level annuity monthly payment plan (LAMP), which requires equal monthly payments of principal and interest. LAMP variations are permissible for transactions involving bond financing and/or tax abatement.

T. **Interest Rate.** The interest rate on an FHA-insured loan is negotiated between the Borrower and Lender and must be fixed for the term of the loan. If the interest rate is locked at a higher rate than is represented in the Firm Commitment, ORCF may reevaluate the terms of the Firm Commitment.

U. **Prepayment Restrictions.** ORCF permits prepayment restrictions in connection with the financing in compliance with 24 CFR 200.87.

V. **Underwriting Existing ORCF insured projects.** When underwriting projects that are currently FHA-insured, the Lender must do the following:

1. Disclose in the application that the project is FHA-insured and provide the existing project number.

2. Review the latest Real Estate Assessment Center (REAC) physical inspection report, if applicable, to assure that the Property Capital Needs Assessment or 3rd Party Architecture and Cost Report addresses the deficiencies if the score was below 60 or had any Health and Safety deductions.

3. Review the current interest rate. If the loan will increase the interest rate, identify reasons why the increased interest rate is an acceptable risk to ORCF.

4. Review the current monthly Principal, Interest and Mortgage Insurance Premium (MIP) payment. If the monthly payment will increase, identify reasons why the increased payment is an acceptable risk to ORCF.

5. Prepayment approval must be obtained from ORCF via the Insurance Termination Request for Multifamily Mortgage.

6. Disclose whether any principals that participate in the project have changed and comply with Previous Participation requirements as noted in Housing Notice H 2016-15 (or successors thereto).

W. **HUD Fees:**

1. **HUD Application Fee.** An application for Firm Commitment must be accompanied by an application commitment fee equal to $3 per $1,000 (30 basis points) of the requested loan amount with the exception of 232 (i) Fire Safety Equipment Loan Program. That fee is listed in Section 2.12 of this Chapter.

2. **HUD Inspection Fee:** Varies by program. See individual program sections below for more information.

X. **HUD Mortgage Insurance Premium (MIP):** The mortgage insurance premiums are based on a percentage of the loan amount and may vary, depending on the insurance program. The initial premium is payable in advance at Initial Endorsement (for Insurance of Advances transactions) and at Initial/Final Endorsement (for Insurance Upon Completion transactions). Current fees are published in the Federal Register. ORCF does not regulate the amount or timing of mortgage insurance premium collection by Lenders from Borrowers. Lenders may have their own policies as they deem appropriate, although regardless of such policies the lender remains responsible for remitting the MIP to HUD under the mortgage insurance contract.

Y. **Lender Fees and Charges.** Varies by program. See Production, Chapter 3 for limits to lender fees and charges.

Z. **Non-profit Developer and Housing Consultant Fees.** Non-profit Developer and Housing Consultant Fees are not permitted as mortgageable expenses on Section 232 projects.

AA. **Reserve for Replacement.** Varies by program. Initial deposits to the account are to be made in cash at the time of the loan closing. See individual program sections below for more information.

BB. **Cost Certification.** Cost Certification requirements can be found in Production, Chapter 11. Cost Certifications are not required on Section 232/223(a)(7) (except those 232/223(a)(7) projects with repairs without a PCNA provided in the Firm Application) or Section 232/223(d) projects. Projects with housing tax credits may be exempt from cost certification requirements (See Production, Chapter 12).

CC. **Insurance Requirements.** ORCF requires several types of insurance for Section 232 projects such as Professional Liability Insurance, Fidelity Bond Insurance, Property Insurance and Hazard Insurance. These insurance requirements are detailed in Production, Chapter 14.

DD. **Licensing.** Licenses are pledged as security for the loan, and any modifications (additions, deletions or major improvements) in the bed authority must be approved by ORCF. Any change in bed capacity without ORCF approval is a violation of the Regulatory Agreement. The Firm Application must include a copy of any current project licenses related to the project

as well as an explanation in the Lender Narrative of the number of beds and units licensed vs. underwritten. For beds requiring licensing, the number of licensed beds must be greater than or equal to the number of underwritten beds.

EE. **State Approvals.** The following approvals are required:

1. Certificate of Need. If applicable in the State where the project is located, Skilled nursing care and intermediate care beds require a certificate of need (CON) from the state agency with jurisdiction.

2. If no authorized State agency exists, or if it is not empowered to execute a CON, the State may conduct or commission an independent study of market need and feasibility acceptable to ORCF that:
    a. meets the standards of the American Institute of Certified Public Accountants, as certified by the State and/or preparer of the market study,
    b. assesses market need on a market wide basis, including excess beds and typical market wide operating occupancy rates of existing projects,
    c. discusses the impact of the proposed project on other healthcare projects and services in the area,
    d. provides demographic projections (size, density, distribution and vital statistics on household income) for the proposed project and market area,
    e. discusses available alternative healthcare delivery systems (geriatric day care, board and care, etc.),
    f. describes the reimbursement structure or payment sources of the proposed project and that of the competing projects in the area, including percentage of self-pay clients and daily cost to the client; percentage of Medicaid/Medicare clients and reimbursement rate; percentage of other clients (managed care, etc.).
    g. estimates market absorption period of beds in the proposed project by month including discussion of market supply, market reaction to unit type (private, semiprivate, 3-bed, etc.) and resident turnover.

3. If the State is not authorized to conduct, commission or certify the study as to form and substance, the Lender must provide financial and market information acceptable to ORCF.

4. The proposed Borrower may reimburse the State for the cost of the independent market and feasibility study.

5. Substantial Rehabilitation. If the authorized State agency requires a new CON, a new certification on Form Certificate of Need, (CON), for Health Project and Assurance of Enforcement (Form 92576A-ORCF) must be submitted. If the authorized State agency does not require a new CON, the Lender must provide a statement from the State agency that a new CON is not required and a copy of the original CON, if available. If a copy of the original CON is not available, please explain. If there is no authorized State agency and the rehabilitation involves new

beds, the alternative market study described above must be submitted.

6. Acquisition or Refinancing. If the authorized State agency requires a new CON, a new certification on Form 92576A-ORCF must be submitted. If the authorized State agency does not require a new CON, a statement from the State agency and the original CON must be submitted, if available. If a copy of the original CON is not available, please explain.

7. Bed authority modifications. Any proposed modifications (additions, deletions or major improvements) in the bed authority for any Section 232 project must receive prior approval from ORCF in order to protect ORCF's security interest. The Lender is expected to provide certification that the security for the loan after the release still exceeds the unpaid principal balance.

8. If the State requires a CON for assisted living or board and care facilities, the Lender must submit a copy to ORCF.

FF. **Experience of the Development Team.** Only Borrowers, Operators and Management Agents whose principals have at least three years of experience successfully operating multiple projects with the types of beds proposed will generally qualify for ORCF mortgage insurance. Those participants with experience successfully operating only one project must have a longer operating history than three years. Experience in a market near the proposed market is more highly valued than experience in a different region of the country. The experience must include marketing, operating, and where applicable, developing and leasing up the types of beds proposed. Experience of the Management Agent or Operator is generally not an acceptable mitigant to offset the Borrower's lack of experience. The evidence provided to document this experience must include a complete list of the names of each project, types of care provided, locations, unit and bed count, and dates. If a firm application proposes to add units to the market, the evidence must also include key operating metrics from initial lease-up to stabilization, including fill pace, occupancy, and Net Operating Income. If the firm application cites the experience of the principals of the Operator or Management Agent, the evidence must also include the specific responsibilities for those entities at each project. ORCF must ensure that participants have the requisite business and healthcare expertise to operate the project successfully and understand the health-related and hospitality-oriented needs of the proposed clientele.

GG. **Previous Participation Certification.** The purpose of the Previous Participation certification review is to assure that controlling participants in ORCF projects are responsible parties with regard to their participation in other governmental housing transactions. Controlling participants in a proposed transaction must submit information regarding previous participation in governmental housing transactions either via the electronic Active Partners Performance System (APPS) or on the Consolidated Certification. APPS submissions and Previous Participation Certification submissions must be approved prior to issuance of a Firm Commitment. Should participants change, revised submissions must be completed and approved prior to closing. Additional information on the previous

participation certification requirements can be found in Housing Notice H 2016-15 (or successors thereto).

1. **Controlling Participants.** Controlling Participants are those entities serving in the specified capacity of Borrower, Management Agent, Operator, General Contractor, or Master Tenant. Controlling Participants are individuals and entities determined by HUD to exercise financial or operational control over the project. Housing Notice H 2016-15 (or successors thereto) provides additional detail on who HUD considers to be a Controlling Participant for Previous Participation Review purposes.

2. **Organization Charts.** Organization charts are a visual representation of the ownership structure of an organization. The organization chart must be clear enough so that a person unfamiliar with the project and the entities involved can understand the ownership and control structure. Housing Notice H0 2016-15 (or successors thereto) details the organization chart submission requirements.

HH. **Risk Management Program.** Operators must implement and maintain a risk management program which incorporates a real-time incident reporting and tracking system that informs Operator's senior management of all incidents with the potential to expose the Operator to liability for personal injury or other damages. Each incident must be reviewed by the Operator's appropriately-trained professional staff, and such staff must follow-up on incidents as necessary. The risk management program must include appropriate training for Operator's staff.

The risk management program, which must be reviewed and approved by ORCF prior to closing, is expected to be maintained for the life of the loan. If at some time in the future the Operator requests to make any changes to the original risk management program that was approved by ORCF prior to closing, Asset Management would review and consider the request on a case-by-case basis.

1. **Internal.** Operator has the capacity to administer risk management that includes developing and documenting a risk management plan, incorporating a comprehensive software-based risk management program and have designated staff positions to implement the risk management program**.** In this approach, a highly experienced long-term care risk manager develops the company's risk management program, tracks incidents, analyzes incident trends, trains/re-trains front line staff as needed, works with the professional liability insurance carrier, etc. This could be implemented across multiple projects. This would be acceptable if the Operator has the capacity and track record as demonstrated through appropriate quality of care indicators.

2. **External.** Operator contracts with an experienced third party provider of electronic risk management. This would be required if the Operator does not have the capacity to develop and implement an internal program or if the quality of care indicators are below an acceptable level. This level of risk management provides the highest degree of confidence, accuracy and follow-through on reducing incidents and claims.

The statement of work must include, at a minimum, the following:

a. Access and use of an electronic incident tracking and reporting system
b. Project incident reporting and tracking with the third party provider's data processing/risk management center
c. Clinical specialists to review all incidents and trends and train staff accordingly
d. Assist the project in developing, implementing and maintaining appropriate risk prevention initiatives

II. **Deposit Account Control Agreement (DACA-Non-Governmental Receivables).** ORCF requires the Borrower, Operator and/or Master Tenant to execute one or more deposit account control agreements or similar agreements in a form approved by the FHA Lender and ORCF. In this agreement(s), the Borrower, Operator and/or Master Tenant acknowledge the FHA Lender as a secured party and grants to the FHA Lender control (as defined in Section 9-104 of the UCC) of one or more deposit accounts of the Project and all cash, moneys and other property on deposit.

JJ. **Deposit Account Instructions and Service Agreement (DAISA-Governmental Receivables).** ORCF requires the Borrower, Operator and/or Master Tenant to execute one or more DAISAs or similar agreements in a form approved by the FHA-insured Lender and ORCF on all projects with Governmental Receivables including accounts receivable from Medicaid, Medicare, or any other federal/state/local governmental entity that reimburses a health care project for patient services**.** This agreement outlines the instructions to the depository bank regarding its receipt of funds from governmental reimbursements and generally requires a daily sweep of such funds into an account subject to a deposit account control agreement.

KK. **Accounts Receivable Financing and Deposit Account Control Agreements.** For projects involving Accounts Receivable ("AR") financing, the AR Lender will also be a party to the deposit account control agreements. In some instances, the AR Lender will also be the depository bank under the deposit control account agreements. The deposit account control agreements must address the priorities between the AR Lender and the FHA Lender in the deposit account. Generally, the AR Lender will have a first lien on the AR and the FHA Lender will have a second lien on the AR. The FHA insured Lender must have a secured interest in the AR and the FHA Lender must be able to capture the funds in the event that HUD takes possession of the Project.

LL. **Sinking Fund.** The purpose of a Sinking Fund Account is to capture excess project capital in the earlier years of a FHA insured mortgage and to set aside funds in a separate account to make principal payments in the later years of the mortgage in the event that project revenues are not sufficient to make the principal payments. The amount to be set aside is provided in the amortization schedule for the FHA mortgage. ORCF requires the establishment of a Sinking Fund Account for nursing homes in States that:

Include a capital component (depreciation and interest) that is greater than an insignificant amount in their Medicaid reimbursement to nursing homes, and

Use a pass-through method of paying the provider for the depreciation (straight line depreciation) on assets.

The sinking fund is "funds held by Lender on behalf of the Borrower," is held under the contract of mortgage insurance "for and on behalf of the Borrower," and as such, is unrelated to the bond transaction.

1. The Borrower must:
    a. Agree to all requirements and conditions of ORCF.
    b. Authorize through a power of attorney the appointment of the Lender as payee of third-party reimbursement checks (project funds) in the event of a default.
    c. Sign a sinking fund agreement with the Lender in addition to a regulatory agreement with HUD.
    d. In the event of default under the terms of the mortgage, pursuant to which the loan has been accelerated, the Secretary may apply or authorize the application of the balance in such fund to the amount due on the mortgage debt.
    e. In the event of any conflict or inconsistency between this agreement and the FHA mortgage insurance documents, rules or regulations, the FHA mortgage insurance documents, rules and regulations shall control and prevail.

2. The sinking fund agreement must provide that withdrawals be made in accordance with an amortization schedule prepared by the Lender and only with the counter-signature of the Lender. The use of these funds for any other purpose is prohibited, without the express written permission of ORCF.

MM. **Initial Operating Deficit (IOD).** An IOD analysis is required on all applications where new units are being added to the subject or when the occupancy performance assumptions used in the underwriting are not presently being achieved by the subject. This analysis must be on the Initial Operating Deficit Escrow Calculation Template (Form HUD-91128-ORCF). Instructions for completing the Initial Operating Deficit Escrow Calculation Template can be found in Appendix 2.1. An escrow will be required when any period of deficit operations is identified. The escrow will provide funding for operating expenses and debt service when net income is inadequate during the initial lease-up and stabilization period. The escrow is not mortgageable, and must be funded either through cash or through one or more unconditional, irrevocable letter(s) of credit issued to the Lender by a banking institution.

Disbursements from the escrow may be authorized monthly with written approval from the Lender's Servicer and ORCF to meet any Cash Deficit in the operation of the Project. The term Cash Deficit means the shortfall between Income and Reasonable Operating Expenses. The IOD may also be used to cover Debt Service Payments and Reserve for Replacement Deposits. Expenses not accounted for in the IOD calculation must not be

considered reasonable operating expenses. Unused portions will be returned to the Borrower twelve months after final closing and when the project has demonstrated to ORCF's satisfaction that the Project has achieved a debt service coverage ratio (including the Mortgage Insurance Premium) of at least 1.45 for each month of three consecutive months. ORCF will look to the servicing Lender to certify that this requirement has been met, based on financial statements provided to the Lender by the Borrower.

NN. **Short-Term Debt Service Reserve Escrow (DSR).** A DSR may be required on applications where units are being added to a market, or in 223(f) applications where projects have not demonstrated the underwritten NOI for an appropriate period of time. The DSR will be between six and twelve months of principal, interest and MIP payments, or longer as needed to mitigate risk. The escrow will provide funding for debt service payments in the event that income is not available during the initial lease up and stabilization period and the IOD is depleted. The escrow is not mortgageable, and must be funded either through cash or one or more unconditional, irrevocable letter(s) of credit issued to the Lender by a banking institution.

Disbursements from the escrow may be authorized monthly with written approval from the Lender's Servicer and ORCF to make debt service payments after the start of amortization. Unused portions will be returned to the Borrower after the project has maintained an average of the underwritten debt service coverage for a 12-month period after final closing. ORCF will look to the servicing Lender to certify that this requirement has been met, based on financial statements provided to the Lender by the Borrower.

OO. **Assurance of Funds to Meet IOD and DSR.** The Borrower may fund the IOD and DSR the following ways. Excess loan proceeds may not be used to fund these escrows.

1. **Cash.** Escrow Agreement for Operating Deficits (Form HUD-92476B-ORCF) must be used when assurance is funded via non-project cash.

2. **One or more unconditional irrevocable letter(s) of credit**. Letters of Credit must be issued to the Lender by a banking institution. Letters of credit cannot be collateralized by project assets. HUD assumes no responsibility for reviewing the letter(s) of credit for sufficiency or enforceability.

PP. **Long-Term Debt Service Reserve Account.** If ORCF determines the loan presents an atypical long-term risk, ORCF may require that the Borrower establish, at final closing and maintain throughout the term of the loan, a long-term debt service reserve account. This account is an eligible mortgageable expense and is to remain for the life of the loan. The amount required to be initially placed in the long-term debt service reserve account and the minimum long-term balance to be maintained in that account will be determined during underwriting and separately identified in the Firm Commitment. Funds may be released from the account in extreme situations with ORCF approval. In the event that ORCF approves a release, the account must be refunded, and Borrower may take no distributions until the account is fully refunded.

QQ. **Fair Housing and Equal Opportunity.** Borrowers and all contractors and subcontractors must comply with HUD Fair Housing and Equal Opportunity requirements, including selection of occupants, employment, physical and programmatic accessibility See (42 U.S.C. 3601, et seq.), (24 CFR Part 100 and subsequent Sections), and "Affirmative Fair Housing Marketing" (24 CFR Part 200.600 and Handbook 8025.1 Revision 2).

RR. **Affirmative Fair Housing Marketing Plan.** Varies by program. See individual program sections below for more information.

SS. **Accessibility.** ORCF requires that projects be in compliance with various accessibility requirements. See the Section 232 Program website for specific requirements.

TT. **Federal Labor Standards.** Varies by program. See individual program sections below for more information.

UU. **Military Impacted Areas.** ORCF generally does not provide mortgage insurance in military impacted areas unless ORCF determines that demand from nonmilitary households is sufficient to sustain occupancy in both the insured projects and the market as a whole.

2.6 Section 232 New Construction & Substantial Rehabilitation

A. **New Construction.** A project qualifies as new construction when all project and construction elements are installed as part of the construction contract and no work has been done prior to the issuance of the HUD Firm Commitment.

B. **Substantial Rehabilitation.** A project qualifies as a substantial rehabilitation project when:

1. The hard costs of repairs, replacements, and improvements (not including major movable equipment) exceeds 15% of the project's value after completion of all repairs, replacements, and improvements; OR

2. Two or more major building components are being substantially replaced. The component must be significant to the building and its use, normally expected to last the useful life of the structure, and not minor or cosmetic. Substantially replaced means that at least 50% of the component must be replaced. Examples of major building components are: roof structures, wall or floor structures, foundations, plumbing, central heating and air conditioning systems, and electrical systems. An example related to a roof replacement is as follows: major building components: roof sheathing, rafters, framing members; minor building components: shingles or built-up roofing.

C. **Insurance of Advances vs. Insurance Upon Completion.** ORCF can insure loans to cover both the construction and permanent loan (Insurance of Advances) or just the permanent loan

(Insurance upon Completion). See Production, Chapter 18 for specific instructions for Insurance Upon Completion projects.

D. **Loan Term.** The maximum loan term is 40 years or 3/4 of the remaining economic life of the property, whichever is less. The minimum loan term may not be less than 10 years.

E. **Commercial Space:** Commercial space is limited to a maximum of 10% of the gross floor area of the project and 15% of the gross project income. Commercial space that is intended to exclusively serve the residents of the project is not counted toward the space and income limitations. The Lender must use a minimum vacancy of 20% when underwriting commercial space income. The Borrower must submit copies of the commercial leases to ORCF for approval. ORCF may require additional documentation prior to approving commercial space.

F. **Cost Certification.** The Borrower is required to submit a cost certification prepared by an independent public accountant upon completion of construction or substantial rehabilitation. The general contractor is required to submit a cost certification where a cost plus form of construction contract is used. Subcontractors with an identity of interest with the Borrower or general contractor are also required to cost certify. The loan amount that is finally endorsed for insurance by ORCF after completion of construction may be affected by the ORCF cost certification review. (See Production, Chapter 11 for complete details.)

G. **Federal Labor Standards.** The general contractor and all subcontractors are required to comply with federal wage and reporting requirements, including the payment of Davis Bacon prevailing wages and the submission of weekly certified payroll reports. Prevailing wage schedules are issued by the Department of Labor, and are available on their website. There are two different types of wage rates that could apply to Section 232 projects, Residential and Commercial, based on definitions established by the Department of Labor. The Lender must review which wage decision applies to the project in the Lender narrative, but ultimately the wage decision is determined by HUD's Office of Labor Standards and Enforcement.

H. **Assurance of Completion.** The Borrower shall provide for assurance of completion of the project in forms approved by ORCF.

1. For non-elevator or three story or less elevator buildings where the cost of construction or rehabilitation is more than $500,000 the assurance must be in the form of corporate surety bonds for payment and performance, each in the amount of 100% of ORCF's estimate of construction or rehabilitation cost. As an option, ORCF would accept a completion assurance agreement secured by a cash deposit or Letter of Credit in the amount of 15% of the ORCF estimate of construction or rehabilitation cost.

2. For elevator buildings of 4 stories or more, the assurance must be in the form of corporate surety bonds for payment and performance, each in the amount of 100% of ORCF's estimate of construction or rehabilitation cost. As an option, ORCF would

accept a completion assurance agreement secured by a cash deposit or Letter of Credit in the amount of 25% of ORCF's estimate of construction or rehabilitation cost. The Lender may provide more stringent requirements.

I. **Inspection Fee.** The HUD inspection fee is $5 per thousand of loan amount for new construction (0.0050 x the loan amount), and $5 per thousand of improvement costs for substantial rehabilitation (0.0050 x Total Structures on the Form HUD 92264a-ORCF, Maximum Insurable Loan Calculation).

J. **Mortgage Insurance Premium (MIP).** As stated in Section 2.5 above, the current MIP rates are published in the Federal Register. For construction projects, the following apply:

1. The Lender must provide a check for one year of MIP at initial closing.

2. For underwriting and cost certification purposes, the MIP must be calculated on a per diem basis.

3. Lenders may request release of funds from the working capital account to make the year 2 payment if the project has not yet reached final closing. This request must be made in writing to the ORCF Closing Coordinator.

K. **Working Capital Escrow:** The working capital escrow requirement for new construction Insured Advances transactions is 4% of the loan amount, half of which will be a construction contingency for cost overruns and approved change orders. A separate section to the working capital escrow will govern the 2% construction contingency. The construction contingency portion of the escrow will be refunded to the developer at final closing if not used. Change orders funded from the contingency portion of the working capital escrow will not be considered as the basis for a request for an increased loan amount. These funds are not mortgageable and the unused portion will be returned to the Borrower if not needed. The working capital portion of the escrow will be released upon the Lender's request 12 months after final closing and when the project has demonstrated to ORCF's satisfaction that the project has achieved break-even occupancy for each month of six consecutive months. Break-even occupancy is defined as 1.0 debt service coverage, based on all sources of project income including ancillary income, for each of six consecutive months. New Construction projects that apply for insurance upon completion (without insured construction advances) and Substantial Rehabilitation projects must meet the working capital requirements for projects with insurance of advances except for the extra 2% construction contingency section of the working capital requirement.

The Working Capital Escrow is designed to cover accruals of taxes, insurance, and interest in the case of construction delay, construction contingencies for cost overruns and change orders, and other miscellaneous expenses which are not included in the loan and is required for new construction and substantial rehabilitation proposals. A working capital escrow is required for both for-profit and non-profit projects.

L. **Major Movables.** Reasonable costs of Furniture, Fixture and Equipment (FF&E) may be included in the mortgageable project costs.

M. **Minor Movable Equipment and Supplies.** Costs for expendable nonrealty items such as china, flatware, utensils and instruments, linens, etc. may not be included in the general construction contract nor in major movable equipment. A minor movables equipment escrow account must be established at initial closing. The Lender must complete an analysis of the needed minor movable equipment and provide ORCF with a cost estimate for the minor movable equipment escrow.

N. **Reserve for Replacement.** A 15-Year Replacement Reserve analysis with recommendations for Annual Reserve Deposits must be submitted by the Lender in the loan application package (in the Final Submission package, in the case of a two-stage application). The Lender is required to obtain a PCNA to re-analyze the capital needs in Year 10. The Reserve for Replacement schedule must include the following:

1. Combined analysis of both capital items and major movable equipment;

2. Recommendation of Annual Reserve Deposits:
    a. Must be based on actual expected capital needs,
    b. Must reflect level annual deposits in years 1 through 15, and
    c. Must have a minimum balance of $1,000 per unit in years 2 through 15.

O. **Builder and Sponsor's Profit and Risk Allowance (BSPRA).** HUD's Section 221(d)(4) Multifamily Housing Mortgage Insurance program allows for the use of BSPRA. The calculation of BSPRA is not applicable for Section 232 projects.

P. **Deferred Builder's Profit.** Borrower and General Contractor may wish to defer payment of part or all of the Builder's Profit until final closing. This is allowable, but must be disclosed in the Construction Contract and on Contractor's and/or Mortgagor's Cost Breakdown (Form HUD-2328).

Q. **Affirmative Fair Housing Marketing Plan.** The Affirmative Fair Housing Marketing Requirements (24 CFR 200.600, Subpart M) apply to all insured new construction and substantial rehabilitation projects. Each applicant must submit an Affirmative Fair Housing Marketing Plan (Form HUD-935.2A). The plan must describe an affirmative program to attract tenants regardless of race, color, religion, sex, marital status, actual or perceived sexual orientation, gender identity, disability, familial status or national origin to the housing for initial rental. The affirmative advertising program must use majority and minority media and must identify those groups within the eligible population that are considered least likely to apply for the housing without special outreach. The plan must also include information on the applicant's nondiscriminatory hiring policy, its training program on nondiscrimination for its rental staff, and the display of the Department's Equal Housing Opportunity logo type and slogan. HUD must review and approve the Plan.

R. **Pre-Opening Management Fees**. Pre-Opening Management Fees include preparing, updating and reviewing lease-up and operational budgets; budgeting, coordinating, and planning for appropriate furniture, fixtures, and equipment; coordination and selection of appropriate business systems (e.g., emergency call, phone and computer systems); occupancy development; licensing submissions and plans; staff hiring and training; and, development of operations and systems manuals for major functions (administration, nursing, marketing, dietary, etc.). ORCF will allow reasonable pre-opening management fees to be included as a mortgageable item in the event that there is not an identity of interest between the Borrower and entity that will be providing the pre-opening management services. The Lender must review the prior experience of the service provider to ensure they have sufficient experience and must submit a line item budget detailing how the funds will be used.

S. **Marketing.** An allowance for marketing expenses may be included as a mortgageable item. The Lender must review the marketing plan and budget to assure that the marketing expenses are reasonable, and that sufficient funds will be available to market the project.

2.7 RESERVED

2.8 Section 232/241(a) Supplemental Loans

A Section 232/241(a) Supplemental Loan may be used to (1) finance improvements or additions to an existing HUD insured Section 232 project (including the addition of new beds/units); (2) provide financing for furniture and major movable equipment to be used in the operation of the project, and/or (3) finance energy conservation improvements. This financing is a supplement to the existing insured loan(s) and is available without refinancing the existing loan(s). The purpose of the supplemental loan is not to provide luxury items, nor is it to provide extensive hospital type equipment in a residential healthcare project. The purpose is to provide projects with a means to keep the project competitive, extend its economic life, and provide for financing replacement of obsolescent equipment.

Borrowers proposing to include a land purchase with a Section 241(a) Supplemental Loan may be able to do so as long as the addition or improvements are funded with the proceeds of the supplemental loan, and the construction is commenced within a reasonable time from closing; however, the 241(a) supplemental loan on an existing 232 project may not exceed the maximum mortgage amount prescribed under Section 232 of the National Housing Act.

The supplemental loan does not alter the usual requirements outlined in the original Regulatory Agreement. Section 232/241(a) projects are generally underwritten and reviewed in the same manner as are the Section 232 Substantial Rehabilitation projects as clarified below:

A. Insurance of Advances. Insurance of advances will be available only for supplemental loans of $100,000 or more.

B. Inspection Fee. Same as for Substantial Rehabilitation.

C. Working Capital. No working capital deposit is required.

D. Labor Relations. When a supplemental loan is provided under Section 241(a) of the Act, it is subject to Davis-Bacon prevailing wage requirements only if (1) the current mortgage on the project is insured under a program that was subject to Davis-Bacon in accordance with Sec. 212 of the National Housing Act, or (2) the current mortgage is a HUD-held mortgage that was originally insured under a program that was subject to Davis-Bacon in accordance with Sec. 212. Davis-Bacon wage rates would not apply to a Sec. 241(a) supplemental loan on a project where the current insured mortgage is not subject to Davis-Bacon and/or an earlier FHA-insured mortgage that was subject to Davis-Bacon has been paid off prior to application for the Sec. 241(a) loan. For example, if the project's original loan was a Section 232 New Construction loan (that has not yet matured or been pre-paid), the Section 241 loan would be subject to Davis-Bacon. If the project's original loan was a 232/223(f) loan, then the Section 241 loan would not be subject to Davis-Bacon.

E. Loan Term. The loan term is limited to the term of the existing insured mortgage, unless otherwise approved by HUD.

The loan term may not be less than 10 years.

F. Commercial Space. Commercial space is limited to a maximum of 10% of the gross floor area of the project and 15% of the gross project income. Commercial space that is intended to exclusively serve the residents of the project is not counted toward the space and income limitations. The Lender must use a minimum vacancy of 20% when underwriting commercial space income. The Borrowers must submit copies of the commercial leases to ORCF for approval. ORCF may require additional documentation prior to approving commercial space.

G. Reserve for Replacement. The Lender must complete an analysis of the existing replacement reserve account to determine whether additional deposits to the account will be required as a result of the supplemental loan. A full 15-year analysis, similar to that completed as part of a Property Capital Needs Assessment (PCNA), may not be required if the status of the reserve for replacement account can be determined in consultation with the ORCF Account Executive. Annual Reserve deposits must be level (the same amount each year) in years 1-15, and must provide for a minimum of at least $1,000 per unit each year.

H. Affirmative Fair Housing Marketing Plan Requirements (AFHMP). An AFHMP is required for new projects and an updated AFHMP is required when there is an increase or reduction in the number of beds or units, or when there is some other form of physical conversion, such as the conversion of beds to more conventional dwelling units or vice-versa. Such physical changes have implications for possible changes in marketing strategy. When any AFHMP is prepared, it must include a marketing strategy designed to reach the population in the market area that is least likely to apply for or occupy the particular project.

Form HUD-935.2A (the AFHMP) provides instructions for determining marketing targets and completing the form.

An existing AFHMP must be reviewed at least every five years and when there are significant demographic changes in the marketing area - to determine whether an update is needed. Also, an existing AFHMP must be reviewed to see if an update is needed when other significant events occur or changes in occupancy policies are proposed - for example, a proposed change in the targeted mix of elderly residents and non-elderly disabled residents. Other examples of circumstances when an AFHMP should be reviewed for a needed update include if the project is having difficulty maintaining occupancy, if there is a change in the designation of the marketing area or expanded marketing area, and if the composition of current occupancy or the waiting list do not sufficiently match the diversity of the current or proposed marketing area. The project owner or management must maintain records of the result of the review and, whether an updated form must be submitted to HUD for approval or not, the records must show that a review was conducted, the results of the review, and whether/how the AFHMP was updated or why an update was not needed.

2.9 Section 232/223(f) Refinance

The major requirements for Section 232/223(f) Projects for acquisition or refinancing are as follows:

A. **Property eligibility.** The project must have been completed or substantially rehabilitated for at least three years prior to the date of the Firm Commitment application. Projects with additions completed less than three years previous are eligible as long as the addition was not larger than the original project in size <u>and</u> number of beds.

   1. Any property acquired before the date of the mortgage insurance application will be treated as a refinance transaction. Any property acquired after the date of the mortgage insurance application will be treated as a purchase.

   2. In a purchase transaction, any identity of interest, however slight, between seller and purchaser requires the application to be processed as a refinance. An owner Operator that continues to operate the project after the sale constitutes an identity of interest.

B. **Ineligible projects.** Projects requiring a level of repairs that constitutes substantial rehabilitation, as defined in this chapter, are not eligible for mortgage insurance under this section.

C. **Insurance upon completion.** ORCF will only insure the permanent loan under this program if all critical repairs are completed before ORCF closing of the loan.

D. **No Equity Take-Out.** Borrowers and Operators may not receive any cash proceeds from the refinance of the loan under Section 232/223(f). The sole purpose for the program is

for owners to refinance at lower interest rates, reduce debt service requirements, and make needed repairs. Special circumstances may exist when dealing with REITs, see Production, Chapter 3 discussion of existing indebtedness.

E. **Loan Term.** The maximum loan term is 35 years or 75% of the remaining economic life of the property, whichever is less (See 24 CFR 200.82). A lower term may be appropriate to mitigate loan risk, but may not be less than 10 years.

F. **Commercial Space:** Commercial space is limited to a maximum of 20% of the gross floor area of the project and 20% of the gross project income. Commercial space that is intended to exclusively serve the residents of the project is not counted toward the space and income limitations. The Lender must use a minimum vacancy of 20% when underwriting commercial space income. The Borrowers must submit copies of the commercial leases to ORCF for approval. ORCF may require additional documentation prior to approving commercial space.

G. **Inspection Fee:**

1. If the total cost of the critical, non-critical and Borrower-proposed repairs is equal to or less than $3,000 per underwritten bed, the HUD Inspection Fee is $30 per underwritten bed. This includes projects where there are no repairs.

2. If the total cost of the critical, non-critical and Borrower-proposed repairs is greater than $3,000 per underwritten bed, the HUD Inspection Fee is 1% of the total cost of the critical, non-critical and Borrower-proposed repairs.

3. Note that if the Lender elects and is approved to follow the optional process for delegated non-critical repair escrow administration described below in Section 2.9 K 3, HUD will not charge an inspection fee

H. **Lender Fees & Charges.** The maximum financing fee the Lender may charge is 3.5% of the loan amount. Higher fees up to 5.5% are permissible in bond transactions. (See Production, Chapter 3)

I. **Federal Labor Standards.** To be eligible under this section, the level of required repairs cannot meet the standard for substantial rehabilitation. Therefore, the prevailing wage requirements (Davis-Bacon) of the Department of Labor do not apply to this program.

J. **Affirmative Fair Housing Marketing Plan Requirements.** Mortgage insurance under Section 223(f) of the National Housing Act, while covered by the nondiscrimination provisions of the Fair Housing Act and Executive Order 11063, is exempt from the submission of a written plan. However, a Section 223(f) applicant is required to conceive, implement and maintain records for its affirmative marketing efforts.

K. **Repairs.** If the Lender is proposing that repairs be financed as part of the loan, the Lender must submit a list of the proposed repairs and their associated costs. The Lender must

include all repairs identified in the PCNA, or an explanation as to why any repairs have not been included.

1. Critical repairs must be performed prior to closing of the loan.

2. Non-critical repairs, including Borrower-Elective Repairs, approved by ORCF may be completed after closing when a financial escrow equal to 120% of the non-critical repair costs is established at closing. Completion of repairs is expected to be performed within 12 months of closing.

3. Optional Process for Delegated Non-Critical Repair Escrow (NCRE) Administration to FHA Lenders/Servicers. See Asset Management, Chapter 3.2.4.H for additional details.
    a. The Lender's Firm Commitment application (in the Lender Narrative) must specify that the Lender will assume noncritical repair escrow administration on that particular transaction.
    b. The fee(s) to pay for the inspection(s) discussed in Asset Management, Chapter 3.2.4.G.3, may be treated as a HUD eligible cost, and must be listed on the Maximum Insurable Loan Calculation (Form HUD-92264a-ORCF) on the Sources and Uses tab in the "Other (Describe)" category under "HUD Eligible Costs."
    c. The Firm Commitment will include a Special Condition acknowledging that the Lender has been approved to administer the NCRE and addressing the refund of the HUD Inspection Fee.

4. See Production, Chapter 10.16 – Completion of Repairs Pursuant to Section 223(f) and 223(a)7, for details.

L. **Reserve for Replacement.** A 15-Year Replacement Reserve analysis with recommendations for Initial and Annual Reserve Deposits must be submitted by the Lender in the loan application package. See Production, Chapter 4.5 – Section 232/223(f), for details. The Lender is required to obtain a new PCNA to re-analyze the capital needs in Year 10. The Reserve for Replacement schedule must be based on the PCNA and must include the following:

1. Combined analysis of both capital items and major movable equipment;

2. Recommendation of an Initial Deposit;

3. Recommendation of Annual Reserve Deposits:
    a. must reflect level annual deposits in years 1 through 15, and
    b. must have a minimum balance of $1,000 per unit in years 1 through 15.

M. **Properties with Fair Housing Act Accessibility violations.** Any property available for first occupancy after March 13, 1991, that does not comply with the Fair Housing Act accessibility design and construction standards must, as a condition of mortgage

insurance, be modified or retrofitted to comply with Fair Housing Act accessibility design standards. The modifications/retrofits may be completed after closing with appropriate financial escrows at closing, with all work items performed within 12 months in accordance with ORCF instructions and critical items completed immediately. The applicability of various accessibility guidelines and laws, and the permissible time for making such repairs is described in the Handicapped Accessibility Matrix for Section 232 available on the Section 232 Program website. Direct link: http://portal.hud.gov/hudportal/documents/huddoc?id=AccessMatrixSec232.docx.

Where a state or local law has higher accessibility requirements, the property must be modified or retrofitted to comply with those standards. In addition, refer also to the Uniform Federal Accessibility Standard and for any place of public accommodation at the property (e.g. leasing office, commercial space), refer to Title III of the Americans with Disabilities Act.

N. **Review of the Project's Financial Performance.** The Lender must review the annual and trailing 12 month financial statements to assess the project's financial performance, and must base underwritten income and expenses on a consideration of historic and trailing twelve-month performance. Changes in recent performance relative to historic performance must be carefully reviewed to assure conservative underwriting. The Lender must use the project-specific expense for underwritten reserve for replacement, taxes and management fee.

2.10 Section 232/223(a)(7) Refinance

The Section 232/223(a)(7) refinance program is an expedited program that requires fewer exhibits than other ORCF programs. The major requirements for Section 232/223(a)(7) Projects refinancing of existing FHA-insured projects are as follows:

A. **Property Eligibility**. Section 232/223(a)(7) loans apply to the refinancing of loans insured under Section 232 and Section 232/223(f)/223(a)(7) loans apply to refinancing of loans originally insured under Section 232 pursuant to Section 223(f), Loans originally insured under Section 241(a) or Section 223(d)(3) can be refinanced under Section223(a)(7)) as 241(a)/223(a)(7) and 223(d)/223(a)(7) loans, respectively.

Multiple FHA-insured loans on the same property may be refinanced under one Section 232/223(a)(7) loan as long as it meets the Maximum Insurable Loan Calculation requirements.

Coinsured, risk-share loans and HUD-held loans are not eligible to refinance under Section 232/223(a)(7).

B. **Loan Term and Extensions:**

1. In general, the term of the new refinanced loan will not exceed the remaining term of the existing loan. In the event that two loans with different terms are being refinanced under one Section 232/223(a)(7) loan, the maturity date of the primary loan determines the term of the new loan. The minimum loan term may not be less than 10 years.

2. However, ORCF may approve a term extension if ORCF determines that the longer term will inure to the benefit of the FHA Fund.

3. Extension Rules:
    a. The extended loan term cannot be greater than the remaining term of the existing loan plus 12 years.
    b. The extended loan term cannot be greater than the statutory loan term of the original ORCF loan program. The loan term of a second or greater 223(a)(7) refinance is not impacted by the term of an earlier 223(a)(7) refinance. It is only limited by the statutory loan term of the original ORCF loan program. For example:
        i. The 223(a)(7) refinance of a 232 new construction loan cannot have a loan term greater than 40 years.
        ii. In the case of a second 223(a)(7) refinance of an earlier 223(a)(7) refinance with a 33-year term, which itself refinanced a 232 new construction loan, the second 223(a)(7) loan cannot have a loan term greater than 40 years.
    c. The extended loan term cannot be greater than the term of the original ORCF loan at the time it was first insured by HUD. For example, if a 223(f) loan originally receives a loan term of 25 years at the time it first receives ORCF insurance, the 223(a)(7) refinance of that loan cannot have a loan term greater than 25 years.

4. The following criteria will be considered as part of the underwriting risk analysis for a proposed extension of loan term:
    a. An increase in annual deposits to the reserve for replacement account.
    b. An additional deposit to the reserve for replacement account funded either through owner contribution or loan proceeds.
    c. The resulting debt service coverage ratio both with and without a term extension.
    d. Remaining economic life of the project.
    e. The physical condition of the property based on a Property Capital Needs Assessment (PCNA) as well as the latest Real Estate Assessment Center (REAC) inspection report.
    f. Strong occupancy trends
    g. A significant owner equity contribution
    h. A high Medicare Star Rating (if applicable)
    i. Demonstrated strong operator performance.

j. Other considerations as deemed appropriate by ORCF

C. **Application Fee.** An application for Firm Commitment must be accompanied by an application commitment fee equal to $1.5 per $1,000 (0.15%) of the requested loan amount.

D. **Inspection Fee.** There is no inspection fee.

E. **Cost Certification.** There is no cost certification.

F. **Prepayment Approval.** Prepayment approval must be obtained from ORCF via the Insurance Termination Request for Multifamily Mortgage (Form HUD-9807).

G. **Federal Labor Standards.** Not applicable.

H. **Affirmative Fair Housing Marketing Plan (AFHMP) Requirements.** No new AFHMP is required as part of the 223(a)(7) application.

I. **Previous Participation Certification.** Existing principals that have previously submitted a Previous Participation Certification are not required to re-submit as part of the Section 223(a)(7) refinance. If new principals are proposed, or current principals have not yet been approved by ORCF, these principals must submit either complete an APPS submission or the Previous Participation portion of the Consolidated Certification. See Housing Notice H 2016-15 (or successors thereto) for additional information on the Previous Participation review process.

J. **Physical Assessment of the Property.** The application is to include either a Project Capital Needs Assessment (PCNA) or a narrative description of the Lender's site visit.

1. **PCNA.** A PCNA is required as part of the 232/223(a)(7) if any of the following apply:
   a. A PCNA has not been completed for the project in the last ten years,
   b. A term extension is requested,
   c. If the project is not fully sprinklered (Skilled Nursing Facilities only). HUD will use the CMS database which lists projects that are fully sprinklered. The CMS database can be found here: http://www.medicare.gov/Download/DownloadDB.asp

   If a PCNA is required, the application must also include a Reserve for Replacement schedule that is based on the PCNA and includes the following:

   a. Combined analysis of both capital items and major movable equipment
   b. Rollover of the existing Reserve for Replacement Account
   c. Recommendation of any additional Initial Deposit
   d. Recommendation of Annual Reserve Deposits
      i. must reflect level annual deposits in years 1 through 15, and

ii. must have a minimum balance of $1,000 per unit in years 1 through 15.

The Lender is required to obtain a new PCNA to re-analyze the capital needs in Year 10. See the PCNA Statement of Work on the Section 232 Program website. Direct link: http://portal.hud.gov/hudportal/documents/huddoc?id=PCNA_SOW_223a7.docx. In addition, refer also to the Uniform Federal Accessibility Standard and for any place of public accommodation at the property (e.g. leasing office, commercial space), refer to Title III of the Americans with Disabilities Act"

2. **Lender Site Visit.** If a PCNA is not submitted, the Lender must conduct a site visit of the project. The site inspection is an integral part of the overall underwriting process, and it is most appropriate that the Lender's underwriter for that transaction perform that site inspection. In rare circumstances this may be infeasible, in which case either the underwriter trainee assigned to that particular project, or another Lean-approved underwriter in that firm, may conduct the inspection. If the Lender has an employee who is a licensed appraiser (not a third-party contractor), ORCF will consider approving that individual to do a site inspection on a transaction-by-transaction basis. Requests for such approvals must be submitted to Lean Thinking.

   The Lender must provide the following information regarding the site visit:

   a. Date of the site visit;
   b. Name of the Lender representative who visited the project and eligibility to conduct the inspection per the requirements above;
   c. Describe the property's general condition, curb appeal and marketability;
   d. Confirm that deficiencies from the latest Real Estate Assessment Center (REAC) inspection have been addressed. It is recommended that the Lender representative use the latest REAC report to ensure that all deficiencies have been corrected;
   e. Name(s) of the individual(s) with whom the Lender representative met with on site (e.g., project administrator, etc.); and
   f. Photographs (optional).

K. **Environmental Review:**

1. **Flood Hazards.** The Lender must consult the most recent Federal Emergency Management Agency (FEMA) Flood Map to determine if the property is located in a 100-year or 500-year floodplain. The Lender must submit a completed Standard Flood Hazard Determination Form (FEMA Form 086-0-32) and ORCF will review the project to ensure compliance with federal law. Depending on the type and location of any floodplain on the property, the Borrower may be required to obtain and maintain flood insurance for the duration of the mortgage (please see Production, Chapter 14, Section 7.H for further information). Additional special conditions related to flood hazards may be added to the Firm Commitment.

2. Refinances of FHA-insured projects under Section 232/223(a)(7) require an environmental review similar to Section 232/223(f) projects under the following circumstances:
    a. The project has completed a building addition without an environmental review;
    b. The project will acquire or has acquired land that was not insured under the original mortgage loan and the project has yet to receive HUD's approval of the additional land; or
    c. The project will involve changes, improvements or repairs that do not qualify as routine maintenance.

3. When an environmental review is required per Section 2.10 K 2:
    a. The Lender must supply a Phase I Environmental Site Assessment;
    b. To assist HUD in making its historic preservation determination, the Borrower or Lender may submit a letter to the appropriate State Historic Preservation Officer (SHPO). Doing so may greatly expedite the Section 106 consultation process. See Production, Chapter 7.5.D.4.;
    c. The Lender must provide the information discussed at Sections 7.5, 7.6 and 7.7 of Production, Chapter 7 to assist HUD in preparation of an Environmental Assessment.;
    d. HUD staff are required to use HEROS – Form HUD-4128 to document all Part 50 environmental reviews.

L. **Repairs.** If the Lender is proposing that repairs be financed as part of the loan, the Lender must submit a list of the proposed repairs and their associated costs. If a PCNA was completed, the Lender must include all repairs identified in the PCNA, or an explanation as to why any repairs have not been included.

1. Critical repairs must be performed prior to closing of the loan.

2. Non-critical repairs, including Borrower-Elective Repairs, approved by ORCF may be completed after closing when a financial escrow equal to 110% of the non-critical repair costs is established at closing. Completion of repairs is expected to be performed within 12 months of closing.

3. Repairs Paid for with Reserve for Replacement Funds. If any repairs proposed under the Section 232/223(a)(7) will be paid for with funds from the project's current reserve for replacement account, the cost of those repairs cannot be included as a mortgageable item. If any of the repairs are non-critical or Borrower-Elective Repairs, the reserve for replacement funds must be deposited into the non-critical repair escrow at closing and will be subject to the 10% owner contribution.

4. <u>Optional Process for Delegated Non-Critical Repair Escrow Administration to FHA Lenders/Servicers.</u> See Section 2.9 K 3 for details.

5. See Production, Chapter 10.16 – Completion of Repairs Pursuant to Section 223(f) and 223(a)7, for details.

M. **Payback Period.** The payback period for transaction costs in a Section 232/223(a)(7) refinance must be 10 years or less. To determine the payback period, divide the costs of the transaction that are outlined in the Maximum Insurable Loan Calculation (Form HUD-92264a-ORCF) by the annual debt service savings including MIP. Exclude from the calculation: Reserve for Replacement Deposit, Required Repairs, Final Month's Interest, and Initial MIP. Any prepayment penalty must be included as a transaction cost in the payback period calculation, but only the portion not covered by an interest rate premium.

N. **REAC Inspection Review.** The Lender must review the latest REAC inspection report. If the latest inspection resulted in a score below 60, the Lender must submit documentation evidencing that all deficiencies cited in the latest inspection report have been addressed. The documentation may take the form of photographs and invoices.

O. **Review of Life Safety, Compliant, and State Annual Surveys.** ORCF staff will review findings from the most recent Life Safety, Compliant, and State Annual Surveys to determine if outstanding findings have been addressed.

P. **Review of the Project's Financial Performance.** The Lender must review the trailing 12 month financial statements to assess the project's financial performance, and must base underwritten income and expenses on the recent trailing 12-month performance. The Lender must use the project specific expense for underwritten reserve for replacement, taxes and management fee.

Q. **No Equity Take-Out.** Borrowers and Operators may not receive any cash proceeds from the refinance of the loan under Section 232/223(a)(7). The sole purpose for the program is for owners to refinance existing FHA-insured debt at lower interest rates, reduce debt service requirements and make needed repairs. In no event may the Borrower "cash out" the Reserve for Replacement or Residual Receipts account. The existing reserves and residual receipts are to be rolled over to the newly refinanced loan.

R. **Use of Operating Funds for Refinance Costs.** All expenses associated with a Section 223(a)(7) refinance (e.g. transaction costs) must be borne by the Borrower (i.e. principals thereof) and must not come from the project operating account. The use of project operating funds for the Section 223(a)(7) transaction is strictly prohibited and will result in a Borrower violation of the Regulatory Agreement, an Audited Financial Statement finding of non-compliance and possible referral to the Departmental Enforcement Center.

2.11 Section 232/223(d) Operating Loss Loan

Section 223(d) Operating Loss Loans (OLL) provide Borrowers of FHA-insured loans a vehicle for recouping their out-of-pocket expenditures to fund unforeseen operating deficits on projects

during the early years of the project's operation. HUD's authority to approve a Section 223(d) Operating Loss Loan is set forth in Section 223(d) of the NHA, which was later amended by Section 427 of the Housing and Community Development Act of 1987. Section 223(d) authorizes two types of OLL, both of which are available to FHA-insured Section 232 new construction and substantial rehabilitation health care projects managed by ORCF. Section 223(f) projects are ineligible for the OLL.

The OLL is an indication of HUD's awareness that a project may struggle in the early years of operations due to cash flow demands and unforeseen expenses; and that HUD is concerned about these debt service problems and net operating losses. To preserve projects and to encourage Borrowers to provide working capital to fund early financial shortfalls and avert mortgage defaults, the OLL permits Borrowers to recover their unplanned contributed equity more quickly than surplus cash notes and surplus cash distributions would otherwise allow. Thus, the OLL may serve as a valuable incentive for encouraging Borrowers to remain financially committed to their projects.

The OLL proposal must demonstrate that the project is financially viable (i.e., that it has sufficient net operating income to meet the increased debt service obligations that come with the OLL). The OLL covers losses that occurred during a 24-month period. This is called the "Loss Period."

A. **Types of OLLs:**

1. Section 232/223(d)(2): Loss period is the 24-months immediately following the cost cut-off date. The application must be submitted to ORCF within 3 years following the end of the loss period.

2. Section 232/223(d)(3): Loss period is any 24-month period within the first ten years following the cost cut-off date. The application must be submitted to ORCF within ten years following the end of the loss period.

There may be two OLLs (one under Section 223(d)(2) and one under Section 223(d)(3)) for any individual project but no more than one per subsection, and loss periods may not overlap.

B. **General Requirements.** To be eligible for an operating loss loan, the following conditions apply:

1. The existing project loan must be insured by the Secretary under Section 232 of the National Housing Act.

2. An allowable loss has been experienced. The loss loan must not exceed the amount of the operating loss and, for loans insured under 223(d)(3), may not exceed 80% of the unreimbursed cash contribution.

3. The operating loss must have occurred during a specific period of time outlined below.

4. The Borrower entity must have owned the project during the loss period.

5. All funds in the Initial Operating Deficit, if applicable, have been disbursed.

6. All cost certification requirements have been satisfied.

7. The Borrower, Operator, and Management Agent, as applicable, meet ORCF standards for project management.

8. The Lender on the first mortgage must consent in writing to the OLL.

9. The original mortgage and the operating loss loan must be cross-defaulted.

C. **Definition of an Operating Loss.** An Operating Loss is the difference between project income and project operating expenses. The following operating expenses may be included: taxes, interest on the mortgage debt, mortgage insurance premiums, hazard insurance premiums, maintenance, salaries, supplies, and other expense for project operation. The following payments and charges may not be included: loan principal payments, depreciation, payments to the reserve for replacement account, payments to a sinking fund, lender fees, charges incurred in connection with the application for the Operating Loss Loan (OLL), projected anticipated losses, expenses that were funded or should have been funded from the working capital deposit (e.g., tax and insurance escrows), construction cost overruns, Officers' salaries, and bad debt or write-offs as a result of an identity of interest tenant.

D. **Determination of the Operating Loss Period.** The loss period (or 10-year period, under 223(d)(3)) begins the day after the cost certification cut-off date. (The National Housing Act refers to the date of completion, as determined by the Secretary. Since costs as of the cut-off date are considered in the original loan computation, the date of completion referenced in the law has been interpreted to mean the completion of development. Therefore, the cut-off date, not the final completion date is used in determining the loss period.) The maximum loss period is two years. Applications within the two-year period may be made, if necessary, to prevent foreclosure or assignment. Losses claimed during the loss period must be evidenced by audited financial statements.

E. **Loan Term.** The loan term may not exceed the unexpired term of the original loan.

F. **Preliminary Discussions for Operating Loss Loan.** At the request of the Borrower, or the Lender, ORCF representatives will meet with the Borrower and/or Lender to conduct informal, preliminary discussions. These preliminary discussions will define the objectives that might be addressed by the OLL, and will seek to ensure that the Borrower is acquainted with ORCF guidelines relative to OLL's. In certain instances where market conditions have changed or not borne out the original underwritten project forecasts; or in instances were a project has failed to perform as originally underwritten, ORCF may require an independent

appraisal, market study or operational assessment, in addition to the firm application exhibits. This preliminary communication must include a discussion of whether an appraisal, market study or other third-party assessment report will be required.

G. **Sustaining Occupancy.** Implicit with the concept of an OLL, is that this special supplemental loan is intended for those projects that survived early financial struggles and finally attained a sustaining occupancy. The OLL proposal must demonstrate that the project is financially viable and stabilized, i.e., that it is currently solvent (revenues exceed expenses and current assets exceed current liabilities) and that it has sufficient net operating income to meet the increased debt service obligations that come with the OLL.

H. **Projects not at Sustaining Occupancy.** In certain instances, an OLL may be proposed as an essential element of a work-out strategy designed to avert an ORCF claim. In those infrequent instances, an OLL may be approved based on *projected* sustaining occupancy. However, only actual losses may be funded, and there must be evidence that sustaining occupancy will be reached within a reasonable period of time.

With regard only to these OLL loans proposed to avert ORCF claims, the proceeds of the loan may be required to cure financial deficits. If the loan proceeds are needed to cover mortgage loan deficit situations, all or part of the loan proceeds must be held in escrow by the Lender until the project has reached sustaining occupancy. The funds escrowed for these purposes may be released only with prior approval from ORCF. The requirements for the escrow will be defined as a Special Condition in the Firm Commitment.

The method of disbursement from the operating loss loan escrow is as follows. The Borrower must submit to ORCF:

1. Monthly income and expense statements signed by a Principal of the Borrower entity and approved by the Lender. The owner's monthly statements must contain the following acknowledgement:

   WARNING: 18 USC 1001 provides, among other things, that whoever knowingly and willingly makes or uses a document of writing containing any false, fictitious, or fraudulent statement or entry, in any manner within the jurisdiction of any department or agency of the United States, shall be fined or imprisoned for not more than five years, or both.

2. Quarterly and year-to-date financial statements submitted by the licensed operator and covering the project operations, including:
   a. Profit and Loss Statement
   b. Balance Sheet
   c. Accounts Payable Aging
   d. Accounts Receivable Aging
   e. Census
   f. Cash Flow Statement

3. The statements must be submitted within 30 days of the end of each quarter. The statements may, at the Operator's option, be Operator-certified rather than audited provided, however, that if ORCF determines that a particular Operator's certified statements are inadequate, unreliable, or not presented in a manner that is as consistent as feasible with Generally Accepted Accounting Principles, then ORCF may, on a case-by-case basis, require more detailed and/or audited financial statements from the Operator. This requirement will continue until all losses have been substantiated as actual losses by an audited statement. This must be a condition of the Commitment. If the Borrower has not submitted the quarterly statement by the due date, ORCF will withhold approval of the disbursement until the statements are submitted. ORCF will review the certified annual statement against the uncertified statements submitted by the Borrower and make necessary adjustments in future disbursements.

4. Operating loss loan funds must be held in escrow and can only be used to offset current losses until it is evident the project is on sound footing. Once the project reaches sustaining occupancy, any balance remaining in the escrow must be held until sustaining occupancy is maintained for a one-year period.

I. **Federal Labor Standards.** Not applicable.

J. **Reserve for Replacement.** The project is subject to an existing loan, so it will continue to retain the existing reserve for replacement requirements. No reserve for replacement analysis will be completed as part of the Operating Loss Loan.

K. **Cost Certification.** Not applicable.

L. **Inspection Fee.** This program does not require an inspection fee.

M. **Affirmative Fair Housing Marketing Plan (AFHMP) Requirements.** No new AFHMP is required as part of the OLL application.

2.12 Section 232(i) Fire Safety Equipment Loan Program

A section 232 (i) loan is used to purchase and install fire safety equipment, primarily fire sprinkler systems. The costs may also include structural modifications where necessary to install the equipment. The equipment to be installed must be in compliance with or exceed the requirements approved by CMS. For non-CMS regulated residential healthcare facilities, the Lender must provide documentation sufficient to ORCF that the fire safety equipment is in compliance with its State's regulatory authorities. Where a state or local law has higher accessibility requirements, the property must be modified or retrofitted to comply with those standards.

The major requirements for Section 232(i) Projects are as follows:

A. **Insurance upon completion.** ORCF will only insure the permanent loan under this program.

B. **Mortgage Insurance Premium.** The ORCF loan insurance premium is 1% of the loan balance per annum unless changed by Notice in the Federal Register.

C. **Loan Term:**

1. Maximum Term of Loan in the amount of $100,000 or greater.
    a. Co-terminus with the maturity of the existing ORCF loan (if applicable),
    b. 15 years or
    c. 100% of the remaining economic life of the property (if applicable), whichever is less.

2. Maximum Term of Loan in the amount less than $100,000
    a. Co-terminus with the maturity of the existing ORCF loan (if applicable),
    b. 10 years or
    c. 75% of the remaining economic life of the property (if applicable), whichever is less.

D. **Fees.** The HUD application fee is $4 per $1,000 of the fire safety loan amount. The HUD inspection fee is $5 per thousand of loan amount.

E. **Assurance of Completion.** The commitment under this program is for insurance upon completion, therefore, an assurance of completion is not required.

F. **Loan Security.** In proposals where the property is already encumbered by a first mortgage or deed of trust, ORCF will accept a mortgage or deed of trust that is subordinate to the first lien.

G. **Federal Labor Standards.** Davis-Bacon requirements do not apply to fire safety equipment installation.

H. **Affirmative Fair Housing Marketing Plan Requirements.** Mortgage Insurance under Section 232(i) of the National Housing Act, while covered by the nondiscrimination provisions of the Fair Housing Act and Executive Order 11063, is exempt from the submission of a written plan. However, a Section 232(i) applicant is required to conceive, implement, and maintain records for its affirmative marketing efforts.

I. **Property Capital Needs Assessment (PCNA).** For non-FHA insured projects, the application must include a PCNA. The Lender must also include an analysis of the reserve for replacement account that is consistent with the PCNA. See the PCNA Statement of Work on the Section 232 Program website.

J. **Reserve for Replacement.** The property must have a reserve for replacement account for the project or establish a replacement reserve account prior to closing. For non-FHA insured projects, the PCNA must be used to complete an analysis of the reserve for replacement account. Additional deposits to the account will be required as a result of the fire safety loan. The Lender must also determine the appropriate annual reserve for replacement deposit for the project.

K. **Repairs:**

1. Critical repairs must be performed prior to closing of the loan.

2. Non-critical repairs, including Borrower proposed repairs approved by ORCF, may be completed after closing when a financial escrow equal to 120% of the non-critical repair costs is established at closing. Completion of repairs is expected to be performed within 12 months of closing. Any repair unrelated to fire safety equipment installation cannot be funded by loan proceeds.

L. **Cost Certification.** A cost certification must be completed by the Borrower on the Borrower's Certificate of Actual Costs (Form HUD-ORCF-2205A) and must be approved by ORCF prior to closing. The Borrower must furnish a certification of all costs including cost charged by the contractor for the improvements and also must certify that no rebate, kickback, refund, etc. has been or will be received.

M. **Properties with Fair Housing Act violations.** Any property available for first occupancy after March 13, 1991, that has violations of Fair Housing Act accessibility design standards is to be in compliance prior to closing of the fire safety equipment loan. Occupancy improvements cannot be funded out of the fire safety loan proceeds. Where a state or local law has higher accessibility requirements, the property must be modified or retrofitted to comply with those standards.

N. **Prior Defaults/Claims.** ORCF does not prohibit applications for mortgage insurance for formerly HUD-held loans, but only does business with Borrowers that have good track records. ORCF may accept such applications where the Lender has considered and documented the economic, physical, operational, or management factors that led to the specific changes that have occurred which would justify an application for new mortgage insurance.

O. **Previous Participation Certification.** Principals that have a previously approved Previous Participation Certification for the subject project are not required to re-submit as part of the Section 232(i) application. If new principals are proposed, or current principals have not yet been approved by ORCF, these principals must submit either an APPS submission or the Previous Participation portion of the Consolidated Certification.

P. **Environmental Review.** For non-FHA insured projects, the Lender must supply a Phase 1 Environmental Site Assessment and meet all other environmental requirements identified in Production, Chapter 7.

Q. **Review of Life Safety, Compliant, and State Annual Surveys.** The Lender will review findings from the most recent Life Safety, Compliant, and State Annual Surveys to determine if outstanding findings have been addressed.

R. **Review of the Project's Financial Performance.** The Lender must review the annual financial statements to assess the project's financial performance, and must base underwritten income and expenses on the recent trailing 12-month performance. The Lender must use the project specific expense for underwritten reserve for replacement, taxes and management fee.

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Production

Appendix 2.1

Calculating the Initial Operating Deficit Escrow

A. **Format**. The Initial Operating Deficit Escrow Calculation Template (Form HUD-91128-ORCF) has been developed for 232 applications. This is a template that incorporates the rules outlined herein and will aid the Lender in preparing an IOD calculation that is acceptable to ORCF. The IOD workbook will be a required exhibit whenever an IOD analysis is required (see above). The workbook should show the cash flows up to the period of stabilized occupancy, rather than stopping at the point when a positive cash flow is achieved. Except in unusual circumstances the IOD calculation will use constant dollars, leaving the income and expenses stable without adjusting for inflation. This means that the later periods of stabilized occupancy will exhibit incomes and expenses consistent with the underwritten assumptions.

   The operating deficit represents the total of all cumulative monthly losses projected to occur until the project reaches breakeven operations and produces a consistently positive cash flow.

B. **Absorption Rate.** The rate that the project is able to fill beds/units should be estimated using a net monthly absorption rate. This rate should account for both move-ins and move-outs, which are part of any normal operation. Preleases can be considered, which will result in more move-ins the first month than the monthly average. The template will delay the reimbursements for the move-ins by two months to account for a payment lag. We urge caution when forecasting or extracting absorption data from comparables –do not double count the preleases in the calculation of the monthly average. While no limit is being placed on the length of the absorption period, the viability of projects with unusually long absorption periods will be brought into question.

C. **Expenses**. At times the expense conclusions of the Lender differ from those of the appraiser. That is because the appraiser is asked to use "market" expenses, and the Lender is asked to superimpose ORCF specific expense requirements over the appraiser's when calculating the maximum loan amount based on Debt Service. For purposes of the IOD calculation, it is the Lender's expense estimates that should be used, rather than the appraiser's.

   Because some expenses vary with level of occupancy and some do not, the expense estimate must be forecasted monthly by categories. Names of example categories are given on the IOD template. The names may be changed to correspond to the categories used by the appraiser, Borrower, or Lender. There are a few basic categories that should not be renamed

in the template. These categories and the reasons to account for them separately are as follows:

1. **Ground Rent.** This expense will not be charged in Interval 1 (see below).

2. **Marketing & Promotion**. The estimated amount in this category is usually derived from comparables and generally only accounts for the amount needed to maintain stabilized occupancy. The IOD template will apply this expense at 200% of normal until the stabilized occupancy has been achieved. This category may not be blank.

3. **Insurance (property & liability).** This expense generally must be paid up front, therefore a year's worth of this expense will be paid at the end of construction (Interval 2 below). Following that, a monthly amount will be impounded so another full year's payout will not be necessary.

4. **Real Estate Taxes.** This fixed expense will generally be the same regardless of occupancy. For that reason, it is accounted for separately so it can be applied at 100%.

5. **Management Fee.** This expense should represent the particular arrangement defined in the management agreement. It is often calculated as a simple percentage of the Effective Gross Income once stabilized occupancy is achieved, but there are generally provisions for a different reimbursement arrangement during the initial lease-up period. The IOD worksheet should reflect those project-specific intricacies.

6. **Reserve for Replacement.** This expense category is constant regardless of occupancy and is not collected during Intervals 1&2 (see below).

    a. **Expense Floors.** In conjunction with the concept that some expenses vary depending on the level of occupancy, the IOD worksheet should include expense floors. The floor is the level that a variable expense category cannot be expected to fall below. For example, the "Housekeeping & Laundry" expense may be quite low when a project is minimally occupied, but it would never be expected to fall to $0, since a minimum level of staff would need to be retained. The expense floors on the IOD template are to be entered as a percentage of the normal amount; the dollar amounts are calculated automatically. The percentages pre-entered in the IOD template represent ORCF's expectations for the example expense categories. Giving justification when departing from these expectations may serve to expedite the review process.

    b. **Intervals.** A project will begin to incur expenses not covered by the loan upon receiving the certificate of occupancy. The monthly debt service payments start later, with interest only at first. Because these expenses phase in at different times there are three distinct expense intervals to consider when calculating the deficit.

i. Interval 1 covers the period of time between certificate of occupancy and the end of the construction period/cost certification period (Note that the construction period is defined as construction time plus two months for cost certification purposes). Technically this is an optional interval, because some projects may have a similar certificate of occupancy date and construction completion date, and thus would not need an Interval 1. However, it is hard to predict if that will be the case when the IOD is being prepared, so the template is set up to assume that Interval 1 will consist of a 2-month period. When calculating expenses for this Interval, no debt service is to be included as an expense. Mortgage interest for this interval is included in the loan amount, not the escrow. Reserve for Replacement and ground rent are not to be included in Interval 1. Ground rent during the construction period is calculated into the loan amount. This interval will only include the underwritten estimate of all of the applicable operating and leasing expenses for each period (month).

ii. Interval 2 begins at the end of the construction period/cost certification process and ends at the beginning of loan principal amortization. This period can be no greater than 2 months and is also technically an optional interval (Amortization must begin no later than 4 months after construction completion for insurance of advances and first day of second month after final endorsement for insurance of completion cases). Again, at the time the IOD calculation is made, the exact length of this period will not be known. For that reason, the IOD template utilizes a standardized 2-month period for Interval 2. Debt service in this interval will include payment of interest and MIP, but not principal payments because amortization signals the beginning of Interval 3. Ground rent must be included if the property is a leasehold since only ground rent during construction can be included in the loan, and this interval begins after construction completion. Reserve for Replacement deposits are not included in Interval 2. This interval will include the underwritten estimate of applicable operating expenses for each month (period).

iii. Interval 3 begins at the start of amortization. Amortized debt service is a mandatory expense in this interval, and must include payment to principal, interest and MIP. Ground rent, if applicable and reserve for replacement deposits are also mandatory in Interval 3. This interval will include the underwritten estimate of applicable operating expenses for each month (period).

c. **Commercial Income**. Where commercial facilities are included in the project, a separate operating deficit estimate should be made. The Lender will ensure that expenses included in the residential deficit estimate are not

duplicated in the commercial operating deficit estimate so as to unfairly penalize the property. The commercial space operating deficit is added to the residential operating income deficit to determine the total project escrow that will be necessary. Any positive income attributable to the commercial space during the deficit period will not offset the residential operating deficit requirements.

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Appendix 2.2

Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care

FEMA website:
www.fema.gov

Form Number	Form Name
HUD-92466-ORCF	Healthcare Regulatory Agreement-Borrower
HUD-92466A-ORCF	Healthcare Regulatory Agreement-Operator
HUD-92576A-ORCF	Certificate of Need, (CON), for Health Facility and Assurance of Enforcement of State Standards
HUD-9807	Insurance Termination Request for Multifamily Mortgage
HUD-91128-ORCF	Initial Operating Deficit Escrow Calculation Template
HUD-92476B-ORCF	Escrow Agreement for Operating Deficits
HUD-92264A-ORCF	Maximum Insurable Loan Calculation
HUD-935.2A	Affirmative Fair Housing Marketing Plan
HUD-2205A-ORCF	Borrower's Certificate of Actual Cost
Notice H 2016-15	Processing Guide for Previous Participation Reviews of Prospective Multifamily Housing and Healthcare Programs' Participants (or successors thereto)
FEMA Form 086-0-32	Standard Flood Hazard Determination Form
HEROS	HUD Environmental Review Online System

Section II
Production

Chapter 3
Loan Sizing

3.1 Introduction

This chapter contains the loan sizing requirements for the Section 232 Mortgage Insurance for Residential Care Facilities program. Each loan program has different criteria for calculating the maximum insurable loan amount. The sections below describe which criteria to use for each program, and how to calculate each criterion. The maximum insurable loan amount is the lowest of all of the criteria rounded down to the nearest 100 dollars. The Maximum Insurable Loan Calculation (Form HUD-92264A-ORCF) (MILC) is a required Firm Application exhibit and is used to calculate the Maximum Insurable Loan.

3.2 Underwriting Benchmarks for Section 232 New Construction, 232 Substantial Rehabilitation and 232/223(f) Loans

Maximum Loan-to-Value Ratios (LTV) and minimum Debt Service Coverage Ratios (DSCR) are set by statutes and regulations. To mitigate risk, the following underwriting benchmarks have been established. Any submittals above the LTV or below the DSCR benchmarks require substantial justification and mitigation. Please note that the DSCR benchmark is calculated using the Mortgage Insurance Premium (MIP). To qualify for the higher Non-profit benchmarks, the Owner-Operator must demonstrate a successful operating track record, significant project operating and management experience, and a solid financial track record. The minimum debt service coverage ratio is 1.45 for all project types with the exception of the 223(a)(7) and Section 232(i) programs, which require a debt service coverage ratio of at least 1.11. Regardless of which underwriting benchmark is used, a Non-profit Borrower must establish a Residual Receipts account.

Type of Unit	New/Existing Units	Borrower Type	Max. Loan to Value*
SNF/ILU	Both	For Profit	80%
SNF/ILU	Both	Non-Profit	85%
ALF	New	For Profit	75%
ALF	New	Non-Profit	80%
ALF	Existing	For Profit	80%
ALF	Existing	Non-Profit	85%

SNF = Skilled Nursing Facility; ILU = Independent Living Unit; ALF = Assisted Living Facility

3.3 HUD Eligible Costs

The following costs are considered eligible mortgageable costs for all programs except for Operating Loss Loans (see Section 3.10) and the 232(i) Fire Safety Equipment Loan Program (see Section 3.11). The Lender must provide evidence of these expenses and must justify how they are reasonable relative to current market conditions.

A. Eligible Mortgageable Costs

1. **Existing Indebtedness.** Section 3.13 describes eligible existing indebtedness requirements. (Eligible debt on Section 223(a)(7) transactions is addressed in Production, Section 2.10Q).

2. **Interest on Existing Debt.** Interest accrued on existing debt may be included in the determination of eligible debt.

3. **Prepayment Penalty.** The Lender must include the prepayment penalty that the Borrower is likely to incur at the time of closing, not at the time of the Lender's underwriting. This may include the yield maintenance fee.

4. **Interest Rate Premium (Section 223(a)(7) projects only).** The Lender may apply proceeds from an interest rate premium on behalf of the Borrower to defray prepayment penalties associated with the existing mortgage note. The amount needed to pay off the existing indebtedness for purposes of MILC Criterion H must not include any portion of the prepayment penalty that is being paid from an interest rate premium. Criterion H of the MILC will automatically deduct the amount of the interest rate premium disclosed on the S&U tab of the MILC. No portion of the interest rate premium will go to the Borrower or any of its affiliates. Any unused portion of the interest rate premium originally intended to defray prepayment penalties must be deposited into the Reserve for Replacement (R4R) account for future project needs.

5. **Initial Deposit to the R4R.** This amount is determined based on a R4R analysis completed by the Lender and reviewed by ORCF. These funds are deposited into the R4R account at closing.

6. **Existing R4R to Transfer.** On Section 232/223(a)(7) and 232/223(f)(/223(a)(7) projects, the existing R4R balance must be transferred to the new loan at closing.

7. **Estimate of Repair Cost (critical, non-critical and Borrower proposed).** The Lender's estimated repair costs to be incurred by the Borrower. Associated architect's fees, mechanical engineering fees, municipal inspection fees, and other similar fees may also be eligible. The Lender must provide evidence of these fees at the time of firm application and justify their eligibility. The contingency portion of the repair escrow agreement is not eligible.

8. **Appraisal (including updates).** Costs associated with completion of the Appraisal as part of the Firm Application submission. The Appraisal must be completed in compliance with the ORCF Appraisal Statement of Work (available on the Section 232 Program website).

9. **Phase 1 ESA / Environmental Review.** Costs associated with any third party reports required to comply with environmental review requirements.

10. **Project Capital Needs Assessment (PCNA).** Costs associated with completion of a PCNA for projects requiring a PCNA as part of the Firm Application submission. The PCNA must be completed in compliance with the ORCF PCNA Statements of Work for Section 232/223(f) and Section 232/223(a)(7) or 232/223(f)/223(a)(7) (available on the Section 232 Program website).

11. **Financial/Placement Fee.** The Lender's fee limit is based on a percentage of the loan amount. The below table shows the limits for each OHP Section 232 Loan Program. The Lender's legal fees are included in the fee limit. Yield maintenance fees are not included in the fee limits. See Section 3.14 for fee limits for bond transactions.

	Fee Limit
232 New Construction	3.50%
232 Substantial Rehabilitation	3.50%
241(a)	3.50%
232/223(f)	3.50%
232/223(a)(7) or 232/223(f)/223(a)(7)	2%
223(d)	3.50%
232(i)	3.50%

12. **Lender Legal.** Lender's legal costs associated with the insured loan transaction. These fees combined with the Financial/Placement Fee are subject to the fee limits in Section 3.14.

13. **Borrower Legal.** Borrower's legal costs associated with the insured loan transaction. Legal fees associated with zoning, land acquisition, environmental or other legal issues related to the land are not eligible for inclusion.

14. **Title & Recording.** The reasonable costs of obtaining a title insurance policy, title search and recording of closing documents. State or Local taxes associated with recording are also eligible for inclusion.

15. **Discounts.** Discounts paid by the Borrower for the FHA-insured loan.

16. **Bond Financing Costs.** Issuance costs associated with bond financing for the FHA-insured loan.

17. **Broker Fees.** Fees must be included in the Lender's fee limits listed in Section 3.14. The broker must have experience in healthcare finance transactions and must have no identity-of-interest with any of the participants other than the lender itself.

18. **HUD fees associated with the transaction.** These include the Application Fee, Inspection Fee (if applicable) and Initial Mortgage Insurance Premium (MIP). Production, Chapter 2 describes the HUD fees for each of the OHP Section 232 Loan Programs.

19. **Survey.** Costs related to the HUD-compliant survey associated with the insured loan.

20. **Additional Other Fees.** The Lender must provide justification at the firm application stage that other fees are reasonable and necessary for the development or refinance/purchase of the project. Examples include non-legal costs to create the borrower entity and costs of maintaining books, records and tax information for the Borrower.

B. Additional Eligible Costs for New Construction, Sub-Rehab and 241(a) Programs

1. **Land Purchase.** Purchase price of the site for the insured loan (subject to the constraints of 3.5.E.2 of this chapter). A purchase contract or other evidence of the transaction must be provided. If the site was subdivided at the time of purchase, this must be discussed in the Lender Narrative.

2. **Construction Contract Line Items.** These must be reflected on Construction Contract (Form HUD-92442-ORCF):
    a. **Land Improvements.** Earthwork, site utilities, roads and walks, site improvements, lawns and planting, and unusual site conditions.
    b. **Structures.**

c. **General Requirements.** Covers project-specific overhead expenses. Calculate as a percentage of the sum of Total Land Improvements and Total structures. Percentage amount is determined by the nature, difficulty and size of the project, and the characteristics of the neighborhood. The contractor shall provide a detailed cost breakdown of the items included in the general requirements.
d. **Builder's Overhead.** Covers contractor's head office and general business expenses. Amount is fixed at 2 percent of the sum of Total Land Improvements, Total Structures, and General Requirements.
e. **Builder's Profit.** Calculate as a percentage of the sum of Total Land Improvements, Total Structures, and General Requirements. Percentage amount is determined by the nature and location of the project.
f. **Bond Premium.** The bond premium covers Performance Bond. Used to ensure completion of construction in event of a default by the general contractor. Bonding company determines applicable rate by the nature and location of the project and the contractor's history. An irrevocable Letter of Credit may be used in lieu of a Performance Bond, provided it is unconditional, valid and collectable and issued by a banking institution.
g. **Contractor's Other Fees.** Costs of various required items and services. These can vary greatly from community to community. Examples of other fees include: building permits and licenses, builder's risk insurance, general contractor's cost certification audit fee, soil tests, concrete tests and other construction testing.

3. **Architect's Fees.** Architect's fees include both design and supervision costs. The architect's fees must match the Owner-Architect Agreement, AIA Form B108.
   a. **Design.** Architect's Design Fee covers preparation of all construction documents (working drawings and specifications) up to start of construction. Typically 75 to 80 percent of total.
   b. **Supervision.** Architect's Supervision Fee covers Architect's construction inspections, reports, and preparation of change order requests. Typically 20 to 25 percent of total.

NOTE: On new construction/sub-rehab, CON costs may be included in the total project cost, but it is not a mortgageable item. Therefore, CON costs can be counted toward the total equity on the project, but it is not cash equity in the form of reserves required to cover cash flow shortfalls during lease up.

C. **Interest Carrying Costs.** Interest on the amount of insured advances during the construction period of the project is allowable as part of Replacement Cost. The Lender must calculate the interest based on the proposed loan amount and interest rate over the proposed construction period. The final amount allowed will be reviewed at cost certification.

D. **Taxes.** Taxes associated with ownership of the property estimated on a per diem basis during the construction period.

E. **Insurance.** Insurance associated with the project estimated on a per diem basis during the construction period, including:

1. Builder's Risk Insurance (This must be part of the Contractor's General Requirements OR under insurance),
2. Liability Insurance,
3. Officer's and Director's Insurance,
4. Fidelity Bond Insurance,
5. Vehicle Insurance (For owner or operator vehicles associated with the project),
6. Business Interruption Insurance, and
7. Additional necessary insurance.

F. **Market Study (including updates).** Costs associated with completion of the Market Study as part of the Firm Application submission. The Market Study must be completed in compliance with the ORCF Market Analysis Statement of Work (available on the Section 232 Program website).

G. **A&E / Cost Reports.** Costs associated with the completion of the Third Party Architecture and Cost Reports. This includes the Geotechnical Report. The reports must be completed in compliance with the ORCF Architecture and Cost Statement of Work (available on the Section 232 Program website).

H. **Borrower's Cost Certification Audit Fee.** CPA Auditing Fee for the Cost Certification Audit. This does not include the cost to set up the books and records, or to file tax returns.

I. **Major Movable Equipment.** Large furniture and equipment with relatively fixed location, but capable of being moved. Examples include: wheeled equipment, office machines (e. g. computers, copiers, and fax machines), hospital beds and mattresses, tables, etc. Do not include any motorized vehicles, such as trucks, vans, automobiles, or golf carts. These are not mortgageable items. Do not include Minor Equipment and Supplies. Expendable non-realty items of small individual cost. Examples: china and flatware, utensils and instruments, linens, etc.

J. **Marketing.** Advertising, Salaries and Commissions of sales representatives, open houses, model units, and other reasonable and necessary expenses associated with marketing the project during the construction period. The Lender must assure that there are sufficient funds available for marketing.

K. **Pre-Opening Management Fees.** Production, Chapter 2.6 R describes Pre-Opening Management Fees.

L. **Contingency Reserve.** The contingency reserve amount is based on available data for the type and condition of structure. It is calculated as a percentage of the sum of structures, land improvements, and general requirements. Percentage ranges from 1% to 10%, depending on the condition of the project, extent of the rehabilitation, and experience and financial capacity of the borrower and contractor. The contingency reserve is only available for Substantial

Rehabilitation projects, and can only be used to cover unanticipated costs, such as discovering more extensive dry rot than was expected. The contingency reserve is not available for items such as an increase in cost of carpet. Subject to lender and HUD approval, the Borrower may elect to apply any funds remaining in the substantial rehabilitation construction contingency account after completion of the approved rehabilitation to:

1. further improvements, betterments or upgrades to the property,
2. an initial deposit to the Reserve for Replacement account; or
3. reducing the mortgage balance.

If excess funds from contingency are used for betterments, those additional improvements will not be considered as the basis for a request for an increased mortgage amount.

M. **Other Fees.** Other Fees are those fees not outlined above, that are reasonable and necessary. Examples of other fees include the cost to create the books and records and file tax returns. Another example is relocation expenses. Relocation expenses must include a cost estimate with a proposed number of residents times the estimated cost per resident.

3.4 Section 232 New Construction

The Maximum Insurable Loan is the lesser of the following:

A. **Requested Loan Amount (MILC Criterion A).** This is the loan amount requested in the Firm Application.

B. **Amount Based on Replacement Cost (MILC Criterion C)**

1. Multiply the Total Estimated Replacement Cost as calculated on the Replacement Cost (Repl Cost) tab of the MILC by 90%.
2. Subtract from the product any of the following: the optional purchase price of leased land, grant or loan funds attributable to replacement cost items, excess unusual land improvements and the unpaid balance of special assessments.

C. **Amount Based on Required Loan-to-Value (MILC Criterion D)**

1. Multiply the appraised value by the maximum LTV limit.
2. Subtract from the product any of the following: the optional purchase price of leased land and the unpaid balance of special assessments.
3. See Section 3.2 for maximum LTV limits.

D. **Amount Based on Required Debt Service Coverage (MILC Criterion E)**

1. Divide the underwritten Net Operating Income (NOI) by 1.45.

2. Subtract from the quotient any of the following: the annual ground rent and the annual special assessment.
3. Divide the difference by the sum of the interest rate, MIP rate and initial curtail rate (as calculated by the MILC Criterion E).
4. Add any annual tax abatement savings to the quotient.

E. **Amount Based on Deduction of Grant(s), Loan(s), LIHTCs and Gift(s) for Mortgageable Items (MILC Criterion L).** Subtract any grants, loans, gifts, tax credits, the optional purchase price of leased land, the cost of any excess unusual land improvements, and the unpaid balance of special assessments from the Total Estimated Replacement Cost as calculated on the Repl Cost tab of the MILC.

3.5 Section 232 Substantial Rehabilitation

The Maximum Insurable Loan is the lesser of the following:

A. **Requested Loan Amount (MILC Criterion A).** This is the loan amount requested in the Firm Application.

B. **Amount Based on Replacement Cost (MILC Criterion C)**

1. Multiply the Total Estimated Replacement Cost as calculated on the Repl Cost tab of the MILC by 90%.
2. Subtract from the product any of the following: the optional purchase price of leased land, grant or loan funds attributable to replacement cost items, excess unusual land improvements and the unpaid balance of special assessments.

C. **Amount Based on Required Loan-to-Value (MILC Criterion D)**

1. Multiply the appraised value by the maximum LTV limit.
2. Subtract from the product any of the following: the optional purchase price of leased land and the unpaid balance of special assessments.
3. See Section 3.2 for maximum LTV limits.

D. **Amount Based on Required Debt Service Coverage (MILC Criterion E)**

1. Divide the underwritten NOI by 1.45.
2. Subtract from the quotient any of the following: the annual ground rent and the annual special assessment.
3. Divide the difference by the sum of the interest rate, MIP rate and initial curtail rate (as calculated by the MILC Criterion E).
4. Add any annual tax abatement savings to the quotient.

E. **Amount Based on Estimated Cost of Rehabilitation Plus (MILC Criterion F)**

1. Property Owned by Borrower: If the Borrower currently owns the property, start with the lesser of: (i) 100% of the existing mortgage debt or (ii) 90% of the "as is" market value of the property before rehabilitation (95% for Non-profit Borrowers).
    a. Add to that amount the Total Estimated Development Cost as calculated on the Repl Cost tab of the MILC.
    b. Add to the sum the estimated offsite construction costs.
    c. Subtract from the sum any grants or loans attributable to replacement cost items listed on the Repl Cost tab of the MILC.

2. Borrower to Purchase Property: If the Borrower will purchase the property, start with the lesser of: (i) 85% of the purchase price of the property or (ii) 90% of the "as is" market value of the property before rehabilitation (95% for Non-profit Borrowers).
    a. Add to that amount the Total Estimated Development Cost as calculated on the Repl Cost tab of the MILC.
    b. Add to the sum the estimated offsite construction costs.
    c. Subtract from the sum any grants or loans attributable to replacement cost items listed on the Repl Cost tab of the MILC.

F. **Amount Based on Deduction of Grant(s), Loan(s), LIHTCs and Gift(s) for Mortgageable Items (MILC Criterion L).** Subtract any grants, loans, gifts, tax credits, the optional purchase price of leased land, the cost of any excess unusual land improvements, and the unpaid balance of special assessments from the Total Estimated Replacement Cost as calculated on the Repl Cost tab of the MILC.

3.6 RESERVED

3.7 Section 241(a) Supplemental Loan for an Existing FHA-Insured Project

The Maximum Insurable Loan is the lesser of the following:

A. **Requested Loan Amount (MILC Criterion A).** This is the loan amount requested in the Firm Application.

B. **Amount Based on Replacement Cost (MILC Criterion C)**

1. Multiply the Total Estimated Replacement Cost as calculated on the Repl Cost tab of the MILC by 90%.
2. Subtract from the product any of the following: the optional purchase price of leased land, grant or loan funds attributable to replacement cost items, excess unusual land

improvements and the unpaid balance of special assessments.

C. **Amount Based on Required Loan-to-Value (MILC Criterion D)**

1. Subtract the "as is" market value from the "as proposed" market value.
2. Multiply the difference by 90%.
3. Subtract from the product any of the following: the optional purchase price of leased land and the unpaid balance of special assessments.

D. **Amount Based on Required Debt Service Coverage (MILC Criterion E)**

1. Subtract the annual debt service (P&I+MIP) on the primary FHA-insured loan from the underwritten NOI after the renovations or additions proposed in the 241(a) loan application are complete.
2. Divide the difference by 1.45.
3. Subtract from the quotient any of the following: the annual ground rent and the annual special assessment.
4. Divide the difference by the sum of the interest rate, MIP rate and initial curtail rate (as calculated by Criterion E).
5. Add any annual tax abatement savings to the quotient.

E. **Amount Based on Total Indebtedness (MILC Criterion I)**

1. Multiply the "as proposed" market value by 90%.
2. Subtract from the product 100% of the total outstanding indebtedness related to the property.

F. **Amount Based on Deduction of Grant(s), Loan(s), LIHTCs and Gift(s) for Mortgageable Items (MILC Criterion L).** Subtract any grants, loans, gifts, and tax credits, the optional purchase price of leased land, the cost of any excess unusual land improvements, and the unpaid balance of special assessments from the Total Estimated Replacement Cost as calculated on the Repl Cost tab of the MILC.

3.8 Section 232/223(f) Purchase or Refinancing of a Residential Healthcare Facility

The Maximum Insurable Loan is the lesser of the following:

A. **Requested Loan Amount (MILC Criterion A).** This is the loan amount requested in the Firm Application.

B. **Amount Based on Required Loan-to-Value (MILC Criterion D)**

1. Multiply the appraised value by the maximum LTV limit.
2. Subtract from the product any of the following: the optional purchase price of leased

land and the unpaid balance of special assessments.

3. See Section 3.2 for maximum LTV limits.

C. **Amount Based on Required Debt Service Coverage (MILC Criterion E)**

1. Divide the Lender's underwritten Net Operating Income (NOI) by 1.45.
2. Subtract from the quotient any of the following: the annual ground rent and the annual special assessment.
3. Divide the difference by the sum of the interest rate, MIP rate and initial curtail rate (as calculated by the MILC Criterion E).
4. Add any annual tax abatement savings to the quotient.

D. **Amount Based on Borrower's Total Cost of Acquisition Section 223(f) (MILC Criterion G).** Criterion G is only relevant if the 223(f) is a purchase transaction.

1. Start with the Total HUD Eligible Costs as calculated on the S&U tab of the MILC.
2. Subtract from the Total HUD Eligible Costs any escrows or items the seller will pay on behalf of the Borrower, as well as any grants or loans attributable to HUD Eligible Costs.
3. Multiply the difference by 85% (90% for Non-profit Borrowers) of the purchase price shown in the purchase agreement and determined allowable by the Lender.
4. **Rules for Eligible Costs on Purchase Transactions.**
    a. The purchase price shown in the purchase agreement and determined allowable by the Lender. If the Borrower is currently the Operator of the project and does not have an identity of interest with the seller (see Handbook Introduction, Chapter 1.6 C), subtract from the purchase price the cost of any improvements that the Operator financed and the seller included in the purchase price.
    b. If repair costs are included in the purchase price, do not itemize them as separate HUD Eligible Costs.
    c. The purchase agreement must specify whether the transfer includes any:
        i. Escrows, and if so, the dollar amounts of those escrows.
        ii. Items which the seller will pay on behalf of the Borrower, such as the operating deficit, discounts, initial deposit to the R4R account, etc.

E. **Amount Based on Cost to Refinance (MILC Criterion H):** Criterion H is only relevant if the 223(f) is a refinance transaction.

1. Start with the Total HUD Eligible Costs as calculated on the S&U tab of the MILC.
2. Subtract from the Total HUD Eligible Costs the amount of any R4R on deposit, as well as any grants or loans attributable to HUD Eligible Costs.
    a. Any collateral held against the loan by the commercial Lender, other than property-related assets, must be treated like R4R on deposit and subtracted from the Total HUD Eligible Costs. This includes any additional collateral held against the loan other than property related assets, including but not limited to, R4R, escrows, restricted bank accounts, debt service reserves and

completion reserves.

b. Collateral to be subtracted from the Total HUD Eligible Costs does not include: recourse or personal guarantees, or tax and insurance escrows. If the Lender intends to include a recourse or personal guarantee in the eligible costs basis, the Borrower will be required to certify that the collateral held against the loan is property-related.

3. 100% of the difference is the eligible loan amount.

F. **Amount Based on Deduction of Grant(s), Loan(s), LIHTCs and Gift(s) for Mortgageable Items (MILC Criterion L)**. Subtract any grants, loans, gifts, and tax credits, the optional purchase price of leased land, the cost of any excess unusual land improvements, and the unpaid balance of special assessments from the Total Estimated Replacement Cost as calculated on the Repl Cost tab of the MILC.

3.9 Section 232/223(a)(7) or 232/223(f)/223(a)(7) Refinance of an Existing FHA-Insured Project

The Maximum Insurable Loan is the lesser of the following:

A. **Requested Loan Amount (MILC Criterion A).** This is the loan amount requested in the Firm Application.

B. **Original Principal Amount (MILC Criterion B)**. This is the original principal amount of the existing FHA-insured mortgage.

C. **Amount Based on Required Debt Service Coverage (MILC Criterion E)**

1. Divide the Lender's underwritten Net Operating Income (NOI) by 1.11.
2. Subtract from the quotient any of the following: the annual ground rent and the annual special assessment.
3. Divide the difference by the sum of the interest rate, MIP rate and initial curtail rate (as calculated by the MILC Criterion E).
4. Add any annual tax abatement savings to the quotient.

D. **Amount Based on the Cost to Refinance (MILC Criterion H):**

1. Start with the Total HUD Eligible Costs as calculated on the S&U tab of the MILC.
2. Subtract from the Total HUD Eligible Costs the amount of any R4R on deposit, as well as any grants or loans attributable to HUD Eligible Costs. HUD Eligible Costs for a 223(a)(7) refinance transaction are limited to costs listed in Section 3.3.
3. Also subtract from Total HUD Eligible Costs any portion of the additional deposit to the R4R that is being paid from an interest rate premium.
4. 100% of the difference is the eligible loan amount.

3.10 Section 223(d) Operating Loss Loan

The Maximum Insurable Loan is the lesser of the following:

A. **Requested Loan Amount (MILC Criterion A)**. This is the loan amount requested in the Firm Application.

B. **Amount Based on Required Debt Service Coverage (MILC Criterion E)**

1. Subtract the annual debt service (P&I+MIP) on the primary FHA-insured loan from the underwritten NOI.
2. Divide the difference by 1.45.
3. Subtract from the quotient any of the following: the annual ground rent and the annual special assessment.
4. Divide the difference by the sum of the interest rate, MIP rate and initial curtail rate (as calculated by the MILC Criterion E).
5. Add any annual tax abatement savings to the quotient.

C. **Amount Based on 100% of the Operating Loss (MILC Criterion J) (**as determined by an independent audit certified by a CPA) and, if loan is pursuant to Section 223(d)(3), 80 percent of unreimbursed cash contributions (see Production Chapter 2, Section 2.11.B).

The Operating Loss is defined as follows: An Operating Loss is the difference between project income and project operating expenses.

The following operating expenses may be included: taxes, interest on the mortgage debt, mortgage insurance premiums, hazard insurance premiums, maintenance, salaries, supplies, and other expense for project operation. The following payments and charges must not be included: loan principal payments, depreciation, payments to the R4R account, payments to a sinking fund, Lender's fees, charges incurred in connection with the application for the Operating Loss Loan (OLL), projected anticipated losses, expenses that were funded or should have been funded from the working capital deposit (e.g. tax and insurance escrows), construction cost overruns, Officers' salaries, and bad debt or write-offs as a result of an identity of interest tenant.

3.11 Section 232(i) Fire Safety Equipment Loan

The Maximum Insurable Loan is the lesser of the following:

A. **Requested Loan Amount (MILC Criterion A)**. This is the loan amount requested in the Firm Application.

B. **Amount Based on Required Debt Service Coverage (MILC Criterion E)**

1. Subtract the annual debt service (P&I+MIP) on the primary loan from the

underwritten NOI.
2. Divide the difference by 1.11.
3. Subtract from the quotient any of the following: the annual ground rent and the annual special assessment.
4. Divide the difference by the sum of the interest rate, MIP rate and initial curtail rate (as calculated by the MILC Criterion E).
5. Add any annual tax abatement savings to the quotient.

C. **Amount Based on 100% of the Cost of Fire Safety Equipment (MILC Criterion K)**. The sum of:

1. Cost and installation of fire safety improvements,
2. Related improvements, and
3. Eligible costs and fees. Eligible Mortgageable Costs for the 232(i) Fire Safety Equipment Loan Program. The eligible costs include the cost and installation of the fire safety equipment, related improvements (e.g. improvements to increase water capacity) and the fees described in Section 3.3 A, specifically subsections: 8, 9, 10, 13, 17 and 18.

3.12 Tax Abatement

The loan amount may exceed the Debt Service Ratio limit by capitalizing the savings from tax abatement. See Production, Chapter 5.5 for details regarding Tax Abatement.

3.13 Existing Indebtedness

National Housing Act Section 223(f)(4)(B) requires that proceeds of any refinancing will be employed only to retire the existing indebtedness, and pay the necessary cost of refinancing of the residential care facility. In order to ensure compliance with this statutory requirement, the following guidelines are provided to assist in analyzing eligible existing indebtedness.

Existing indebtedness must meet the eligibility criteria outlined herein to be included as an eligible mortgageable cost for HUD Section 232 insured mortgages. HUD does not permit FHA-insured loan proceeds to be used directly for an equity takeout for Section 232 transactions. The following guidance applies to all Section 232 pursuant to 223(f) refinances and Section 232 Substantial Rehabilitation projects.

A. **Definition of Eligible Debt.** In order to be included as part of the Section 232 mortgage, existing indebtedness must meet the following FHA requirements. The debt:

1. Must be existing indebtedness incurred in connection with the project,
2. Must not have been created with an Identity of Interest (IOI) Borrower and the proposed FHA Lender, and

3. Must not otherwise circumvent program intent.

B. **Categories of Eligible Debt.** When demonstrating the eligibility of existing indebtedness, the FHA Lender must provide satisfactorily documented evidence that the existing debt incurred in connection with the project conforms to one of the categories below:

1. **Outstanding mortgage(s).** Outstanding mortgage(s) on the project as confirmed and fully documented by the current Lender.

2. **Other Recorded Indebtedness.** Other recorded indebtedness in connection with the project incurred by the Borrower pursuant to the normal course of business may be considered. Examples include, but are not limited to, mechanic's liens, tax liens and past due assessments provided they did not result from personal obligations of the Borrower principals. Note that operator agreements with the former owners that do not appear to be arm's length or with abnormally high lease cost arrangements need to be thoroughly analyzed.

3. **Unrecorded Debt.** Unrecorded debt of, or costs incurred in connection with the project and supported by documentation satisfactory to HUD may be considered eligible debt. The Lender must be provided with documentation and a certification that verifies the obligation is directly connected to the project. In instances where there are costs incurred, the documentation could include invoices, payment documentation, photographs, and a description of the work done. This includes indebtedness or costs incurred to make HUD eligible capital expenditures, structural repairs and betterments to the property.

4. **Operator Debt.** Certain Operator debt tied directly to the project, supported by documentation satisfactory to HUD and made by a related party with an IOI to the borrower, may be considered eligible. Examples include costs related to the purchase of additional furniture fixtures and equipment, working capital related to lease-up and stabilization of the project and other capital expenditures. Costs associated with an accounts receivable line of credit will not be considered eligible. Costs related to acquiring bed authority or Certificate of Need will not be considered eligible.

   CON costs may be included in the total project cost, but it is not a mortgageable item. Therefore, CON costs can be counted toward the total equity on the project, but it is not cash equity in the form of reserves required to cover cash flow shortfalls during lease up.

5. **Reserves held by Current Lender**. Escrows and reserves comprising any additional property-related collateral held by the current Lender against the loan, but then released at some point after initial funding of the loan will only be considered eligible

if:

a. The loan comprising the existing indebtedness meets eligible debt and debt seasoning requirements,
b. The release provisions for the funding of the current loan were predetermined at the time the original loan was made, and
c. The escrow is released before the FHA Lender makes application to HUD for mortgage insurance.

Any reserves not meeting these criteria will be treated like R4R on deposit and subtracted from the Total HUD Eligible Costs pursuant to MILC Criterion H.

An example of the Current Lender holding back escrows or compensating balances is:

A commercial Lender makes a loan for $8M, but increases the amount of the Note to $8.5M by holding an escrow of $500,000 (funded by the Borrower) to collateralize the increased amount. The Lender reports outstanding debt of $8.5M, but with HUD costs of $500,000, the total eligible costs are $9M and HUD insures a loan for $9M. The commercial Lender then releases the escrow to the Borrower when the commercial loan is paid off. This results in the Borrower receiving equity cash out from FHA-insured loan proceeds and would not be permissible.

6. **Other Eligible Costs.** Examples of other eligible costs associated with paying off the eligible debt are:
   a. Reasonable, non-delinquent accrued interest to a non-IOI party,
   b. Provided they do not cumulatively exceed 10% of the proposed mortgage amount, prepayment/program penalties:
      i. on the mortgage loan and program penalties arising from the defeasance (or yield maintenance) of conventionally – financed loans,
      ii. arising from the defeasance of tax-exempt and taxable bonds, and/or
      iii. related to swaps or other derivatives, i.e., the costs of settling prepayment penalties or yield maintenance fees associated with swaps or other derivatives (e.g., swap breakage fees)
   c. Recording, release, and re-conveyance fees, and
   d. Documentation or processing fees.

C. **Debt Investigation.** Instances which trigger a debt investigation - HUD requires a debt investigation of the existing indebtedness when:

1. The creation of the debt involved a lender with an IOI to the borrower or project,

2. The current loan was created less than two years ago,

3. Circumstances are present that indicate the previous financing may have included other forms of non-standard collateral that suggest the debt was not created in an arms-length transaction,

4. The current loan involved alternate financing structures (e.g., pooled debt, line-of-credit financing, and mezzanine debt) and requires further explanation, as deemed necessary by HUD,

5. The current Lender held escrows or compensating balances that will be released back to the Borrower, or

6. Any other non-traditional debt or atypical obligations/interests/agreements are involved.

The following are the types of documentation that may be provided to substantiate the eligibility of existing indebtedness when a debt investigation has been conducted:

Fully executed mortgage note, settlement statement, payoff statement, purchase & sale agreement, purchase contract, option agreement, allonge, capital invoices, fully documented title search, title exceptions, release documentation and other updated loan documents.

If the debt is more than two years old and the FHA Lender has adequately addressed all IOIs, the FHA Lender can submit the firm application, subject to HUD's review, underwriting and final approval. HUD, however, reserves the right to request that the FHA Lender conduct a debt investigation on debt created more than two years prior to firm application.

D. **Debt Seasoning**. Debt seasoning is a minimally required period of time between the closing date of a loan and the date that an application to refinance the existing debt is submitted to HUD. HUD uses the debt seasoning period to determine whether the project has demonstrated the ability to generate a sufficient level of cash flow to support the value and pay debt service (These provisions do not alter the requirements of 24 CFR Sec. 232.902 where otherwise applicable). If the existing debt to be refinanced does not meet the debt eligibility requirements defined in section 3.13.B, then 2 years debt seasoning is required. However, ORCF has identified specific exceptions to the full 2 years seasoning requirement as outlined in this section.

The below matrix will be used in determining debt seasoning. All debt must be in place prior to the submission of the firm application.

% of Existing Debt Used for Project Purposes	Requested FHA Loan Amount <60% LTV	Requested FHA Loan Amount 60% - 70% LTV	Requested FHA Loan Amount > 70% LTV
> 50%	Application may be submitted within 2 years	Application may be submitted within 2 years	2 year seasoning applies
<= 50%	Application may be submitted within 2 years	2 year seasoning applies	2 year seasoning applies

Consideration for less than two years seasoning requires value supported by a 3rd party appraisal and 3+ years of stabilized historical cash flow which supports the value. Additionally, an ORCF appraisal review will be required.

Reduced debt seasoning times are intended for certain low risk projects. Special Use Facilities, given ORCF's risk concerns about these types of facilities (see Chapter 2.5.E of this Handbook), are not eligible for reduced debt seasoning time, even if they meet the existing debt % and LTV parameters in above chart.

E. **Identity of Interest Lenders**. An Identity of Interest (IOI) is defined in Handbook Introduction, Chapter 1.6. In addition to determining if the existing debt will be subject to additional underwriting mitigants, as outlined above, the FHA Lender must fully disclose and examine any IOIs involving the Borrower or Lender. In the event that it is determined that an IOI exists, the FHA Lender's valuation of the project must be thoroughly analyzed by HUD pursuant to the following:

1. The documentation supports that the project is valued at fair market value,

2. The transaction must not include other forms of non-standard FHA collateral that suggest the project-related debt was inflated or included costs that overstated arms-length project debt, and

3. Evidence provided to support that the debt meets the debt seasoning requirements outlined above.

F. **Review of Recent Indebtedness Involving a Purchase.** If the outstanding debt was generated less than two years ago and involved a purchase, HUD will require a review of existing indebtedness.

1. **Identity of Interest (IOI) Purchase.** A transaction is considered to be an IOI purchase when there is any IOI (as defined in Section I, Introduction, Chapter 1.6) between the seller and purchaser that survives a sales transaction, or when a partner buys out the interest of another partner or member of the borrowing entity. Under these circumstances, the documented existing indebtedness used to effectuate such a transaction may be immediately eligible as provided below:
   a. The seller has no residual rights to control the project.
   b. The seller has no residual rights to reacquire the project until not less than five years of the HUD closing, otherwise the HUD loan will need to be paid off,
   c. The purchase must have occurred prior to the date on which the firm commitment was issued.

2. **Identity of Interest (IOI) Refinance.** A transaction is considered to be an IOI refinance when a portion of the debt to be refinanced with the FHA mortgage was created by a person or entity with an IOI to the borrower (e.g. partnership debt). Examples of this situation include transactions completed below market value due to

a pre-negotiated purchase price or a quick turnaround of a previously underperforming project. Existing indebtedness used to effectuate such a transaction may be eligible subject to the following:

a. A minimum of 12 months (under the new operator) demonstrated net operating income (NOI) that supports the requested mortgage amount,
b. For turnarounds, the operator must have a proven track record of successful turnarounds and maintaining operations. In support, the FHA Lender will provide in the Lender Narrative documentation from other similar project operations, including:
    i. Project name and address
    ii. For a time period (3 or more years) including before, during and after transition to the new operator:
        1. Revenue
        2. NOI
        3. Number of beds or residents or units
        4. Occupancy

Additionally, an ORCF appraisal review is required.

3. **Sale-leaseback transactions.** An Owner-Operator that sells its interest in a project, but continues to operate the project after the sale is generally considered an IOI purchase as outlined immediately above. If the selling entity continues to operate the project after the transaction, it will NOT be considered an IOI purchase when the following conditions are met:
    a. The transaction was completed at arms-length,
    b. The sales transaction was completed at market value (ORCF-approved full appraisal review),
    c. The operating lease is a typical market rate lease transaction between the old owner and the new owner,
    d. Documentation of organizational structures clearly indicates that there is no IOI between or among individuals actually involved on both sides of the transaction, and
    e. The seller has not taken back any note and has no residual rights to reacquire the project.

    Such transactions that meet the sale-leaseback criteria may be processed as a purchase, as long as the firm application is submitted prior to the date of the transaction.

G. **Alternate Financing Structures.** HUD recognizes that it is commonplace for conventional Lenders to use various alternate financing structures to finance the construction, purchase, rehabilitation or refinancing of one or more projects. The guidance in this subpart addresses some of these financing structures. Please note that the inherent complexity of alternative financing structures requires explanation by the Lender and may require a Debt Investigation by the FHA Lender (as indicated in 3.13 F above), or an in-depth review by ORCF.

1. **Bridge Loans**. A bridge loan is a loan that is short term in nature that allows a Borrower to borrow short term funds to bridge a gap between the repayment of the previous loan or financing structure (or a purchase) and permanent financing such as an FHA-insured loan. Bridge loans are subject to requirements for debt seasoning, identity of interest between lenders and borrowers, and Debt Investigation as outlined in Section 3.13 A, Section 3.13 B, Section 3.13 C, Section 3.13 D and Section 3.13 E.
    a. The bridge loan itself does not need to season for two years if the amount of the bridge loan is equal to the outstanding principal amount of the previous loan, and there was no equity cash out to any individual or entity.
    b. As incentive for lower risk loans to seek FHA financing, two-year seasoning may not apply based on a combination of LTV and the portion of the bridge loan that consists of outstanding principal amount of a previous loan. If the bridge loan includes payoff of outstanding principal from an arms-length loan and/or other proceeds, then the full amount of the bridge loan is eligible for an FHA loan within two years as long as it meets the criteria in the above Section 3.13D.:

    A Debt Investigation will be required when the total timeframe of the two previous loans, the outstanding project loan and the short term bridge loan, is less than 24 months.

2. **Portfolio Indebtedness (Pooled Debt).** It is normal industry practice for conventional Lenders to finance multiple projects using a single cross-collateralized financing mechanism, or various "pooled" financing structures, such as CMBS (a Commercial Mortgage Backed Security). Typically, both HUD and the Current Lender require that the FHA Lender obtain a partial release from the Current Lender to "pull" the project seeking HUD financing out of the existing pooled credit facility.

    Absent a partial release, HUD expects the FHA Lender to document the amount of the existing debt related to each project proposed for an FHA-insured mortgage, or to otherwise substantiate that all the subject projects are liable for all the outstanding notes that will be paid off with FHA-insured mortgage proceeds. For portfolio transactions, the Lender shall specify if any debt is non-project related and provide a reasonable allocation of total debt between non-project and project-related debt. For example, a large transaction may also include certain non-project subsidiaries such as rehabilitation firms, operating entities, hospices, corporate office buildings or other non-project facilities or entities. FHA Lenders must adhere to the following guidance for analyzing and investigating portfolio indebtedness if the partial release information is not available:
    a. The FHA Lender must perform Debt Investigation and submit to HUD documentation that substantially connects the proposed project to the outstanding indebtedness (See Section 3.13 F above).
    b. HUD expects eligible debt will be allocated (both individually and collectively) using one of the following methods which can be demonstrated

to bear a direct relationship to the existing indebtedness:

i. **Allocation of Debt**. An allocation of debt based on ORCF-compliant appraisals for all the projects covered by the existing debt is the preferred allocation method. To calculate, add up the approved values for all the projects and divide the total debt by the sum of the values. Multiply the result by a project's value to determine the amount of existing indebtedness to be assigned to a project.

ii. Lenders may develop other options for assigning debt, such as debt based on number of beds, number of units, percentage of revenue or percentage of overall NOI. However, all are subject to ORCF review, and approval will be considered on a case-by-case basis and appraisals must support the proposed value.

iii. **Reallocation of Debt**. When existing notes have specific mortgage amounts for each project, absent a partial release, any reallocation of debt based on appraised value or an alternative approach must be approved by HUD and the current Lender. The FHA Lender must submit evidence that the loan documents and terms have been amended, extended, allonged or otherwise modified prior to the submission of firm application. Otherwise, HUD will only approve a reallocation of debt that is substantially demonstrated to conform to program intent and *not* involve equity takeout. Reallocation of debt is acceptable when project values have changed over time, but in all cases, the changes in value must be defensible on the merits of the valuation.

3. **Line-of-Credit Financing.** HUD will consider as eligible line-of-credit indebtedness attributable to HUD eligible acquisition costs, capital repairs and improvements. It is permissible for the line-of-credit financing to be initiated to reimburse the person or entity that financed the costs (e. g. reflect a loan made to the project to repay the parent corporation that purchased it with cash or another source of equity), so long as the reimbursed costs are traceable to the project and it meets the requirements for HUD eligible costs. All such transactions, must comply with the following:

   a. HUD will recognize line-of-credit portfolio indebtedness attributable to HUD eligible acquisition costs, capital repairs and improvements that are fully documented. If the project debt is currently pooled with debt from other properties, the FHA Lender must obtain a partial release of the portion of the indebtedness being brought in for an FHA-insured mortgage and demonstrate that the HUD eligible debt allocated to the project is fair and reasonable.
   b. Absent a stated release amount, the eligible debt amount will be determined following Section 3.13 G 2.
   c. When the line-of-credit indebtedness reflects reimbursed acquisition costs that exceed 15 percent of the purchase price, the Borrower must also submit a report from an independent CPA of the cash or equity payment incurred for the project. The report must be attached to a cover letter, signed and dated by an authorized officer of the borrower entity, which attests to the accuracy of the CPA's report, with the Section 1010 Criminal warning clearly set forth.

4. **REITs**. HUD has eliminated the Two-Year Look Back policy for REITs as previously described in the May 22, 2014 version of this Handbook. In a refinance pursuant to National Housing Act Section 223(f), all REITs are required to demonstrate debt such as through a line-of-credit financing (see above Section 3.13.G.3 for the requirements for line-of-credit financing).
    a. They will be required to demonstrate debt, such as through a line-of-credit that covers reimbursed acquisition costs, like other corporate entities and to apply as a refinance transaction.

5. **Mezzanine Debt.** Mezzanine debt is hybrid debt where one debt issue is subordinated to another debt issue. Typically, mezzanine debt is provided by a private lending source and can be secured by a pledge of partnership equity interests, a pledge of other assets and/or personal guarantees. The provisions limiting eligibility only apply when the debt is secured with a pledge of partnership equity interests. Mezzanine debt may have embedded equity instruments and profit sharing mechanisms included, which increase the net present value of the subordinated debt to the mezzanine holders. The existence and terms of all mezzanine debt must be fully disclosed and approved by HUD during the application process. Mezzanine debt will only be considered in the eligible basis for refinancing when:
    a. There is no IOI between the principals and the mezzanine Lender or any of its affiliates,
    b. The loan documents associated with the mezzanine financing clearly identify the debt as directly funding the costs of the property and of any HUD eligible improvements, and
    c. Any equity contributions made as part of the mezzanine financing are memorialized in a Note and reflected on a balance sheet as a liability.

    The Borrower must "settle up" on any contributions for a fixed amount, and the difference between the amount of the contribution and the total payments made to the entity could be treated as existing indebtedness. Any mezzanine debt that remains from a previous financing of the property is subject to the secondary financing guidance for private sources (See Section 3.15 below) and will subordinate to HUD's first lien interest.

3.14 Bond Financing

A. Review of Financing Documents. A tax-exempt bond is a security issued by a governmental agency in which the interest income produced is free from federal income tax and sometimes free from state and/or local income tax. Financing documents associated with mortgage bonds or tax-exempt bonds are prepared and reviewed by the bond underwriter and the bonds are secured by a mortgage on one or more assets. In FHA-insured transactions, these bonds are backed indirectly by an interest in the insured loan which is further enhanced by a GNMA Security.

The Lender must submit, with the application for commitment processing, a separate statement itemizing the estimated costs of bond issuance, issuer fees and discounts and financing fees to be paid out of pocket by the Borrower/participant with an explanation of the necessity and reasonableness of each cost. The Lender's underwriter must check the statement for reasonableness, using the data from previously processed bond-financed projects and make adjustments where appropriate.

B. Loan Rates.

1. The construction loan and the permanent loan rates may exceed the interest rate on the bond obligations. When this occurs, the spread will create a surplus of funds which must be held by the bond trustee. At initial closing, the bond counsel must supply ORCF with a legal opinion stating that any investment income received by the Lender but not held for its own account must be under the control of the bond trustee and will not flow through the books and records of the project. The bond documents will instruct the trustee to invest the funds in a federally insured interest bearing account, submit annual statements with the project financial statement, or the Borrower may use the surplus of funds to cover costs associated with the bond financing transaction but not recognized in traditional ORCF processing.

2. In many cases, the interest rate on the bonds will not be known during the commitment processing and it is not uncommon for the rate to change once the bonds have been sold and the bond interest rate has been established. If the interest rate changes, an amendment to the Firm Commitment must be requested by the Lender reflecting the actual interest rate. If due to time constraints, ORCF does not have sufficient time to reprocess a higher loan for the project:
    a. The Firm Commitment must contain the following condition:

       "Any interest savings resulting purely from a differential between the ORCF processed interest rate and the actual final interest rate should be identified in a footnote and should not be included in interest cost in the Borrower's cost certification submission. Interest savings will not be viewed by ORCF as an allowable cost."

    b. However, savings resulting from the early completion of construction must be reflected in interest cost in the Borrower's cost certification. Compute interest savings by:
        i. Recalculating the estimated interest line item on the MILC Replacement Cost Tab, using the actual interest rate for the scheduled construction period.
        ii. Subtracting the actual interest cost recognized at cost certification from the revised interest figure developed in (1) above.

3. ORCF will allow a total financing and placement fee of 5.5% on bond financed applications. This limit applies to all Section 232 projects except Section 223(a)(7) mortgages and is reflected in the cost amount confirmed at cost certification.

C. Fee Limits:

Section 232 Loan Program	Bond Transaction Fee Limit
232 New Construction	5.50%
232 Substantial Rehabilitation	5.50%
241(a)	5.50%
232/223(f)	5.50%
232/223(a)(7) or 232/223(f)/223(a)(7)	4%

D. Bonds may be sold at a premium to investors, whereby the investor pays an amount in excess of the face value of the bonds. The premium results from the bonds carrying a higher coupon rate than is generally available in the marketplace.

1. Any premium raised by a transaction is considered part of the Lender, bond underwriter, or issuer's profit. The one exception involves tax-exempt bond transactions where the issuer of the bonds may permit the Borrower to receive some portion of the premium to offset the cost of issuance so that the Lender, bond underwriter and issuer are simply conduits for the transfer of funds.

2. If any portion of the premium is returned to the Borrower, it will be treated as a Windfall for Section 232 new construction and Section 241(a) projects, reflected in the Windfall calculation for substantial rehabilitation projects, and transferred to the R4R account for Section 232/223(f) projects. Details on the Windfall calculation can be found in Production, Chapter 11.

   Closing documents must detail the amount of the premium being given to the Borrower or the borrower entity it controls. The Borrower's accountant for an audited cost certification, or the Borrower for an unaudited cost certification, must detail in the notes to the financial statement the amount of premium received.

E. Itemized Statement of Costs. Attached to and reflected in the Lender Certification (Form HUD-92434-ORCF), is an itemized statement of the costs of issuance of the obligations, discounts and financing fees paid through the Lender.

1. The statement must explain why each individual item is necessary for the issuance of the obligations.

2. The Lender must review the amount of each item to ensure its reasonableness in relation to comparable projects.

3. The Lender, bond underwriter, and issuer have the option of deferring collection of additional discounts, financing fees slow draw fees, etc. in accordance with the provisions of the Lender Certification.

a. The deferred collection of these items must be an obligation of a third party. Both the third party and the Lender, bond underwriter or issuer must attest in writing that they will not look for payment from the:
    i. Borrower,
    ii. Mortgaged property,
    iii. Loan proceeds,
    iv. Any reserve or deposit required by ORCF and/or the Lender in connection with the insured loan transaction, or
    v. Rents or other income from the mortgaged property.
b. The borrower entity may issue, as evidence of the debt, surplus cash or residual receipts note to the third party for costs identified in this paragraph which ORCF determines to be reasonable.

F. State and Local Bond Financed Projects.

1. Prepayment of Note. Must include the following prepayment restrictions and prepayment penalty charges:
    a. Prepayment restriction period (lockout) must not exceed 10 years plus the construction period stated in the Construction Contract, or, in the alternative, must not exceed 10 years from the commencement of amortization, and
    b. Prepayment penalty may be charged after expiration of the lockout provided the charge:
        i. During the first year following the lockout does not exceed 5% of the original mortgage,
        ii. Declines on a graduated basis (to the extent practicable, the decline in the penalty percentage should be the same each year), and
        iii. Does not exceed 1% at the end of the fifth year following the lockout.

2. State/Local Occupancy, Use and/or Rent Restrictions. Use or rent restrictions sought by the State or local jurisdiction for projects financed by proceeds from State/local tax-exempt obligations are often more restrictive than the minimum requirements of the Internal Revenue Code. ORCF may approve a State or local restriction exceeding the minimum requirements of the Internal Revenue Code, but only if the following conditions are met:
    a. ORCF must determine that the restriction is not likely to have an adverse impact on project occupancy, marketability or long-term feasibility. This determination must be made on a project-by-project basis.
    b. The restriction must not conflict with any applicable ORCF mortgage insurance regulations or related administrative requirements.
    c. The restriction must not appear in the Note, Mortgage, Regulatory Agreement or any other ORCF mortgage insurance document.
    d. The restriction must be qualified to provide that it will automatically terminate in the event of foreclosure or transfer of title by deed in lieu of foreclosure. Such a termination provision must be included in every legal instrument (e.g., deed, land use restriction agreement, Security Agreement, or financing agreement) in which the restriction appears.

3.15 Secondary Financing

The amount, form, terms and conditions of any permitted secondary financing is based on the source of funding, as follows:

A. **When secondary financing is from a Federal, State or Local Governmental Source:**

1. The secondary financing may be on a form of promissory note and secured by a mortgage lien as is prescribed by the governmental funding source and reviewed and approved by ORCF.

2. Secondary financing or grants lent to the property as a secondary loan may be used to cover up to 100% of the applicable Section of the Act equity requirements.

3. Secondary financing or grants lent to the property as a secondary loan may also be used to finance non-mortgageable costs, and when added to the FHA-insured loan and required equity contribution, may exceed 100% of the project's Fair Market Value (FMV) or Replacement Cost.

4. Non-mortgageable costs (i.e. replacement cost items, not eligible for inclusion in the FHA-insured loan) to be covered by governmental secondary loans, or grants lent to the property as a secondary loan, must be certified by the funding source to be reasonable and necessary to complete the project and that the project costs to be covered by the secondary financing are reasonable. Documentation to this effect must be included with the application submission.

5. The governmental secondary financing Lender must agree to and enter into a Subordination Agreement – Financing (HUD-92420-ORCF) that details the rights and legal relationship between the FHA-insured first mortgage and the secondary financing loan.

B. **When secondary financing is from a private source:**

1. **Section 232 New Construction and Substantial Rehabilitation.** Secondary financing from a private source is not permitted.

2. **Section 223(f).**
   a. The secondary financing must be evidenced by a promissory note conforming to the Surplus Cash Note (Form HUD-92223-ORCF). For Section 232 pursuant to 223(f) transactions involving Non-profit Borrowers use the Residual Receipts Note – Non Profit Mortgagor (Form HUD-91710-ORCF). This form must not be altered in any manner.
   b. The secondary financing is permitted to cover a portion of the equity requirement under Section 223(f). The aggregate amount of the FHA-insured first loan and the private second loan cannot exceed 92.5% of FMV. Therefore, the amount of a private loan may range from 7.5% of FMV (the

difference between 85% and 92.5% of FMV) to a larger percentage if loan criteria lower than 85% of FMV controls. Secondary financing from private sources are not permitted under other Sections of the Act. However, this allowance must not be used to circumvent existing policies which do not permit equity take-out on Section 232 refinance transactions or on purchase transactions, a way to finance costs that otherwise would not be permitted. For example, seller take backs on property acquisition costs that are not supportable by market data must not be approved.

c. When private secondary financing is combined with federal, state or local governmental agency secondary financing, the aggregate amount of FHA-insured first loan and the private second loan cannot exceed 92.5% of FMV. However the governmental loan, in aggregate with the FHA-insured first and private second, may exceed the property's FMV. The addition of the governmental loan may result in total liens that exceed the property's FMV.

d. Private secondary financing may be used to cover non-mortgageable costs in combination with equity or solely for one purpose or the other. Whatever option is decided upon, the aggregate of the FHA-insured first and private second cannot exceed 92.5% of FMV.

e. Non-mortgageable costs or non-HUD replacement cost items to be covered by secondary financing from private sources must be certified by the funding source to be reasonable and necessary to complete the project and that the project costs to be covered by the secondary financing are reasonable. Documentation to this effect must be included with the application submission.

f. **Mezzanine Financing.** Mezzanine financing is provided by a private lending source and is usually secured by a pledge of partnership interests rather than by a secondary lien on the real estate. The existence and terms of all mezzanine debt must be fully disclosed to and approved by HUD during the application process. Any remaining mezzanine debt of the property is considered private secondary financing, and is subject to the secondary financing guidance for private sources in this section. Repayment of mezzanine financing can only be made from surplus cash. It must be shown that the projected surplus cash may be reasonably expected to pay the interest due on the mezzanine loan. The mezzanine loan interest rate typically will be higher than the rate of the first mortgage, but must be reasonably consistent with market rates for mezzanine debt and must not be so high a rate that it jeopardizes the ownership stability of the property or that the interest due cannot reasonably be expected to be repaid from surplus cash. Interest due or accruing on the mezzanine loan must be approved as reasonable by ORCF.

   Any transfer of an ownership interest in the borrower entity or in its principals to the mezzanine Lender in the event of nonpayment or a default on the mezzanine debt must have prior written approval by ORCF through the Transfer of Physical Assets (TPA) process or it will be invalid. The mezzanine Lender can exercise no enforcement remedies against the real estate or against the borrower entity during the term of the mezzanine loan.

C. **Repayment of Secondary Financing.** Repayment of public or private secondary financing, including interest, must be soft and be made solely from 75 percent of available surplus cash or residual receipts (Percentages other than 75% that are set forth in existing previously executed surplus cash notes shall continue to be honored). The Borrower's principals may elect to make additional payments from nonproject funds, however, these payments must not be pledged or scheduled for repayment.

D. **Promissory Notes.** The Borrower may secure a promissory note with a subordinate lien against the property under the following conditions:

1. The Lender on the insured mortgage must consent to the placing of the subordinate lien and agree that its existence does not constitute a basis for default on the first mortgage.

2. There must be a simultaneous closing and same day recordation of the subordinate financing documents and the first mortgage insurance documents.

3. The terms of the subordinate mortgage must be:
    a. Approved by the HUD Counsel;
    b. Consistent with the terms of the insured promissory note, the first mortgage, the Regulatory Agreement and all HUD Regulations and OHP Section 232 Program Requirements.
    c. The subordinate mortgage must not contain a cross default provision or any right of foreclosure before the termination of the FHA-insured mortgage.
    d. The term of the subordinate mortgage must be extended, if:
        i. The note matures, there are no surplus cash funds or residual receipts available for repayment and the first mortgage has not been repaid in full.
        ii. HUD grants a deferment of amortization or forbearance that result in an extended maturity of the insured mortgage.
    e. The subordinate mortgage must be assumable when a sale or transfer of physical assets occurs and the insured mortgage remains in place.
        i. The holder of the subordinate mortgage cannot require that more than 75 percent of the net proceeds of the sale or transfer be applied to the reduction of the loan.
        ii. For these instructions, net proceeds are the funds available to the original Borrower after correcting any monetary or covenant default on the first mortgage, making:
            1. Required contributions to any reserve fund, and
            2. Needed improvements to the property as evidenced by HUD's annual inspection reports.
    f. The subordinate mortgage must automatically terminate if HUD acquires title to the project by a deed in lieu of foreclosure.
    g. Only 75 percent of surplus cash can be pledged to the repayment of the subordinate loan(s).

E. **Accounts Receivable (AR) Financing.** AR financing is permitted provided that all of the requirements in Production, Chapter 15 are met, and ORCF has approved the terms of the AR financing.

Section II
Production

Appendix 3.1
Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care

Form Number	Form Name
HUD-91710-ORCF	Residual Receipts Note – Non Profit Mortgagor
HUD-92223-ORCF	Surplus Cash Note
HUD-92264A-ORCF	Maximum Insurable Loan Calculation ("MILC")
HUD-92408-ORCF	Amendment to AIA Document B108
HUD-92420-ORCF	Subordination Agreement – Financing
HUD-92434-ORCF	Lender Certification
HUD-92442-ORCF	Construction Contract
AIA Form B108	Owner-Architect Agreement
HEROS	HUD Environmental Review Online System
N/A	ORCF Appraisal Statement of Work
N/A	ORCF Architecture and Cost Statement of Work
N/A	ORCF Market Analysis Statement of Work
N/A	ORCF Project Capital Needs Assessment (PCNA) Statement of Work – 223(a)7
N/A	ORCF Project Capital Needs Assessment (PCNA) Statement of Work – 223(f)

Section II
Production

Chapter 4
Architectural Analysis and Cost Processing

4.1 General

A. Qualifications of Lender's Third Party Representatives

1. Architectural Reviewer – See Lender's Architectural Reviewer and Cost Analyst's Statement of Work – New Construction, Substantial Rehabilitation, and 241(a), Section I.A (available on the Section 232 Program website).

2. Cost Analyst - See Lender's Architectural Reviewer and Cost Analyst's Statement of Work – New Construction, Substantial rehabilitation, and 241(a), Section I.B (available on the Section 232 Program website).

3. Needs Assessor – See Project Capital Needs Assessment (PCNA) Statement of Work – 223(f), Section I, and PCNA Statement of Work – 223(a)(7), Section I (both are available on the Section 232 Program website).

B. Required Architectural Services for Design and Supervision - See Lender's Architectural Reviewer and Cost Analyst's Statement of Work – New Construction, Substantial Rehabilitation, and 241(a), Exhibit C.

C. Architectural Standards and Other Criteria

1. HUD's Minimum Property Standards, Handbook 4910.1

2. Accessibility Standards (See Section 4.1 D below)

3. Seismic Resistance Requirements. Seismic Resistance for Substantial Rehabilitation and Existing Projects pursuant to Section 223(f). Structures in seismic zones 3 and 4 must meet three fourths (3/4) of the seismic force level resistance contained in FEMA-310, Handbook for the Seismic Evaluation of Buildings – A Pre-standard, FEMA-356, Pre-standard and Commentary for the Seismic Rehabilitation of Buildings, and FEMA-274, NEHRP Commentary on the Guidelines for Seismic Rehabilitation of Buildings.

a. A seismic hazard analysis of the building(s) must be made by a registered engineer familiar with lateral force design, where applicable code requirements at the time of construction did not equal or exceed the referenced seismic standards.
b. The evaluation must include an examination of the structure for continuity, ductility, and resistance to lateral forces.
c. Structural elements and connections between elements must be strengthened and new elements installed as required, if the existing structure does not provide three fourths (3/4) of the seismic force level resistance required by paragraph A above.

Note: New construction seismic standards are dictated by local code.

4. Energy Efficiency Requirements. For New Construction or Substantial Rehabilitation, the project design must meet or exceed the requirements of the 2006 International Energy Conservation Code (IECC) (or later versions adopted by the Secretary of HUD), or in the case of care facility high rises (defined as structures of 4 or more stories), the requirements of the American Society of Heating, Refrigerating, and Air-Conditioning Engineers (ASHRAE) Standard 90.1 – (1989 for substantial rehabilitation and 2004 (or later versions as adopted by the Secretary of HUD) for new construction), and shall be cost-effective with respect to construction and operating costs on a life-cycle cost basis. HUD, in cooperation with the Environmental Protection Agency and the Department of Energy, has adopted a wide ranging energy action plan for improving energy efficiency in all housing programs, which includes encouraging program participants to use Energy Star products.

5. Department of Health & Human Services, Centers for Medicare & Medicaid Services, final rule entitled, "Medicare and Medicaid Programs; Fire Safety Requirements for Long Term Care Facilities, Automatic Sprinkler Systems."

6. Subsurface Exploration (Soil Investigation). Before foundation design and application for Firm commitment, reliable information about subsurface conditions and foundation recommendations must be made available to the Lender's analyst by the borrower.
   a. The Architect must advise the Borrower of the scope and type of soils information and/or subsurface investigation required for structural design.
   b. The Borrower must provide the services of a registered design professional for determining subsurface conditions. These services shall be provided in accordance with the Owner-Architect Agreement.
   c. The Lender's architectural analyst will assure that the architect has comprehensive, well documented soils information and that project foundation design follows the report recommendations. When necessary, the Lender's architectural analyst may request engineering help in reviewing soil reports and related designs.

d. Soils investigation shall be in accordance with Chapter 18 of the International Building Code, except that an investigation and report is required for every project involving new construction, whether or not required by the building official.

See PCNA Statement of Work – 223(f); Lender's Architectural Reviewer and Cost Analyst's Statement of Work – New Construction, Substantial Rehabilitation, and 241(a); and PCNA Statement of Work – 223(a)(7), for a full list and details of requirements and standards.

D. Accessibility for Persons with Disabilities

1. See Accessibility Matrix for Section 232 (available on the Section 232 Program website. Direct link: http://portal.hud.gov/hudportal/documents/huddoc?id=AccessMatrixSec232.docx), for guidance on the applicability of the Fair Housing Act (FHA), Section 504 of the Rehabilitation Act of 1973, and the Americans with Disabilities Act (ADA), as they relate to Purchase/Refinance, New Construction, and Substantial Rehabilitation loans), and

2. See Lender's Architectural Reviewer and Cost Analyst's Statement of Work – New Construction, Substantial Rehabilitation, and 241(a), Section IV.A.1.c., for more details, including accessibility for the vision or hearing impaired, and residential accommodation kitchens. Please see direct link here: http://portal.hud.gov/hudportal/documents/huddoc?id=LenArCsReSOW.docx.

E. HUD Labor Standards and Enforcement Protocol

Applicable when Davis-Bacon wage rates apply as indicated in Production Chapter 2. See Appendix 4.1, HUD Labor Standards and Enforcement Protocol, for procedures during:

1. Firm Commitment Processing,
2. Initial Closing Clearance,
3. Construction Phase, and
4. Final Closing Clearance.

4.2 Section 232 New Construction, Substantial Rehabilitation and 241(a) Supplemental Loans

A. Lender Processing

1. Architectural Reviewer – See Lender's Architectural Reviewer and Cost Analyst's Statement of Work – New Construction, Substantial Rehabilitation, and 241(a), Sections III.A, and IV.A and B.

2. Cost Analyst - See Lender's Architectural Reviewer and Cost Analyst's Statement of Work – New Construction, Substantial Rehabilitation, and 241(a), Sections III.B, and IV.C and D.

B. ORCF Underwriter Review

The following areas shall be reviewed:

1. check for complete Plans and Specifications;

2. compliance with the Fair Housing Accessibility Act Section 504 of the Rehabilitation Act of 1973 (also known as Section 504), and Title II of the ADA (if applicable), as well as the applicable accessibility standards as shown on the Accessibility Matrix for Section 232;

3. if the project is in compliance with regulatory requirements regarding number of full bathrooms per resident (if the project is an ALF or BC);

4. Reserve for Replacement (R4R) Funding Schedule (for Sub-Rehab where they are adding units to an existing project);

5. existing R4R Account (for 241(a) Supplemental Loans);

6. General Contractor's Overhead; and

7. Owner-Architect Agreement, to confirm it is complete and correct.

4.3 Section 232 Substantial Rehabilitation

A. Definition – Substantial Rehabilitation

A project qualifies as a substantial rehabilitation project when:

1. The hard costs of repairs, replacements, and improvements (not including major movable equipment) exceed 15% of the project's value after completion of all repairs, replacements, and improvements. Additions that do not include new units are permitted in substantial rehabilitation projects, but the costs of the addition are not included in the eligibility test; OR

2. Two or more major building components are being substantially replaced. The component must be significant to the building and its use, normally expected to last the useful life of the structure, and not minor or cosmetic. Substantially replaced means that at least 50% of the component must be replaced. Examples of major building components are: roof structures, wall or floor structures, foundations,

plumbing systems central heating systems, air conditioning systems and electrical systems. An example related to a roof replacement is as follows: major building components: roof sheathing, rafters, framing members; minor building components: shingles or built-up roofing.

NOTE: Estimates for determining the cost for substantial rehabilitation must include general requirements and fees for contractor's general overhead and profit, bond premium, borrower's and contractor's other fees and design architect and supervisory architect. However, when determining the *eligibility* of Section 232/223(f) projects, include only the repair costs; do not add general requirements and fees.

B. Joint Inspection. See Lender's Architectural Reviewer and Cost Analyst's Statement of Work – New Construction, Substantial Rehabilitation, and 241(a), Exhibit F for details.

4.4 Section 232/223(f) Refinance

A. Lender Processing

1. Needs Assessor – See PCNA Statement of Work – 223(f).

2. **Timing:** The effective date of the PCNA should be the date the Needs Assessor inspected the subject property. For 223(f) refinances the PCNA is to be submitted to ORCF by the Lender within 180 days of the PCNA's effective date. Expired reports must either be updated or granted a waiver through consultation with the ORCF.

B. ORCF Underwriter Review

The following areas shall be reviewed:

1. PCNA: Check for changes to repair conclusions. Has the Lender suggested a lower dollar amount or fewer repairs than the Needs Assessor's repair conclusions?

2. Check for repair inspectability. Are the repairs clearly described in terms of inspectability (location and what the need is)?

3. Verify compliance with the Fair Housing Act, Section 504, and Title II of the ADA (if applicable), as well as applicable accessibility standards as shown on the Accessibility Matrix for Section 232.

4. Review R4R Funding Schedule. Has the Lender supplied an acceptable R4R Funding Schedule showing a positive account balance through year 15?

4.5 Section 232/223(a)(7) Refinance

A. Lender Processing

1. Needs Assessor – See PCNA Statement of Work – 223(a)(7).

2. **Timing:** The effective date of the PCNA should be the date the Needs Assessor inspected the subject property. For 223(f) refinances the PCNA is to be submitted to ORCF by the Lender within 180 days of the PCNA's effective date. Expired reports must either be updated or granted a waiver through consultation with the ORCF.

B. ORCF Account Executive / Asset Manager Review

The following areas shall be reviewed, if a PCNA is required and submitted:

1. PCNA: Check for changes to repair conclusions. Did the Lender address the status of all deficiencies from last REAC Inspection?

2. Check for repair inspectability. Are the repairs clearly described in terms of inspectability (location and what the need is)?

3. Verify compliance with the Fair Housing Act, Section 504 and Title II of the ADA (if applicable), as well as applicable accessibility standards.

4. Has the Lender supplied a R4R Funding Schedule (showing all funding needs, and a proposed Initial and Annual Deposit) that shows a positive Reserve balance in years 1 – 15?

5. Has the Lender's Underwriter justified any deviations from the third Party PCNA?

Section II
Production

Appendix 4.1
HUD Labor Standards and Enforcement Protocol Section 232 and 241(a)

Protocols set forth herein are applicable when Davis-Bacon applies, as indicated in Section II, Chapter 2.

Early Commencement of Construction Processing

When an application for Early Commencement of Construction is submitted, the U/W will contact the Regional Labor Standards and Enforcement Officer (RLSEO) in the manner specified below in the Firm Commitment Processing section. If the application is acceptable, ORCF will issue an Early Commencement Approval Letter, which will include language requiring Davis-Bacon compliance. The wage decision effective date is the construction start date. The FHA Lender's pre-construction conference coordinator (PCCC) must notify the RLSEO of the actual date of start of construction.

Firm Commitment Processing

1. When the Firm application is submitted, the ORCF Underwriter (U/W) will contact the RLSEO via email to initiate coordination with the Office of Labor Relations (OLR). A list of the RLSEO's and their contact information is posted at:

   http://portal.hud.gov/hudportal/HUD?src=/program_offices/labor_standards_enforcement/laborrelstfh

   The U/W shall furnish to the RLSEO (or his/her designee) via email the Lender's Narrative (the Memo for Post-Commitment Early Start of Construction Request should also be included, when applicable), and Division I (when using the MasterFormat 1995) or Division 00 73 00 (when using the MasterFormat 2010), of the Specifications, which includes the Davis Bacon Wage Decision, and the Supplementary Conditions of the Contract for Construction. The Lender's Narrative will contain the following information:

   - Project location.
   - Number of stories.

- Details on any commercial areas (square footage, percentage of gross floor area and description).

- A statement as to whether all units have both a kitchen/kitchenette and bathroom.

- The contact information (name, phone number and email address) for the PCCC.

2. The RLSEO/designee shall review the Narrative and specifications and determine whether the specifications contain the correct Davis-Bacon wage decision based upon the project description. The RLSEO/designee shall notify the U/W via email either confirming the wage decision is correct, or advising the wage decision must be changed. The RLSEO/designee shall attach an electronic copy of the correct wage decision if a change is required. Upon receipt, the U/W will email a copy to the OHP Construction Manager (CM) and to the PCCC. The wage decision is subject to modification and must be verified as current by OLR during initial closing clearance. The effective date of the wage decision is the date of initial endorsement provided that construction starts within 90 days. For projects utilizing a Post-Commitment Early Start of Construction (Early Start), the wage decision effective date will be the construction start date. On Early Start projects, the PCCC must notify the RLSEO of the actual date of start of construction to verify the most current applicable Davis-Bacon wage rate.

3. The Firm Commitment will include language requiring Davis-Bacon compliance, as follows:

   The borrower(s), its contractors and subcontractors, shall comply with all applicable Federal labor standards provisions as expressed in the Supplementary Conditions of the Contract for Construction, in connection with the construction of said Project.

<u>Initial Closing Clearance</u>

1. The PCCC shall notify via email the RLSEO/designee, the ORCF Closing Coordinator (Closer) and the CM of the proposed location, date and time of the Pre-Construction Conference and Initial Closing. Such email shall attach the most recent version of Division I of the Specifications.

2. The RLSEO/designee shall review the contract specifications to determine whether the current and correct Davis-Bacon wage decision and the Supplementary Conditions of the Contract for Construction are incorporated. The RLSEO/designee shall provide initial closing clearance via email which shall include the contact information for the Labor Relations Specialist (LRS) that will be responsible for Davis-Bacon technical support, compliance monitoring, and enforcement.
   Initial closing clearance may be conditioned upon the incorporation of a corrected wage decision (e.g., updated) and/or the Supplementary Conditions of the Contract for Construction in the contract specifications. If so, the RLSEO/designee shall attach an electronic copy of the current/correct wage decision to the clearance email.

3. At the Pre-Construction Conference the PCCC will notify all appropriate parties (general contractor, architect and borrower) of the contact information for the LRS staff.

4. The PCCC shall notify the LRS of the actual date of initial endorsement.

Construction Phase

1. The project architect and the PCCC shall notify, via email (followed by a hard copy), the CM of the date of construction start, the CM will then notify the LRS via email of the date construction started. In the event construction did not begin within 90 days after initial endorsement, the LRS shall determine whether the wage decision had been modified and whether any updates must be incorporated into the Contract. The LRS shall promptly notify the CM via email if the contract wage decision must be updated and will attach an electronic copy of the required wage decision.

2. During construction, the CM will provide the LRS with electronic versions of the Record of Employee Interview (HUD-11) and HUD Representative's Trip Report (Form HUD-95379-ORCF) completed by the HUD Inspector.

3. During construction and should an investigation occur, the LRS will provide electronic notice and summaries of said investigations and findings (excluding confidential information) to the CM.

4. Should the LRS or the U.S. Department of Labor instruct withholding of requisitions/advances, the CM shall be notified via email of such instructions (including a copy of the proposed notice to the contractor and the withholding amount required). The CM shall work with the LRS or the U.S Department of Labor staff to implement such instructions or address the concerns (if at all possible). Should requisitions/advances be withheld, the CM shall work with the LRS or the U.S Department of Labor staff to determine when or if the requisitions/advances shall be resumed.

5. At approximately 70% construction completion, the CM shall notify the LRS via email, to encourage the LRS to address any labor relations issues well in advance of construction completion.

6. The CM shall notify the LRS via email of any requests for retainage reductions. The CM and LRS will recommend approval/disapproval of such request in an expeditious manner.

Final Closing Clearance

1. For each new construction, substantial rehabilitation, or 241(a) project subject to labor standards provisions, the LRS must ensure that any/all labor standards issues are resolved or that provisions are made to ensure the payment of wage restitution that may be found due. At the earlier of at least 10 days prior to Final Closing or when the Final Closing documents

are received, the Closer will request via email OLR clearance to proceed with the Final Closing.

2. The LRS shall perform a final project review and shall provide final closing clearance based on the results of this review.

   If there are no labor standards issues outstanding the LRS shall provide final closing clearance without conditions via email to the Closer. The Closer will notify the Closing Attorney and lender of such clearance via email.

   If there are outstanding labor standards issues the LRS shall provide conditional final closing clearance via email to the Closer. The Borrower or general contractor will be required to deposit to a specified U.S. Treasury account, via Fedwire, funds sufficient to satisfy any deficiencies. The LRS shall attach wire transfer instructions; a deposit agreement and a schedule detailing the purpose(s) and amount(s) to the conditional clearance email. The Closer shall forward this email to the Closing Attorney. The LRS shall likewise notify the Borrower or general contractor of the deposit requirement.

3. No later than the day of the final closing and before the closing concludes, the depositor must furnish evidence of deposit in the amount required (e.g., bank receipt, wire transfer advice) and the depositor must execute the deposit agreement. The Closer shall promptly deliver to the LRS the original, signed deposit agreement and the deposit evidence.

Section II
Production

Appendix 4.2
Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care

Form Number	Form Name
HUD-11	Record of Employee Interview
HUD-2328	Contractor's and/or Mortgagor's Cost Breakdown
HUD-91124-ORCF	Design Architect's Certification
HUD-92264A-ORCF	Maximum Insurable Loan Calculation
HUD-92326	Project Cost Estimate
HUD-92408-ORCF	Amendment to AIA Document B108
HUD-92437	Request for Construction Changes on Project Mortgages
HUD-92442-ORCF	Construction Contract
HUD-92448	Contractor's Requisition – Project Mortgages
HUD-92554-ORCF	Supplementary Conditions of the Contract for Construction
HUD-95379-ORCF	HUD Representative's Trip Report
N/A	Project Capital Needs Assessment (PCNA) Statement of Work – 223(f)
N/A	Lender's Architectural Reviewer and Cost Analyst's Statement of Work – New Construction, Substantial Rehabilitation, and 241(a)
N/A	Project Capital Needs Assessment (PCNA) Statement of Work – 223(a)7
N/A	Accessibility Matrix

Section II
Production

Chapter 5
Appraisal Reports and Market Studies

5.1 General

Appraisal reports are required for all Section 232 applications with the exception of the 232/223(a)(7), 232/223(f)/223(a)(7), 223(d) and 232(i). Market studies must be included in all appraisal reports. The market study may at times be truncated under conditions outlined in Section 5.3.Q. The market study will be authored by the same person(s) who produced the appraisal report and the conclusions carried throughout the appraisal report. In the past, appraisal reports and market studies were required to be separate documents. Now single reports are encouraged.

When an appraisal report assignment involves complex or unusual valuation issues, the appraiser and/or the Lender should consult with the Office of Residential Care Facilities (ORCF) before beginning the assignment.

HUD expressly asserts its role as a regulatory enforcement agency as outlined in the confidentiality provision of the Uniform Standards of Professional Appraisal Practice (USPAP). Appraisers may be required to present their entire work file and fully disclose the identity and source of confidential information should HUD determine a review of the appraiser's work file is in order. All confidential information received either by initial request or by invoking the confidentiality provision of USPAP will be kept confidential by HUD, especially with regard to the "Freedom of Information Act." Any questions regarding the confidential information received will be directed to the originating appraiser for clarification.

When appraisal reports do not meet the program requirements as outlined in this chapter, the following remedies may be invoked:

1. Issuance of a warning letter to the lender or appraiser.
2. Limited Denial of Participation (LDP) of an individual or company.
3. Lender referred to the Mortgagee Review Board.
4. Appraiser referred to the state regulatory agency.

Chapter 2 of Section I – Handbook Introduction, addressing "Lender Relations," discusses remedies against lenders in more detail.

5.2 Selection of Appraisers

The Lender is responsible for the selection and approval of appraisers and familiarizing them with the 232 insurance program guidelines. Lenders must ensure that each appraiser selected is qualified to complete the assignment by reviewing their experience, education, work quality, relevant assignment frequency, and state licenses or certifications.

In order to qualify as the appraiser, the individual must meet all of the following conditions:

1. personally inspect the property being appraised on the date of valuation;
2. perform the analysis;
3. have the necessary knowledge and experience;
4. sign the appraisal report certification as the appraiser; and
5. be a Certified General Appraiser under the appraiser certification requirements of the State in which the subject property is located, as of the effective date of the appraisal report (temporary certifications are permissible). Lender verification of an appraiser's current standing can be done at http://www.asc.gov.

These requirements do not preclude an appraiser from relying on individuals that are not state-licensed or certified to provide professional assistance (such as an appraiser trainee or an employee doing market data research or data verification) in the development of the appraisal report.

Further, the appraiser must meet all requirements of the competency rule of the USPAP. If more than one appraiser works on the appraisal report, they are each required to sign the report and a certification outlining their involvement. The appraiser's signed certification must acknowledge the roles and extent of the professional assistance provided by others.

The appraiser must be independent of and may not be affiliated with the loan originator, broker, developer, borrower, lender, or any individual or institution involved in any other financial role in the application. The appraisal report must be ordered and paid for by the Lender and not by the originator, broker, developer, or Borrower.

The appraisal report must identify HUD as an authorized user of the report. The contract between the lender and appraiser will contain no language prohibiting contact between ORCF and the appraiser.

5.3 Appraisal Report Requirements (Statement of Work)

A. **USPAP Compliance:** The report must be in compliance with the USPAP. Any data contained in the appraisal report that is not the work of the appraiser and is from an outside source is to be cited. In addition to USPAP-required items, the report will contain the following deliverables:

1. Resume for each appraiser signing the report.

2. Copy of appraisal license or temporary permit for each appraiser signing the report.

3. Adequate photo documentation of the subject to allow a desk reviewer to get a sense of the quality, condition, and adequacy of the physical plant. In the case of new construction or substantial rehabilitation, exhibits such as floor plans, site plans, and elevations are to be included in addition to site photographs. The exhibits should be adequate to give the review appraiser a sense of what is planned. The report exhibits should be clear and readable. Plans may be incorporated into the appraisal report by reference (cite version or date), so long as said plans are supplied alongside the appraisal report.

B. **Timing:** The effective date of the opinion of value should be the date that the designated appraiser inspected the subject property. The date of valuation may not be a future date.

For 223(f) refinances, the appraisal report is to be submitted to ORCF by the Lender within 180 days of the appraisal report's effective date. For expired appraisal reports, a new appraisal report must be submitted or granted a waiver through consultation with the ORCF review appraiser. Consult with ORCF to see if a re-inspection will be required.

For new construction, substantial rehabilitation and 241(a) loans, the appraisal report is to be submitted to ORCF by the Lender within 120 days of the appraisal report's effective date. For expired appraisal reports, a new appraisal report must be submitted or granted a waiver through consultation with the ORCF review appraiser. Consult with ORCF to see if a re-inspection will be required. The appraiser will indicate there is a hypothetical condition that the improvements have been completed and the forecasted occupancy levels have been achieved as of the appraisal report date. In addition, the appraiser must indicate the timeframe necessary to achieve these projected results.

C. **Purpose of the Appraisal Report and Definitions:** The purpose of each appraisal report is to provide the Lender and ORCF an opinion of the fee simple "Market Value of the Total Assets of the Business" (MVTAB) for the subject property. The report will be used by the Lender and ORCF in the underwriting of a FHA-insured mortgage.

The Lender will specifically inform the appraiser if the appraisal report is for another purpose.

D. **Definition of Market Value of the Total Assets of the Business (MVTAB):** "The market value of all the tangible and intangible assets of a business as if sold in aggregate as in a going-concern" *(The Dictionary of Real Estate Appraisal, Fourth Edition, Appraisal Institute).* The appraiser is hereby instructed to exclude any business assets (such as holdings or investments, working capital, accounts receivable, and accounts payable) that are separate from the real estate. Implicit in this definition of the MVTAB is the definition of Market Value which is defined below.

Definition of Market Value: The most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently, knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

1. buyer and seller are typically motivated;

2. both parties are well informed or well advised, and each acting in what they consider their own best interest;

3. a reasonable time is allowed for exposure in the open market;

4. payment is made in terms of cash in U. S. dollars or in terms of financial arrangements comparable thereto; and

5. the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions by anyone associated with the sale.

(Office of the Comptroller of the Currency, 12 CFR Part 34.42g)

The MVTAB differs from a "Going-Concern Value" in that it assumes a sale (see definition of market value above). The appraiser's projection of income and expenses should include any applicable resets of rates that would be triggered by a sale. These resets will vary from one locality to another and may include a tax reassessment, or a reset of the Medicaid reimbursement rates.

In developing the MVTAB, the appraiser is being asked to mimic the processes of the market and estimate the most probable sales price of the going-concern. If the property is currently under contract or has recently sold under normal arm's length market conditions, any departure from that price will be scrutinized. The assumption is that if the property has been adequately exposed to the market, the purchase price is a strong indicator of the price the market will bear.

E. **Extraordinary Assumptions:** Extraordinary Assumptions should be used infrequently and when used, must be prominently outlined in the appraisal report.

F. **Jurisdictional Exceptions:** Jurisdictional exceptions should not be invoked and are not required in order to comply with any instructions contained in this chapter.

G. **Hypothetical Conditions – 223(f):** Typically, the only Assumptions in a 223(f) appraisal report should be the completion of the proposed repairs/construction. On rare occasions, there may need to be other assumptions, such as the execution of a proposed land lease. It is not appropriate to assume stabilized operations if the property is not at stabilized, without accounting for the impact on the value associated with reaching stabilization.

The valuation should not be based on any significant change in occupancy, unit mix, bed configuration, room rate increases, or expense reductions that would require an extended period to implement. The appraised value should reflect the subject's configuration and economics on the date of appraisal report, but with consideration to increases in income, occupancy, or decreases in expenses that could be implemented immediately by a typical buyer (but these changes must be fully supported by the market and discussed in the appraisal report). It is recognized that occupancy levels can vary substantially from day-to-day, so while the occupancy of the facility on the date of inspection should be considered, the focus should be on forecasting achievable occupancy for the 12-months following the date of value based on the subject's historical occupancy, market area dynamics, and anticipated changes in the market.

In cases where there are proposed repairs, the appraisal report will conclude an "as completed" value, making a hypothetical assumption that all proposed repairs are completed. The appraisal report should indicate the dollar amount of the repairs assumed and give a general overview of what items are included. This is to ensure the consistency of the appraisal report with the loan underwriting. The completion of the repairs should be considered in determining rents, vacancy, expenses, and depreciation; however, these shifts in operations will likely occur over time. The appraisal report should not make the assumption that the new stabilized levels have been achieved. Instead, the value should reflect what a typical buyer would pay for the current operations on the valuation date if the repairs were finished.

ORCF may, at its discretion, allow a Lender to underwrite a 223(f) loan that assumes a shift in operations or change in the number of units (as is done for construction loans). In these cases, the Lender will have the appraiser determine what the stabilized occupancy of the reconfigured project will be once the repairs are completed. A "truncated" market study as outlined in 5.3.Q will not be allowed. The appraiser will also supply an analysis of the cost to reach new levels of operation, showing the forecasted monthly cash flows until stabilized occupancy has been achieved. This analysis is required even if the monthly Net Operating Income (NOI) never drops below $0. The appraiser will assume the repairs have been completed and the forecasted stabilized occupancy has been achieved as of the appraisal report date.

H. **Hypothetical Conditions – New Construction, Substantial-Rehabilitation and 241(a):** For New Construction, Substantial Rehabilitation and 241(a) loans, the appraisal report is to conclude an "As Completed and Stabilized Value", making a hypothetical assumption that all improvements are completed and the appraiser's forecasted occupancy has been achieved.

For all ORCF appraisal reports, income and expense conclusions are to be as of the effective date of the appraisal report and are <u>not</u> to be trended to the projected date of stabilization.

1. **Operating Deficits:** The Appraiser is to perform an operating deficit calculation when the subject property is not currently able to achieve the NOIs forecasted in the appraisal report. The format of the IOD is dictated within the Initial Operating Deficit Escrow Calculation Template (Form HUD- 91128-ORCF). More information

on Operating Deficits can be found in Production, Chapter 2.

2. **Additional Instructions:** When portions of a project already exist (i.e., Section 241(a) and substantial rehabilitation loans), the appraiser will also provide an "As Is" Market Value of the Total Assets of the Business. The "As Is" MVTAB should not assume repairs are completed. Do not make a hypothetical assumption that the subject is operating at stabilized occupancy if it is not.

I. **Regional Description:** This section should describe the region (typically the U.S. Census-defined Metropolitan Statistical Area- MSA when in urban and suburban areas) relevant to the property, and should include:

1. An overview of recent and forecasted population and household growth;

2. A description of the economic base of the area including recent and forecasted job growth statistics, stability of local industries, major employers, and current and historical unemployment levels.

J. **Neighborhood Description:** In discussing the neighborhood, the appraiser should include the following:

1. A general discussion of the neighborhood's demographics, new development, economic and employment trends, and a summary of the neighborhood's relevant strengths and weaknesses, and their influence on the desirability and remaining economic life of the subject.

2. A description of neighborhood land uses in general, including predominant age, quality, and condition of the properties, and their influence on the subject.

K. **Site Description:** In the analysis and description of the site the appraiser should:

1. Include a reference to the panel number and date of the FEMA map reviewed and if the site is partially or fully within a designated Special Flood Hazard Area. Be careful to differentiate between Zone X and Shaded Zone X flood hazard areas.

2. Obtain a copy of the land survey from the lender and discuss the effect of easements, encroachments or encumbrances on the subject site.

3. Identify the immediately adjacent land uses in all directions and indicate if they have a negative impact on the site.

4. Indicate the number and adequacy of parking stalls on site, and if off-site parking is utilized.

L. **Zoning and Conformance**: The appraiser should identify the zoning code. Zoning requirements concerning density, unit size, parking, etc., should be analyzed for the subject

property. A statement should be made as to whether the property is a legal-conforming, legal non-conforming, or an illegal use, and include the issues of non-conformance, if applicable. This need not be original research on the part of the appraiser, since the Lender will be supplying their own evidence of zoning compliance with their application.

M. **Improvement Description**: The appraiser is to provide a description of existing and any planned improvements. This section should include the estimate of total building area. Include descriptions of living areas, patient areas, nursing or therapy units, common areas shared by residents and support areas. Include an inventory of room type (private, semi-private and ward) or unit mix as well as a description of their restroom and bathing accommodations.

Color photos should generally include, but not be limited to, site access, common areas, nurse's stations, hallways, rehab space, parking, building exteriors, and interior views of typical units.

Note: Although it is recognized to be outside their area of expertise, the appraiser is encouraged to note any violations of building, health, fire, or safety codes that were suspected at the property. ORCF understands the appraiser is not an accessibility expert; however, if an accessibility issue is obvious, a detailed description (inclusive of pictures) should be provided.

Advisory Note: When analyzing properties that do not have all the necessary facilities or services on-site or that share such functions with an adjoining or affiliated facility, the appraisal report must not assume that the current sharing agreements will continue. By way of example, such shared facilities might provide for dining and food services, laundry, treatment space, management, parking, maintenance, etc. The appraisal report must recognize the property as an operation with deficiencies. For appraisal report purposes a provider of a missing service can be considered an off-site vendor and apply market expenses to that service, not recognizing any below-market expenses granted for existing relationships. The cost of supplying missing services must be clearly defined in the appraisal report. It is noted that off-site costs are typically higher than the costs for similar services with all in-house operations. If the appraisal report assumes an off-site vendor the capitalization rate should also consider the reduced ability to control expenses or other related risks. The appraisal report may hypothetically assume that deficiencies are cured if the cost of renovations and or additions required to provide those services have been accounted for in the valuation. Such assumptions are limited to physical and legal restrictions. Assumptions about construction need to account for any lost income from the change in operations and for time and vacancy needed to implement the change. At that point the expense to operate an in-house good or service should be abstracted from similar facilities with in-house operations.

N. **Remaining Economic Life**: The appraiser will estimate the remaining economic life of the improvements. Remaining Economic Life is defined as: "*The estimated period during which improvements will continue to represent the highest and best use of the property; an estimate of the number of years remaining in the economic life of the structure or structural*

components as of the date of the appraisal report; used in the economic age-life method of estimating depreciation."[1]

The analysis should discuss the following three types of depreciation: physical deterioration, functional obsolescence, and economic or external obsolescence.

1. **Physical Deterioration.** In determining the remaining economic life, the appraiser will include an estimated economic life and effective age. At a minimum, the economic life estimate from the Marshall & Swift Cost Estimating Manual or equivalent should be quoted. Other published life estimates may also be quoted when available. While HUD will require a reserve account to continually maintain the building, the appraisal report should not assume any specific type of ownership or financing when determining the probable life. Maintenance done in the past may be considered in determining the effective age, but assumptions about future maintenance should be tied to the amount of repairs that can be funded with the "market" reserve expense concluded in the appraiser's income approach.

2. **Functional Obsolescence.** Lives can be extended or shortened based on the presence or absence of functional obsolescence as compared to other facilities in the subject's market. For nursing facilities, these comparisons may include the number of private rooms compared to semi-private or wards, shared toilets/showers, quality and location of therapy space, size of common areas, corridor width, etc. For assisted living facilities, the comparisons alternately might focus on building amenities, common space, and room configurations.

3. **External or Economic Obsolescence.** Again, lives can be extended or shortened based external factors. Items to consider here may include but are not limited to long term population trends, stage of neighborhood life cycle, type of license and certifications, the likelihood of new competition, whether supply is controlled by State Certificates of Need (CON), the subject's relative competitive position in the market, hospital referrals, Medicaid reimbursement issues, alternate highest and best uses, etc.

O. **On-Site Services.** The appraiser is to provide a detailed description of the services and personal care levels to be provided by the subject project, including but not limited to the number of meals, housekeeping, laundry facilities, transportation, activities, therapies, assistance with activities of daily living (ADLs), etc. For multiple use facilities, the services offered or available for each resident group (e.g., board and care, assisted living, dementia, skilled nursing) should be segregated in the narrative.

P. **Highest and Best Use.** The Highest and Best Use is to be developed according to USPAP. It is to include both the highest and best use "as vacant" and "as improved." Properties are to be appraised based on their highest and best use. Usually this use will be the same as the intended use of the property; however, when there is a conflict between the two the Lender or

[1] The Dictionary of Real Estate Appraisal, 5th Edition, Appraisal Institute

appraiser should approach ORCF for guidance on how to approach the valuation for their particular circumstances.

Q. **Market Analysis.** For New Construction, Sub-Rehabilitation and 241(a), a complete market study must be part of the appraisal report. Appraisal reports for 223(f) refinances may supply a "truncated market analysis" if the project meets specific criteria. The case for submitting a truncated analysis should be presented in sufficient detail for the ORCF reviewer to arrive at the same conclusions.

1. A truncated market study is allowed if:
    a. The property is not adding beds/units and no substantial shift in the subject's census mix has been assumed.
    At the time of the appraisal report, the property is operating at and is expected to continue operating at its estimated stabilized occupancy into the foreseeable future.
    b. There are no anticipated or foreseeable increases in supply that will significantly alter the subject's competitive position or performance.
    c. There are no anticipated decreases in demand in the foreseeable future for the type of services offered at the subject.

2. With a truncated analysis it is not necessary to quantify (put a number to) the current demand level or "unmet need" in the primary market area. A truncated market analysis will include the following:
    a. A definition of who is the subject's target market(s).
    b. A definition and explanation of the Primary Market Area (PMA) including a discussion of geographic, demographic, and economic influences on and characteristics of the target market. Include a map showing the boundaries of the PMA.
    c. A description of the primary competition within the market area. Report each competitor's name, location, year built, and number of units/beds. If available, also report on unit type/sizes, payor mix, private pay bed/room rates, any significant shift in rates within the recent past, vacancy, recreational facilities and other amenities, condition of improvements, additional fees for personal care levels and/or second occupants, etc.
    d. A description of the local research into proposed construction or expansion of competitive facilities. For States that require certificates of need (CON), or its equivalent, the state agency should be contacted to determine the current and future intentions for granting additional beds or units in the primary market area that would represent additional competition.

3. Whenever truncated studies are not appropriate, a complete market analysis that conforms to the following rules must be included in the appraisal report.

    a. **Define the Primary Market Area (PMA).** PMA in this document is defined as "the area that a majority of the project's demand will be drawn from

considering physical barriers, psychological barriers, density of population, linkages, and the location of competing facilities.

Advisory note: The need to be nearby friends, family, physician, church, among other familiar services is a primary determinant for the selection of most senior housing and nursing facilities. Typically, 60 to 80 percent of the demand for senior housing and / or a nursing facility will come from the PMA. The analyst should study the market and determine natural boundaries, social or economic boundaries as well as other factors that generally define the PMA. The analyst should also determine if nearby areas have sufficient supply and would be a significant area to draw potential patients. Certain services that the subject may offer may also extend the PMA due to the lack of services in that area, therefore, the services the subject may offer should also be considered.

Market area analysis for long term care and seniors housing should focus not only on seniors but also on adult children who may be caregivers for an elderly person residing outside the market area." When defining the boundary of a market area, the analyst must include:

i. A description and map of the geographic boundaries of the subject's market area and a discussion of any physical or psychological barriers of the primary market area.
ii. The locations and a map showing all facilities (supply) that offer the same care as the subject facility (IL, AL, MC, SN, etc.) must be provided for the primary market area as well as for adjacent secondary market areas where a competitor's PMA overlaps the subject's PMA (existing, under construction, and planned).
iii. A general description of the localities from which the occupants in competing projects originate, if available. If the subject is an existing project with a proposed addition or a replacement project, a resident origin analysis should be performed.
iv. Location of significant referral sources.

b. **Define the Target Resident.** The report must include a qualitative description of the target resident and the type of housing and care offered by the subject. Include the economic and demographic characteristics of the target market (subject residents): income levels, wealth and assets, age, physical and/or mental limitations, and other similar factors.

Advisory Note – The economic and demographic focus for the target market may be different for assisted living than for memory care or skilled nursing facility. For example, income, wealth and assets are more important for private pay assisted living than for skilled nursing for which Medicare and/or Medicaid are the primary payor.

c. **Describe the Current Inventory and Supply Count.** While all facilities offering the same type of care as the subject will be mapped as described above, only those competing for the same Target Resident as the subject facility need to be identified as competitive supply. These direct competitors are to be used in forecasting unmet or displaced demand, rates, occupancy, resident/patient mix etc. Any beds/units identified in the PMA, but not included in the competitive supply must describe the reasons why they will not compete directly with the subject facility for the same Target Resident.

i. A datasheet for each of the subject's primary competitors is to include the following information:
    1. Project name, location, number of unit/beds.
    2. Operated beds versus licensed beds. Operated beds are those beds that are actually available and set up for immediate occupancy. Many nursing homes and assisted living facilities do not operate all of their licensed beds. A description of why the number of operated beds varies from the number of licensed beds should be provided,
    3. Private pay rates by unit type, and level of services. Provide information on the base rate and any added costs for optional services, as applicable.
    4. Typical census mix by payor source (i.e. private pay, Medicare, Medicaid, HMO, VA, etc.).
    5. Age and condition of the competing project, with consideration of aspects that may be substandard or obsolete in terms of physical plant, services, amenities, etc.
    6. Occupancy rates – indicate if the occupancy percentage is for a point in time or the average for the year.
    7. Existence or extent of concessions.
    8. The level of competitiveness in comparison to the subject should be discussed.
    9. Photographs should be provided.
    10. Contact information for the person who supplied the data. The administrator/executive director/marketing director should be interviewed for each primary competitor as part of the confirmation process.

ii. In addition to the datasheets presented for the primary competitors, the following information is to be presented.
    1. Describe any off-line product.
    2. Give the total number of beds/units (of the types housed within the subject) in the PMA, by type of care.
    3. Description of turnover rates (length of resident stays) within the PMA.
    4. Supply an occupancy survey for the PMA of the product type offered by the subject. Include an explanation of any vacancy

or absorption problems in the market. Supply any information gathered on waiting lists.

5. Describe the absorption experience of any recently completed projects, discussing the level and extent of pre-sales, move-ins, move-outs, and net absorption.

d. **Rate Determination.** This may be done within the market analysis section or the income approach section. The analysis should contain a determination of the appropriate rates for the subject. Differences in pricing strategies should be accounted for. For example, some facilities may charge lower base shelter fees with higher care fees, while others will quote higher shelter fees with lower care fees. The rate conclusions for the subject must show a consistent pricing strategy between shelter and care charges.

   The report should also include, as applicable, a discussion of the current levels of public payments by the State relative to the typical "private pay" rate for the same level of shelter, care, and services.

e. **Alternative Care and Service Systems.** The demand analysis should discuss the impact of other care and housing options that cater to the same target populations as the subject. These may include: home healthcare, continuing care retirement communities (CCRCs), assisted living facilities (ALFs), board and care facilities, congregate care facilities, retirement service centers, independent living facilities, nursing facilities, etc.

f. **Characteristics of Pipeline Activity.** The following information should be provided in the report for each project in the construction pipeline or planning process:
   i. Total number of beds currently under construction or proposed, by unit size or type of accommodation. Provide the projected rates if known. If proposed, what is the likelihood of being developed.
   ii. Typical types of services to be offered.
   iii. Provide contact information for data source.

g. **Licensing and Certificate of Need.** For intermediate and skilled nursing facilities, provide a narrative discussion and description of the licensing and Certificate of Need requirements and processes or any moratoriums imposed by the State in which the project is to be located. The discussion should focus on any required or recommended demand or need models and any other specific licensing requirements that would impact demand for the proposed project. Where CON requirements significantly curtail the building of new facilities, the appraiser will describe the state's rules relating to "transfer" of CON beds (e.g., must the transfer be within the same county? Must the transfer be from an over-bedded county to an under-bedded county? If data is discoverable, what are typical arms-length unit prices for these transactions?).

Certificate of Need restrictions, moratoriums on new development, and in particular licensed supply versus operated supply, must be considered when forecasting unmet or displaced demand in the PMA.

h. **Demand Estimate and Analysis.** The market study report should:

i. Estimate the unmet demand, or oversupply for the unit type(s) offered by the subject.

Rather than only comparing the subject's saturation rate to the rates of other markets, the market study should quantify the demand in numbers of units/beds. The unmet demand should be determined for the current market and include a forecasted demand for five years in the future. The demand estimate should show the number of units/beds by payor source (private pay, Medicare, Medicaid, etc.). For independent living, assisted living or memory care, the demand estimate must be based on the number of prospective Target Residents/Patients meeting the relevant economic and demographic criteria (sufficient incomes, age, etc.) that reasonably would be expected to require the level of care provided at the subject. As discussed subsequently, a demand estimate for nursing homes would rarely be based on demographic criteria such as sufficient incomes, age, etc., but would be based on need by type of insurance such as Medicare, Medicaid managed care or commercial insurance. Supply or a portion of a unit at a competitor that does not compete for the Target Resident/Patient population should be excluded as competitive units as part of the unmet or displaced demand calculation.

1. The demand analysis and forecast for senior housing (assisted living, memory care, group homes, independent living etc.) should include:
    a. Current and forecasted population of the target group(s) by age cohort and the proportion of the population each group comprises.
    b. Current and forecasted estimates for the Target Resident group of social, physiological, psychological limitations that require intermediate or skilled care.
    c. Current income band of prospective Target Residents demand segment, including rent to income ratio analysis, if necessary.
    d. Discuss the impact of anticipated population changes on the demand for this project.
    e. Discuss changes in the population (including migration patterns) of adult children of the frail elderly, if applicable.
    f. Indicate the proportion of secondary demand expected to come from outside of the PMA. Secondary demand should not be confused with the impact on demand tied

to the influence of adult children or family members. Secondary demand is the portion of the demand that cannot be directly tied to the influence of primary market area. Do not double count in-migration tied to the influence of adult children with the percentage coming from outside the PMA, as those residents/patients are usually accounted for in the population estimates used in the primary demand calculation.

g. Include demographic data sheets in the addendum.

2. The demand analysis and forecast for nursing facilities should include:
    a. Current and forecasted population of the target group(s) by age cohort and the proportion of the population each group comprises.
    b. Current and forecasted estimates for the Target Resident/patient group of social, physiological, psychological limitations that require intermediate or skilled care.
    c. If a significant portion of the Target Resident/patient census mix is private pay or Medicaid, include an income range for the prospective Target Resident/patient demand segment, including rent to income ratio analysis.
    d. Discuss the impact of anticipated population changes on the demand for this project.
    e. Discuss changes in the population (including migration patterns) of adult children of the frail elderly, if applicable.
    f. The demand forecast for specialized residential medical services may need to be based on the number of skilled nursing discharges from those hospitals serving the primary market area.

ii. Include an estimate of the absorption period needed for the project to reach sustaining occupancy. The absorption estimate should be tied to the analysis of demand, not just the historical experience of comparable buildings.

iii. When the supply is compared to demand it is acceptable to account for enough vacancy for the market to operate fluidly. Since the point of a supply analysis is to quantify the capacity of the existing inventory; it is not appropriate to discount the supply count for vacancies beyond a basic frictional vacancy. Frictional vacancy is defined as the minimum vacancy needed for a market to operate in an orderly fashion.

iv. Because the focus of the supply count should be on capacity, the market study will discuss the existence and impact of any off-line product in the PMA. An off-line unit is one that is not being operated because of lack of market demand for the unit. Facilities that are licensed for more beds than they operate may or may not count as off-line units, depending on the reason for operating fewer beds.

i. **Data, Estimates, and Forecasts.** The analysis should document the methods and techniques used to develop all estimates and forecasts; and provide adequate citations on the sources of all data, estimates, and forecasts. The data and estimates provided should be relevant and current.

The demand model utilized by the appraiser or market analyst must be supported by the case studies demonstrating the relevance of the demand model for estimating unmet or displaced demand regardless if the demand methodology is based on a published model or it was independently developed by the appraiser or market study analyst.

j. **Low Income Housing Tax Credits (LIHTC).** For LIHTC projects, the market study is to provide an estimate of demand, based on potential income-eligible resident. In many states income eligibility is satisfied when a resident is defined as income-eligible under Medicaid. Otherwise, an income-eligible resident is one whose income does not exceed the maximum permitted by the affordability restrictions but who has sufficient minimum income to pay the LIHTC rent without being overburdened by the amount of the restricted rent. Some LIHTC projects have other forms of assistance (such as Section 8 rental assistance or soft subordinate financing) to further reduce rents and thus expand the number of income-eligible tenants.

R. **Valuation.** The appraisal report should establish the subject's market value supported by the reconciliation of the income approach, the sales comparison approach, and cost approach (if applicable).

1. **Land Valuation**. In cases where no cost approach is developed, the appraiser is not required to estimate the value of the land.

The appraiser will base their land value on the highest and best use as if vacant. A minimum of three comparable sales should be used. The appraiser should ensure that the comparable transactions were arm's-length between buyer and seller and indicate how the sales data was verified. An explanation of the adjustments should be given in the narrative. If there is a recent or pending sale of the subject land, the sales price must be analyzed. This is a USPAP requirement.

For guidance on appraising properties involving ground leases, refer to Section 5.4.

For New Construction, Substantial-Rehabilitation and 241(a) loans, the appraiser will

also supply the "Market Value of the Site Fully Improved". This is a HUD-specific value that is defined in HUD Handbook 4465.1. The "Market Value of the Site Fully Improved" essentially assumes the site is ready for development and specifically that:

a. All necessary utilities are available to the site.
b. Any environmental conditions needing to be corrected prior to construction have been resolved.
c. Any required demolition has occurred.
d. There are no unusual site costs or that the conditions leading to such costs have been corrected.
e. All off-site improvements have been completed.

The extra costs associated with these site conditions need to be kept separate from the land value for correct loan sizing on Form HUD-92264a-ORCF. The "Market Value of the Site Fully Improved" is a HUD-specific value used in the derivation of the HUD replacement cost of the project. A conventional market value of the site as if vacant must also be derived by the appraiser when developing a cost approach, in order to keep that value strictly a market value, not a HUD-specific value. In cases where all of the above stated assumptions are already true, there may be no difference between the "Market Value of the Site Fully Improved" and the site value as if vacant prepared in the normal non-HUD way.

2. **Cost Approach to Valuation**. The Cost Approach is typically more relevant in the case of new construction or recently completed properties. This approach may be eliminated with older properties when not a reliable indicator of value; however, a narrative justification of its elimination is required. ORCF requires this approach when the actual or effective age of the facility is 5 years or less and whenever the appraiser believes this approach is applicable and relevant to producing a credible appraisal report.

   ORCF will expect to see a fully developed cost approach in cases where there is little depreciation or in cases where the undepreciated replacement cost new would be expected to be lower than the conclusions of the Sales Comparison or Income Capitalization Approaches. For that reason, base costs of new facilities will need to be carefully discussed in the narrative justification for excluding the approach.

   When developing a Cost Approach, the appraiser will prepare an independent estimate using comparable data and industry publications (e.g., Marshall and Swift) and conclude to the total cost for all improvements and major movable equipment. In order to arrive at the MVTAB, absorption, staffing costs, other intangible start-up operating costs, occupancy costs, and entrepreneurial profit should be considered and identified. The entrepreneurial profit should be an amount sufficient to attract a typical owner/investor to develop a project versus purchasing a stabilized project. Disparity between the conclusions of the cost approach and the other approaches should be discussed and reconciled as it relates to the principle of substitution.

All applicable forms of depreciation (also applies to major movable equipment) are to be considered. The final cost approach estimate is to assume completion of all required and proposed repairs included in the financing.

3. **Sales Comparison Approach to Valuation.** In obtaining sales data for the Sales Comparison Approach, the appraiser should verify the data with a party involved in the transaction (this source should be cited) and confirm that the transactions were arm's-length between buyer and seller. The appraiser should visit all improved sale comparables when in the subject's statistical market area. Photographs should be provided of the comparables that were inspected. For those comparables which the appraiser was not able to visit, inclusion of second party or published photos is permitted, and preferred to omitting a photo entirely. The source of the second party photographs should be cited.

   The sales comparison should be formulated based upon those sales which are most relevant and meaningful. The scope of the appraisal report should include a complete description of the comparable search. If the sales that are utilized require substantial adjustments the appraiser must provide an explanation why the sales utilized are appropriate. Although the market for the property type appraised may be regional or national in scope, if there have been recent sales in the area and those sales were not utilized for comparative purposes, an explanation of why the more proximate sales were not utilized is needed. All adjustments of the sales should be justified in the narrative report. The value of any excess land should be deducted from the comparable transaction sales price (if applicable). Contact information for sales comparable data should be given.

   When economic indicators such as income, expense, vacancy, cap rate, etc., are quoted from a sales comparable, the source of the data, whether it be from the buyer, seller, the appraiser's estimate, third-party estimate, etc., should be stated. Whether the income was historical or prospective in nature should also be disclosed. Also, state if the expense information is inclusive of management fees and reserve for replacement deposits, to be consistent with the subject's income forecasts.

   If the sales price includes consideration for accounts receivable, retained earnings, or intangible assets that may be sold off by the buyer without affecting the going concern, then the value of those assets should be deducted from the purchase price.

   Sales of leased fee and partial interests should not be used as comparables in the Sales Comparison Approach unless they can be reasonably adjusted for differences in the interest being sold, nor should they be used in the derivation of market-extracted capitalization rates.

   Sales that are part of a small group transaction or portfolio are discouraged but may be used if:

   a. At least one of the facilities in the portfolio is within the same state as the subject,

b. Adjustments are made for premiums or discounts associated with the "bulk" sale, and
c. The price allocation of each facility is verified. Details of the aggregate sale, with unit price indicators should also be given.

The larger the portfolio the less the sale can be relied on for comparison to a single project. Reliance on a majority of portfolio comparables will not be acceptable.

If the appraiser wishes to use an NOI adjustment in the sales comparison approach, the guidance in this paragraph is to be followed. Using an NOI adjustment in the Sales Comparison Approach is a way to adjust for all differences between properties with one adjustment. In theory, all differences between two properties will be reflected in the different NOIs the projects can generate. The use of an NOI adjustment exclusively will largely replicate the results of the income approach in the sales comparison approach. The danger is that the sales comparison approach cannot function as a check, as any mistakes in the income approach will be passed through to the sales comparison approach. In order to preserve the independence of the sales comparison approach, an NOI adjustment can be utilized as additional support for the conclusion but not to the exclusion of a fundamental analysis of the unit price.

The price per bed is a common unit of comparison utilized in the sales comparison of skilled nursing facilities. In addition to the price per bed comparison, the appraiser should consider, where appropriate, analyzing the sales on a per room basis. The price per bed can be misleading at times because the rooms can be shared or private, depending on the marketing strategy of the Borrower. This requirement is meant to prevent a bed value derived from private rooms being applied to semi-private or ward beds, resulting in an incorrect valuation.

If there is a recent or pending sale of the subject, the sales price must be analyzed. If the property has sold within 3 years, or within the date range of the comparable sales, the price per unit/bed, capitalization rate, marketing time and market exposure must be provided.

4. **Income Approach to Value.** The income capitalization approach to value is often the most significant indicator of value for properties purchased for their cash flow.

   The scope of the appraisal report should include a complete description of the comparable search and data gathering process. The appraiser is to inspect and provide a photo of all comparables utilized to forecast rents, census mix or occupancy for the subject facility.

   The appraisal report will provide a detailed description of the subject's

reimbursement structure or payment sources. In projecting all sources of income for the subject property, consideration should be given to foreseeable changes in competitive market conditions that will affect current occupancy, payer mix, and rate levels. Examples include changes in: the condition of state finances, state laws offering alternative forms of housing types, reimbursement structures, and competitors in the marketplace.

For existing operations, an analysis of the subject's income, expense, and census mix (by payer source) for the year-to-date and the last three fiscal years should be provided and analyzed.

The analysis should provide a discussion of any foreseeable changes in reimbursement.

Advisory Note: For example, if the capital cost component of a project's Medicaid reimbursement will diminish over a 10-year period as the capital is depreciated, this would need to be considered when setting the reimbursement rate and accounted for in the capitalization processes of that income. This may also lead to the inclusion of a sinking fund. See Production, Chapter 2.5 GG.

Advisory Note: Revenue and expenses should always be estimated based on market expectations as a stand-alone facility of that particular asset type and class. For example, if an operator owns several small facilities in a market sharing an administrator between two or more facilities, this expense should be adjusted to market as a stand-alone facility, which means one administrator to one building. However, this does not mean that if the subject is a regional or national asset class that economies of scale such as purchasing power or marketing cannot be considered.

ORCF does not have a minimum threshold of acceptability for the percentage for occupancy. However, if the property in question has a lower occupancy rate than comparables, it may be that the property is inferior in the marketplace. The lender narrative will need to explain why this is occurring and what steps the Borrower is taking to make the project more competitive. Also, ORCF does not put a limit on the maximum occupancy rate that can be used in the appraisal report. Appraisal reports must be based on market values. Appraisers may use whatever occupancy a typical market participant would use. The appraiser's burden of demonstrating the market's action grows the more they depart from market norms. At the same time, ORCF expects the lender to present a loan sizing that is conservative. In cases where the appraiser has assumed unusually high occupancies, ORCF expects the lender to implement a more conservative assumption. The loan sizing would then be based on the lender's lower value.

a. **Private-Pay Rates.** Facilities with private pay as a payor source need to include an analysis of the current rent roll, and how achieved rents differ from asking rents. This should be taken into consideration in the rate conclusions. For independent living, assisted living and memory care a comparison and adjustment grid should be provided for each private-pay unit type. For skilled

nursing facilities, an adjustment grid is not required but the appraiser/analyst must provide an analysis with a rate comparison chart to determine if the private-pay nursing rates are at market levels. Use of fewer than 3 similar comparables requires an explanation. At a minimum, the rent comparison will discuss building ages, unit types, unit sizes, amenities, services, location, and rental concessions. The narrative should provide the rationale behind the adjustments and offer support in the form of market data and/or pairing analysis, when available.

Advisory Note: Many private-pay patients in nursing homes are patients with short-term assets and often will convert to Medicaid later. The forecasted private-pay rate must also consider the private-pay mix or census at the facility. As the private-pay rate increases, the average length of stay of the private pay patient may decrease due to limitations on their private assets.

b. **Medicaid Reimbursement – 223(f).** For 223(f) refinances, the appraisal report will include an outline of the State's reimbursement system, discussing how reimbursement rates are set, or any local peculiarities. Medicaid reimbursement rates should be based on the project's current rate, with the following exceptions:
   i. If a firm rate change has been published and the change will occur within 6 months of the date of the appraisal report, the new rate can be used. The appraiser should acknowledge any foreseeable drop in rates.
   ii. If the reimbursement rate includes a capital and/or financing component from which a new rate can be calculated based on the proposed/required repairs to be completed as part of this financing, the prospective rate can be calculated and used. A Certified Public Accountant should be used to determine the new reimbursement rates. This would also lead to the inclusion of a sinking fund. See Production, Chapter 2.5 GG.
   iii. Determination of the MVTAB assumes a market sale, and if the state resets rates upon sale, then a new rate must be estimated. The ways these rates are calculated vary from state to state. If the appraiser is not experienced in making these rate determinations, they should work with an accountant experienced with long-term care reimbursements within the state in which the subject is located to determine the new reimbursement rates. The "reset" Medicaid reimbursement rate(s) must tie back to the appraiser's forecasted operating expenses when the reimbursement system is facility-specific and not cost based.

   Advisory Note: The Medicaid rate may not always be the current rate. For example, some states issue quarterly rates and they may change significantly quarter by quarter depending on the case mix index. If the most recent quarter is used and that rate is the highest it has been in the last 4 quarters, the rate may be overestimated.

c. **Medicaid Reimbursement – New Construction, Substantial Rehabilitation and 241(a)**. For New Construction, Substantial Rehabilitation and 241(a) loans, the estimated Medicaid rate must incorporate the rate-setting methodologies used by the respective state. For rates that are developed from cost-based, facility-specific systems, the Medicaid rate must be reconciled to the forecasted "Medicaid-allowable" operating expenses of the subject. It is not permissible to apply an un-reconciled rate to the appraiser's forecasted expenses where cost-based, project specific systems are used. Facility specific, cost-based Medicaid rates developed or provided by third party experts (e.g. developer, operator, or management company) must be reconciled to the appraiser's forecasted "Medicaid-allowable" operating expenses.

d. **Medicare Reimbursement – 223(f)**. For 223(f) refinances the analysis of the Medicare reimbursement rates should be based on the project's weighted average rate based on an analysis of average Resource Utilization Group (RUG) census over the preceding 6 to 12 months of operations. If a firm rate increase has been published and the increase will occur within 6 months of the date of the appraisal report, the published rate can be used when the appraiser feels this outcome is expected and supported.

e. **Medicare Reimbursement – New Construction, Substantial Rehabilitation and 241(a).** For New Construction, Substantial Rehabilitation and 241(a) loans, the analysis of the Medicare reimbursement rates should be based on weighted market reimbursement rates for the proposed care type, and supported by an analysis of average RUG census of comparables offering the same type of care over the preceding 6 to 12 months. The appraiser should make a concerted effort to show that the expenses forecasted for the subject, match the level of care in the reimbursement rate. For projects with preexisting units, the rate should be reconciled with the facility's historical weighted average rate.

   Advisory Note: RUG data is provided in Medicare cost reports. Although local market comparable data needs to be provided, when the subject is new constructed it may be appropriate to use other newly construction facilities in similar markets rather than using older local comparables.

f. **Other Reimbursement (HMO, VA, etc.).** For other forms of reimbursement, the appraisal report will base the rate conclusion on an appropriate analysis of comparable market data, published rates, provider agreements, and/or the subject's historical data, as applicable.

g. **Other Income:** Other income should be estimated based on market data. Significant components, such as personal care/ancillary services, second occupant charges, beauty shop, day care services, and other miscellaneous sources, should be supported by historical or comparable market data and presented individually in the report. Interest income is not to be included as it is not considered to be tied to the real estate.

   Fundraising revenue cannot be included in the NOI. This would not be a

dependable source of income and would not be available to a purchaser in the event of sale of the property.

h. **Commercial Income.** If the subject contains commercial space, the forecasted income from that space is to be estimated based on property history (when existing) and market data. Use of fewer than three comparable commercial leases requires an explanation. Small spaces, such as those leased for beauty/barber shops and therapist's rooms are not considered commercial space.

i. **Vacancy and Collection Loss (Economic Vacancy).** HUD requires that the appraiser forecast a vacancy factor for the subject. Consider both a physical vacancy and a collection loss allowance. These components should be separately identified and supported in the report.

   Advisory Note: Collection loss in healthcare properties is primarily listed as bad debt.

   If the physical vacancy in the market exceeds the factor selected for the subject property, the appraiser must explain why the Property's performance is expected to be stronger than the market. The appraiser should also address the trends that would indicate a change from the current vacancy in the near future. The discussion of trends should generally include:

   i. Recent vacancy patterns, including any seasonal variations at the property and in the market.
   ii. Turnover rates.
   iii. Economic factors (e.g., employment, supply of comparable units) that may have a long-term impact.
   iv. Changes in the supply of competitive facilities and/or units.

j. **Expenses.** The appraiser's expense estimate should conform to the following rules: All projects should stand alone and must not reflect shared expenses from nearby projects under the same management.

   i. Categorize and provide commentary as needed to support each item. A suggested chart of accounts (expense categories) is included in the Lender Narrative Template, but this is not a mandate on how the expenses should be categorized. The goal should be to record the expenses of the subject and the comparables in a way consistent with one another and in a way that requires the least amount of subjective re-categorization from the source reports.
   ii. For existing properties, the appraisal report will analyze the subject's historical operating statements. If any expense estimate used by the appraiser is lower than the historical expense, the appraiser should be particularly diligent in providing information concerning that expense estimate.
   iii. At least three expense comparable properties will be considered. The expense comparables should be included in the report and strive to:
      a. contain approximately the same payer mix (Medicaid, Medicare, Private Pay, etc.),

b. have similar unit/bed capacities,
c. be located in a market similar to the subject,
d. represent the same licensed level of care (skilled nursing, assisted living, memory care, etc.).

In cases where comparables with similar care mixes cannot be found, at least three expense comparables for each care type should be used.

Advisory note: The size as well as the census mix of a senior housing and/or nursing home must be considered in the selection of expense comparables. These two factors have the largest impact on variations in expenses from facility to facility. For example, it is not relevant or appropriate to forecast the expenses for an assisted living facility with an assisted living facility that is 50 percent smaller in size. It is not relevant or appropriate to compare a nursing facility with a substantial Medicare and managed care census mix to a nursing facility with substantially less Medicare and managed care patients.

iv. The appraiser must indicate from which period/fiscal year the expense comparables were taken. The appraiser will adjust or trend the comparables for changes in the market over time to the effective date of the appraisal report. The appraiser will describe how the adjustments were applied.

v. For properties with commercial space, the expenses associated with that space must be discussed and supported at least three additional expense comparables will be analyzed and considered, unless the lease is on an absolute/triple net basis whereby the tenant pays all expenses. Commercial expenses should be reflected separately from the residential expenses. The conclusion should reflect any special conditions indicated in the commercial leases that would reduce the net income of the property.

vi. Regarding confidential expense comparables, the appraiser may only use confidential expense comparables that are supportive and consistent with the fully disclosed comparable(s) used in the analysis. Using only confidential comparables is not allowed.

k. **Reserve for Replacement Reserve.** The appraiser should reflect a reserve for replacement that is supported by the market and/or historical levels. HUD has a programmatic requirement to require a reserve for replacement; however, in order to preserve the integrity of the "Market Value" called for, if the amount required by HUD differs from what the market demands, the appraiser will use the market-based amount and the Lender will revise the amount in their underwriting to meet HUD's requirements. The Lender is not required to recapitalize the value conclusion for this revision of expenses. The Lender will however use their altered net income conclusions in the calculation of the Debt Service Criterion used for loan sizing.

l. **Real Estate Taxes.** The appraiser must consider current assessed value, trends, and levy rates of the local jurisdiction taxing the subject property. In

cases that involve new construction, at least three comparable tax properties should be considered and analyzed. The current taxes (for the immediate tax year) should be clearly stated. The appraiser should discuss how the appraised value compares to the current assessment. If a jurisdiction resets the tax assessment after a sale, the appraiser's expense conclusions should implement the hypothetical reassessment.

For properties subject to tax abatement or tax exemptions, the appraisal report will follow the procedures outlined in 7.5.

m. **Capitalization Rate.** Under the direct capitalization method, the appraiser extracts the over-all capitalization rate from sales comparables. The methodology for estimating the comparable's NOI should match the methodology used in developing the subject's NOI. That is to say, if the subject's income is prospective in nature, so the comparable's should be; if the subject included a management fee, so should the comparable; if the subject's expenses included reserve deposits, so should the comparable's, etc. When extracting market capitalization rates from sale comparables, the appraiser should attempt to interview the buyer, seller, and brokers to learn their expectations of income and expenses. This is to ensure agreement between the subject's projected income/expenses and the sale comparable capitalization rates.

   The appraisal report must explain the adjustments to a comparable's NOI when deriving a capitalization rate. The appraiser should comment on the relative quality, reliability, or appropriateness of comparable's capitalization rate. The narrative is to provide pertinent discussion as to how the subject's final capitalization rate-was determined.

n. **Discounted Cash Flow (DCF).** The appraisal report may use a discounted cash flow analysis or Yield Capitalization as an additional check against the direct capitalization approach above. This method can be a useful and valid analysis in situations where incomes will vary over time in a predictable way. However, due to the subjective nature of the DCF and the potential for misuse of cash flow estimates, discount rates, terminal rates, etc., ORCF will only permit this methodology to be utilized as an indicator of value in addition to other valuation methodologies. With rare exceptions, the Income Approach conclusion should not be weighted to the results of a Discounted Cash Flow Analysis.

o. **Special Appraisal Report Considerations.** The appraiser should be aware of the following program restrictions:

   i. **Continuum of Care Retirement Communities (CCRC's).** HUD does not insure facilities that require upfront fees or substantial down payments for occupancy. For facilities that offer services to more than one type of resident (e.g., assisted living, dementia, skilled nursing) the appraisal report will need to adequately evaluate each group in terms of income, expense, and sales comparable data. If comparable data from projects of a similar resident mix is not available, the

appraisal report will need to include a separate analysis for each resident type. Likewise, for the income and expense comparables.

ii. **Day Care.** An eligible health care facility may provide nonresidential (outpatient) care for elderly individuals and others (e.g., persons with physical or mental disabilities) who require care during the day. To be eligible for the program, non-resident day care space may not exceed 20% of the gross floor area of the facility and non-resident day care income may not exceed 20% of gross income.

iii. **Clinics, Medical Offices, and Similar Related Services.** Clinics, medical offices, and similar related services included in a residential care facility are to be treated as commercial space in accordance with the current ORCF instructions and limitations.

iv. **Rent Restrictions/Rent Subsidies.** In some cases, assisted living facilities may receive subsidies and be tied to restrictions. If the property's rental rates are restricted or subsidized, the appraisal report will discuss the particulars of the restriction/subsidy, including how the rates are determined, the duration of the restriction/subsidy, identify the entity responsible for monitoring the restriction/subsidy, and identify the effect on marketability of the non-restricted/non-subsidized units. For unit- or project-based restrictions/subsidies, the appraisal report should use the lower of the market rent conclusion and the restricted/subsidized rent in determining value, unless otherwise instructed. This may require the appraiser to cite a hypothetical condition.

Payments from Medicare, Medicaid, HMO's and Private Insurance are not considered subsidized rents. Subsidized properties cannot be used as comparables for non-subsidized properties with respect to sales, expense, or rent comparability.

v. **Contradiction.** In the event that this appraisal report guideline contradicts the provisions of the HUD/FHA Regulations or does not comply with USPAP (and a jurisdictional exception cannot be made), the appraiser will immediately bring the issue to the attention of the Lender's underwriter.

5.4 Ground Leases

A. **Lease Duration:** To be eligible, the lease term may be at any stage of a 99-year lease, so long as the lease is renewable, or have at least 10 years remaining after the maturity date of the proposed mortgage.

B. **Mortgage Amount Limitation:** HUD regulations state, "In the event the mortgage is secured by a leasehold estate rather than a fee simple estate, the value of the property described in the mortgage shall be the value of the leasehold estate (as determined by the Commissioner) which shall in all cases be less than the value of the property in fee simple"

(24 CFR 232.903(a)). Compliance with this regulation will be met through the following steps:

1. The appraiser is asked to develop the Hypothetical Fee Simple Value of the Going Concern as if unencumbered by the ground lease. The lender will enter this amount on Form HUD-92264a-ORCF, (Tab MILC Page 1 – Line D.a).

2. Next the lender will enter the option to purchase price from the Lease Addendum (Form HUD-92070-ORCF), on the line that calls for the "Value of the Leased Fee" - Line C.b.(1) and Line D.b). In the rare cases where the Lease Addendum does not specify a purchase price, the hypothetical fee simple value of the land will be entered on line C.b.(1). Cases where there is a single up-front ground lease payment or where the lease payment is a token $1, will be treated more like fee simple land ownership in that $0 will be entered on line C.b.1. Only government entities can request waivers to not name a purchase price.

   The form will automatically deduct the option to purchase price from the fee simple value before applying the prescribed loan to value percentage limitation. This procedure assumes parity between the Leased Fee Value and the option to purchase price. Even when there is not parity, HUD's interest is covered as the loan size decreases based on how costly it will be to purchase the land.

   For the Debt Service criterion on Form HUD-92264a-ORCF, the lender will include the annual ground rent under the "Land Calc" tab on the line item that says "Annual Ground Rent".

   The land value should not be included on Form HUD-92264a-ORCF. Likewise, when leased land contains pre-existing buildings that are to receive substantial rehabilitation, the contributory value of the pre-existing improvements is not to be included. The value of these items is assumed to be paid for annually by the lease payments; therefore, their value should not be included in the overall costs.

   In cases where there is a single up-front ground lease payment that covers the ground rent through loan maturity, the amount of the payment may be entered in the "Land Calc" tab of Form HUD-92264a-ORCF, under additional cost. Include a note explaining what the additional cost is for. Otherwise, the processing is the same as with other ground leases.

C. **ORCF Appraisal Report Review:** The ORCF review appraiser will perform a review of the ground lease that examines the following:

1. The review appraiser will analyze the lease parameters and the ground rent payment amounts. Although certain kinds of annual increases may be allowed, variable lease payments are not acceptable because they raise the risk that future payments may be too burdensome and may cause a potential default in the mortgage payments. Examples of unacceptable methods of determining variable ground rents are:

a. A graduated schedule of future increases on a lump sum year-by-year basis.
b. Cost of Living increases (waivers of this restriction will be considered if there is a cap in place to the amount of increase).
c. Increases based on the results of future appraisal reports.

2. Annual increases are acceptable when computed using any of the following three methods:
   a. A fixed percentage of effective gross income. The percentage must remain the same throughout the term of the lease. Effective gross income shall mean the annual amount collected from all sources, less refunds.
   b. A fixed percentage of net cash flow. The percentage must remain the same throughout the term of the lease. Net cash flow shall be the annual amount remaining after debt service payments are subtracted from net income.
   c. A stated dollar amount per year which must remain fixed for at least 10 years more than the term of the insured mortgage.

D. **Acceptability of Lease Payments:** The lease payments may not exceed market levels. The appraisal report is to determine the amount of the "market" ground rent by first determining the fee simple value of the land, then presenting comparable data on ground lease returns. The market ground rent is then to be compared to the proposed ground rent. When local comparables are not available, data from comparable markets will be acceptable. The review appraiser will ensure that the ground rent amounts do not exceed market levels.

E. **Lease Provisions:** The review appraiser must review other provisions of the lease to determine that they will not restrict the successful operation of the project, keeping in mind that the provisions of the Lease Addendum, must be included in, or legally appended to, the lease. If the above conditions are met and the annual lease payments required under the lease meet the test for acceptability, the appraiser may recommend that the lease be accepted.

F. **Ground Rent during Construction:** For proposed construction under all sections of the Act, normal monthly lease payments during construction may be included in the estimated replacement cost of the project and in the certified cost, subject to the following conditions:

1. The period for which ground rent is estimated must be the same as that for which interest and other related charges are calculated, or, the estimated construction time plus two months.

2. Ground rent during construction may be entered in the replacement cost tab of Form HUD-92264a-ORCF (labeled "Warranted Price of Land"). A remark should be entered indicating that the amount includes ground rent during construction.

3. Ground rent must not be included in the base on which profit (AMPO – allowable for making non-profit projects operational) is calculated.

5.5 Tax Abatement Procedures

Tax abatement/exemption herein shall mean a reduction of property taxes by the taxing authority, whether in the form of forgiveness or refund. The appraiser will investigate how long the abatement will last and whether or not the abatement will be passed on to a new owner when there is a sale. For purposes of Section 232 underwriting abatements will be classified as one of the following three types:

1. **Type A:** Abatements that will not be inherited by a typical buyer, and abatements where there are less than 5 years of abatement remaining.

2. **Type B:** Abatements that would be inherited by a typical buyer, where the abatement amount is level, or the exemption is complete, and lasts the term of the mortgage.

3. **Type C:** Abatements that would be inherited by a typical buyer, but are variable in amount and/or shorter than the term of the mortgage.

A. **Type A Abatements:** Properties that have real estate tax abatements that would not be passed onto a typical buyer or where there are less than 5 years of abatement remaining are to be appraised and underwritten assuming full market-level tax as an expense. It will not be necessary for the appraiser to invoke a hypothetical condition for this assumption, as they will already be assuming a sale. Deciding whether or not abatements can be inherited will require an analysis of the rules that govern the abatement. These rules could show that some buyers, such as non-profit organizations, could inherit the abatement, whereas for-profit organizations could not.

   When determining who a typical buyer of the property would be, it is inappropriate to assume a non-profit organization would be the next buyer simply because the current Borrower is a non-profit. This is not to say that there are not cases where another non-profit would be the most likely buyer.

   While the appraised value will recognize full market taxes, the lender can recognize the tax abatement in sizing the mortgage by debt coverage, so long as the abatement lasts more than 5 years.

B. **Type B Abatements:** For properties that have tax abatements that would be passed onto a typical buyer, AND where the abatement amount is constant or there is forgiveness of the complete amount, AND lasts the term of the mortgage, the appraiser and lender may recognize the savings in their expense conclusions both in market value and in debt coverage calculations.

C. **Type C Abatements:** For properties that have tax abatements that would be passed onto a typical buyer where the tax abatement is variable in amount, and/or shorter than the term of the mortgage (but longer than 5 years), the value of the abatement may be considered as follows: The appraiser will first determine the values produced by all applicable approaches,

assuming full market taxes in their expense calculations. Next, the appraiser will estimate the Net Present Value (NPV) of the tax savings. The discount rate used in this calculation is to be determined by the appraiser. Below is an example of a 6-year variable tax abatement and the concluded NPV. In this example seven years have been shown for illustrative purposes but there is no tax savings in year seven.

Year	2012	2013	2014	2015	2016	2017	2018
Forecasted Market Taxes	$115,387	$117,118	$118,875	$120,658	$122,468	$124,305	$129,983
Actual Taxes with Abatement	$0	$5,856	$11,888	$18,099	$24,494	$31,076	$129,983
Tax Savings	$115,387	$111,262	$106,988	$102,559	$97,974	$93,229	$0
Discount Rate	13.0%						
NPV of Abatement	$424,252						

The NPV can then be added to value conclusions from each approach before concluding a final rounded value.

Type C tax abatements can be recognized in Debt Service criterion on the Form HUD-92264a-ORCF (maximum mortgage amount based on debt service ratio).

5.6 Restricted Rents

For loan applications that involve rent restriction from Low Income Housing Tax Credits (LIHTC) or Tax Exempt Bonds, the income and expenses are to be evaluated under two scenarios, namely with and without the rent restrictions. The two scenarios will be used as follows for loan sizing on the Form HUD-92264a-ORCF:

1. Loan-to-Value Criterion: In Loan-to-Value criterion of the Form HUD-92264a-ORCF, the lender is allowed to use the market value as if unencumbered by the rent restrictions. The appraisal report statement of work (Section 5.3) always calls for a Market Value that incorporates all the applicable rent restrictions, therefore, whenever the Lender wishes to use an unencumbered value, they will need to expand the appraiser's assignment to provide the second value (unencumbered) value. The appraiser will then make a hypothetical assumption that the rent restrictions do not apply. Market rent levels will be established using the normal procedures outlined in the statement of work. Expenses will also need to be reanalyzed based on the hypothetical census shift. The market analysis requirements always call for an analysis that recognizes all rent restrictions that will be in place. In order for the appraiser to produce a hypothetical unencumbered value, they will need to revisit the demand calculations to determine how well the proposed units will be received when not limited to restricted income residents. The comparable selection and the adjustments made in the sales comparison approach will also need to be revisited. If the lender is requesting a loan amount that is less than the Loan-to-Value criterion limit, the lender may simply use the Market Value that recognizes the rent restrictions and not provide the second hypothetical value as if unencumbered. This will make

the appraisal report assignment less complex and generally less costly.

2. Debt Service Criterion – Debt Service Analysis: In calculating the NOI the lender uses for the Debt Service criterion, rent restrictions must be observed.

A. **Expenses/Fees:** Properties with LIHTC restricted units will commonly have a higher operating expense ratio per unit than market rate properties, which may be due to increased administrative costs for tax credit compliance monitoring, and due to performing tenant income certifications and staffing to provide on-site resident services.

C. **Audit Fee No Longer Recognized:** With the elimination of the requirement for an audited cost certification for mortgage insurance transactions with LIHTC, assuming the ratio of loan proceeds to the actual cost of the project is less than 80 percent, the audit fee will no longer be recognized as an allowable cost in the Total Estimated Replacement Cost of Project, replacement cost tab of the Form HUD-92264a-ORCF.

5.7 Non-Profit Operations

ORCF is seeking the as-is market value based on the hypothetical condition that all repairs are complete as of the effective date of value. The as-is market value is what a facility would sell for as of the effective date of the appraisal hypothetical. It is not always the mission of non-profit organizations to maximize cash flows. Potential for-profit buyers would likely modify the operations with the goal of improving cash flows in mind. Potential differences between non-profit and for-profit operators include but are not limited to staffing ratios, employee benefits packages, higher level food service, even potentially higher occupancy rates, reputational differences, etc. It is appropriate for an appraiser to adjust these and other revenues and expenses to reflect a true market operation (both on the revenue and expense side) in determining the value. If the appraiser believes that the operations would materially change with a market sale, the appraiser must factor into their analysis the additional costs and risks associated with converting a facility from the current non-profit operation to a for-profit operation (see Production, Chapter 5.3.G Hypothetical Conditions). The method for factoring in the additional costs and risks is up to the appraiser but could conceivably take the form of an increased cap rate or a reduction to value based on a discounted cash flow analysis to support the value or other methods as the appraiser deems appropriate.

When considering modifications to the current operations, the following additional standards must be met. The appraiser must separately discuss the market income and support any changes from the original operating statements.

- The income capitalization analysis of the appraisal report must first analyze the project's actual non-profit operations, with no market-based adjustments being made. No valuation analysis is considered in regard to this income.
- A market based reconstructed income statement to be used for capitalization purposes will also be required. The market income must separately discuss and support any changes from the original operating statements.

- Many non-profit organizations have established and consistent fundraising income. This may be considered as an underwriting strength however that income is not to be considered for valuation or debt coverage purposes.
- The market's reaction to a hypothetical shift from non-profit to for-profit and the timing of the shift should be analyzed and discussed.
- A hypothetical condition needs to be included if the valuation assumes a transition to for-profit operations.

Lenders need to pay particular attention to the debt coverage limits to loan sizing when working with non-profits. While the net income operating income used in valuation includes market income and expenses, the NOI for the debt cover assumes the performance of the subject's own specific operator. The lender should not introduce adjustments to NOI used in the debt coverage test for any items besides reserves for replacement. The subject's historical NOI, not the appraiser's conclusion, will be relied on by HUD to determine the reasonability of the NOI proposed by the lender in the debt coverage test.

Section II
Production

Chapter 6
Participant Credit and Financial Review

6.1 Determining Acceptability of the Borrower, Operator, Parent of the Operator, and the General Contractor

A. **Overall Requirements**

A key component of the underwriting process is to assess the Borrower and/or Operator's ability to manage the development, construction, completion and successful lease-up of the FHA-insured property. The underwriting of Section 232 projects involves evaluating the experience and financial condition of the Borrower and its principals, the Operator, parent of the Operator and the general contractor. The FHA lender (the "Lender") must:

1. Identify the Borrower, Operator, parent of the Operator, general contractor and each of their respective principals.

2. Analyze the credit worthiness of the borrower entity, and if formed, the principals of the borrower entity, Operator, parent of the Operator and the general contractor.

3. Analyze the experience and qualifications of the Borrower Operator, parent of the Operator and general contractor.

4. Determine the financial capability of the Borrower and the general contractor.

Take a wholistic approach to evaluating credit worthiness and assessing credit risks. ORCF expects the FHA Lender to inquire about and to bring to ORCF's attention any potential credits risks such as, without limitation, governmental investigations, criminal convictions (including convictions resulting from plea agreements) or instability in entity's management structure.

B. **Terrorism Checks and Verifications**

Terrorism checks and verifications on all principals are required by the USA Patriot Act. These checks must be completed and documented prior to Initial Endorsement of the FHA-insured loan, regardless of whether or not the Lender is a regulated financial institution. The

Office of Foreign Assets Control of the United States Department of Treasury administers and enforces economic and trade sanctions based on US foreign policy and national security goals. Information and guidance on the requirements of the Patriot Act can be found on the Department of Treasury's website: http://www.ustreas.gov.

C. **Identifying principal ownership interest.** There are numerous ways for investors to own an interest in real property. Each form of ownership offers different benefits and risks. If the Borrower (and/or the Operator and parent of the Operator) has a complex or layered organizational structure, the Lender must review the structure and identify the individuals or entities that have control under the organizational structure. The Lender must confirm that the Borrower (and/or the Operator and parent of the Operator) is legally organized in a manner that meets U.S. Department of Housing and Urban Development's ("HUD") requirements for owning and operating an FHA-insured facility, and consider any difficulties or increased risk that the organizational structure might pose in the event of default or foreclosure on the FHA-insured mortgage loan. All principals (as defined below in E.1) are subject to the disclosure and certification requirements regarding bankruptcy, judgments, pending litigation and delinquent federal debt. Those principals with decision-making authority, active management roles, or a significant percentage of financial investment in the project are subject to a more complete credit investigation. The Lender is responsible for identifying the principals and the extent of the credit review required and appropriate for each such principal.

Each FHA-insured property must be owned by a single-asset entity unless another form of entity is approved prior to application submission (See Production, Chapter 2). The following types of single asset entities are acceptable:

1. General Partnership (GP);

2. Limited Partnership (LP);

3. Corporation, C corporation, S corporation;

4. Limited Liability Company (LLC);

5. Trust;

6. Non-profit corporation;

7. Any other public or private single-asset borrower entity; however, the FHA-insured property may not be owned by a natural person or as tenants in common;

8. Any combination of ownership forms can be used to establish a joint venture, for the purpose of jointly sharing the risks and the rewards by contributing the appropriate knowledge, skills, or assets that are necessary for a successful development project. However, a single-asset borrower entity is always required.

D. **Foreign national and corporate entity participation.** Generally, foreign nationals and corporate entities may participate as principals. However, the single-asset borrower entity must be registered in the United States in the state where their corporate office is located and at least one principal, with operational decision-making authority, must be a United States citizen.

Where eligible to do so, foreign participants must obtain an international tax identification number ("ITIN") from the Internal Revenue Service. Information on the process to obtain an ITIN is available at: http://www.irs.gov.

E. **Identifying the principals:** A principal is a public or private entity proposing to participate in a project as a Borrower, Operator, parent of the Operator, Management Agent, general contractor or the like. A principal can have an active role in a project and direct the activities and affairs of the borrower entity or be involved in decision-making; or a principal can have a passive role where the principal's participation is limited to an ownership interest in the project. All principals must be identified and analyzed based on their experience, creditworthiness and financial histories.

1. **Principals:** "Principals" are:
    a. The borrower entity, any entities and individuals with a significant ownership interest in the borrower entity (as described below), and any affiliate (whether individual or entity) of the borrower entity or any of the individual or entities with a significant ownership interest. For partnerships, all general partners are principals, and limited partners having a 25% or more interest in the partnership are principals. If the principal is a corporation, all operating officers, all officers of the board of directors, and each stockholder having a 10% or more interest in the corporation are principals, and all limited partners having a 25% or more interest in the corporation are principals. For non-profit corporations, principals include officers of the board of directors and any staff members who are designated by the corporation as corporate officers.
    b. All managers and managing members of LLCs are principals and all members that have a 25% or more interest in the LLC are principals. A member is an owner of the LLC and is similar to a stockholder in a corporation. A manager is a person chosen by the members to manage the LLC and is similar to a director of a corporation. A manager can also be a member.
    c. General contractors.
    d. Management agents (*Note: the Lender does not have to conduct a financial and credit analysis of a management agent.)*
    e. Packagers, and other persons or organizations hired to furnish advisory services in connection with project financing, construction or operation are principals even if the services provided are limited to selecting and negotiating contracts with contractors, architects, attorneys or managing agents; or to negotiating contracts to secure financing for the project; and
    f. Consultants (except for architects and attorneys that are engaged in an arm's length cash fee arrangement to provide professional services for a project and

who do not have an ownership interest or a management role, or who do not participate in other ways as a principal in the project).

2. **Non-principals:** Those who are not considered "principals" for purposes of credit and financial investigations are:
    a. Stockholders with less than 10% interest in a corporation;
    b. Limited partners with less than 25% interest in the partnership;
    c. Attorneys and architects with only an arms-length fee arrangement to provide services for a project;
    d. Minor corporate officers;
    e. Subcontractors;
    f. Brokers whose services are limited to referring the loan to a Lender and presenting information on behalf of the Borrower (provided that the services provided fall short of consultant or packaging services);
    g. Public housing authorities;
    h. Members of a non-profit's board of directors who are not board officers and do not have a decision-making role over the property;
    i. Officers of passive investors (e.g., pass-through/shell companies, tax credit investors, or syndicators);
    j. Management agents.

Note: A determination of the principals of a trust requires an analysis of which individuals control the assets of the trust and what restrictions are placed upon them. Individuals who have effective control of trust assets should be treated as principals. The Lender Narrative should explain the Lender's identification of trust principals.

3. **Liability:** Section 38 of the Healthcare Regulatory Agreement – Borrower (HUD-92466-ORCF), requires that individuals or entities who will be personally liable for certain enumerated matters be identified within the document.
    a. For privately held entities: Section 38 generally requires two signatures for project sponsors. In most cases, HUD, upon the Lender's recommendation, shall select one individual signatory to sign in his or her individual capacity and the project parent/sponsor entity to sign in a corporate capacity. In any specific deal, underwriting may point to a different entity with the requisite control and involvement or interest in the Project, positive credit history, and adequate financial strength relative to the size of the loan to serve in the capacity required by Section 38.
    b. For publicly traded corporations or REITS, or Non-profit organizations: The parent/sponsor entity itself is acceptable as the sole signatory. For such entities, any individual signing on behalf of the corporate entity does not sign in an individual capacity, but to bind the parent/sponsor, and no personal liability will be claimed against the individuals signing in such a capacity.
    c. For any corporate entities required to execute Section 38: Every corporate officer is not required to sign. Whomever the corporation entity has authorized to bind the company in connection with the proposed transaction

may sign, provided that ORCF, upon considering the Participant Credit and Financial Review, has discretion to require additional signatories if warranted in a specific (exception) situation.

d. If state or local law requires these signatures to be notarized in order for Section 38 to be enforceable or for recordation purposes, then the signatures are to be notarized.

e. Please note the following prohibitions related to Section 38:
    i. Insertions of "or successors" language to the identification of signatories is NOT allowed. The Regulatory Agreement can and should be amended when there is a new individual who is responsible for the provisions of Section 38.
    ii. Riders to the Regulatory Agreement that attempt to limit a signatory's liability are NOT allowed.
    iii. Section 38 may not be omitted because a project has been processed as an (a)7 versus another section of the Act.

f. It is the Lender's responsibility to perform the Participant Credit and Financial Review of the parent/sponsor entity and to identify and justify who has been proposed to sign Section 38 of the Regulatory Agreement.

F. **Controlling Participants for Previous Participation Review Purposes.** Controlling Participants for Previous Participation review purposes may or may not be the same as the principals for credit review purposes. See Housing Notice H 2016-15 (or successors thereto) for additional details on who must file a previous participation certification.

G. **The credit investigation.** Lenders are required to obtain credit reports or credit histories in order to validate and check the information contained in the financial statements and application forms that are submitted by the Borrower. Credit reports give a picture of the Borrower's payment history and financial interactions with its creditors, and allow the underwriter to make sound conclusions about the Borrower's credit-worthiness. Credit reports also assist the Lender in reconciling any significant contradictions between the financial statements and the credit report.

A commercial credit report for a business or a residential mortgage credit report for individuals must be current within 60 days of the application acceptance date and the Office of Residential Healthcare Facilities ("ORCF") may require updated reports during processing. Credit reports are required on:

1. The borrower entity, if formed, before submission of an application.

2. Principals of the Borrower as defined in Section 6.1H above. (*Note: If a principal is a business entity, i.e., corporation, partnership, limited partnership, with an operating history, a credit report is required only on the business firm, not the owners or partners of the firm.*)

3. All businesses with pending judgment(s), legal action(s), lawsuits, or bankruptcy claims.

4. 10%, up to a maximum of 10, of the sponsor's other business ventures as selected by the Mortgagee.

5. The facility operator.

6. The parent of the operator.

7. The general contractor.

8. The housing consultant, as applicable, for non-profit transactions.

9. A credit review of members of public and non-profit boards of directors is not required unless the board member is also a board officer with an operational decision-making role over the property.

Lender's review of the credit report.

1. The Lender may obtain a Dun & Bradstreet or similar commercial credit report for business entities and a residential credit report for individuals. An acceptable commercial credit report should include public filings (lawsuits, liens, judgments, bankruptcies and federal debt; Uniform Commercial Code (UCC) filings; credit payment history; financial stress/payment trends compared to industry standards; and a credit payment delinquency risk score over a twelve month period.

2. The Lender should compare all information obtained from credit reports and credit histories to the financial statements provided by the relevant Borrower or principal(s). Any contradictory information should lead to further inquiry until the evidence shows a consistent and complete picture.

3. The Lender should make reasonable inquiries to determine if the applicant or any principal is in default on any federal debt (i.e., direct loans, FHA-insured loans, student loans, and Small Business Administration loans) or any judgment liens against the property for a debt owed to the federal government.

4. The Lender should determine if the information is incomplete, or if there are inconsistencies or discrepancies between the information included in the financial statements and the information in the credit reports and resolve those inconsistencies or discrepancies.

5. The Lender should investigate any adverse credit information that appears on the credit report or information that becomes known from making inquiries of bank and trade references and of other HUD offices. The Lender must require a written explanation of any late payments, adverse actions, judgments or other derogatory information.

H. **Delinquent federal debt:** When a delinquent federal debt exists, the Lender shall include as part of the required application exhibits:

1. a detailed written explanation from any applicant or principal with a prior federal default or claim or whose credit report and financial statements contain conflicting or adverse information.

2. a letter from the affected agency, on agency letterhead, signed by the appropriate agency officer, stating that the delinquent federal debt is current or that satisfactory arrangements for repayment have been made.

3. the Lender's reason(s) for recommending the applicant, which may be included in the Lender Narrative.

I. **Additional review:** In addition to the formal documents and credit investigation described above, the Lender's underwriter must conduct and describe the results of a thorough internet search of each principal and determine if there are any citations which raise concerns about creditworthiness of any principal.

J. **Rejection because of unacceptable credit.** The Lenders should use its professional judgment when approving or rejecting a principal based on the applicable principal's creditworthiness. The individual may be rejected if:

1. the credit investigation evidences that the principal has a history of not paying creditors in a timely manner or lacks liquidity.

2. any delinquent federal debt has not been resolved or satisfactory arrangements for repayment have not been made.

3. There are judgments or actions against the principal that:
    a. could significantly impact upon the financial position of the individual/ firm or corporation.
    b. result in a determination that the individual, firm or corporation is an unacceptable credit risk.
    c. the principal is insolvent or is the subject of a pending bankruptcy or insolvency proceeding at the time of application, firm commitment, or at the time of loan closing. [*Note: The Lender should update credit reports or investigations at firm commitment and prior to closing]*

K. **Analyzing the Borrower, Operator, parent of the Operator and general contractor's previous experience:** The Lender's underwriter must evaluate the resume of each principal. Each principal must have proven experience and qualifications in developing, owning, or building health care facilities similar to the proposed project. The Lender should pay particular attention to:

1. the type and size of previous residential healthcare facilities in which the applicable principal has been involved and assess whether the principal's requisite business experience shows that the principal is able to operate and manage a residential healthcare facility of the size and complexity of the subject property throughout the term of the mortgage. For Borrowers on a property receiving LIHTC or other forms of public subsidy, the Lender must ensure that the Borrower has demonstrated experience in owning comparable regulated and subsidized properties and assess the Borrower's handling of any adverse circumstances.

2. the geographic area of business involvement.

3. the length of time of the principal's involvement with development, ownership and operation of residential healthcare facilities.

4. past roles performed by each principal in the residential healthcare business.

Each resume should demonstrate the level of experience needed to successfully complete the development of the proposed project. The Lender should identify new Borrowers whose primary business is not healthcare facility development or operations, that have little residential healthcare experience, or that are new to a particular market or state regulatory environment. It may be necessary to inspect a sample of the new Borrower's real estate holdings to determine the quality of the assets and management of the Borrower's existing portfolio. The Lender should explain any identified risks in the Borrower's existing portfolios. The Lender may require that the Borrower bring in additional members to the development team to satisfy the experience requirements.

L. Any principal found to have an outstanding violation of the Fair Housing Act by the final determination of an administrative agency or court is ineligible under this section, unless the principal is operating under a remedial order or agreement.

6.2 Participant Financial Review

A. Financial statements give a picture of the financial position of an individual or a /company at a certain point in time and provide: historical information for measuring and evaluating the financial performance of a principal or a firm, and advance warning of financial problems. Lenders should use the information in financial statements to determine if the Borrower, Operator, parent of the Operator and/or their principals have the financial capacity to develop, build and complete and operate the project, and whether the general contractor has the ability to deliver the project based on their respective:

1. past financial condition;

2. present liquidity;

3. projected future financial capacity.

The Lender must complete a financial review to determine the amount of funds available for investment in the project by performing an analysis of the working capital for a proposed project. Working capital is the difference between current assets and current liabilities and may be used to purchase assets, pay off debt and make up deficits from operations. The financial analysis also determines which non-pledged, unsecured assets can be readily hypothecated to secure the proposed FHA-insured loan.

B. **Exhibits:** The Borrower, Operator, parent of the Operator, and general contractor must furnish current financial statements with supporting schedules as part of the application for commitment processing.

> *Note: For new construction and substantial rehabilitation projects the firm commitment application must include the last* three (3) *full years and year-to-date financial statements for the party who will be responsible for providing the financial requirements for closing and beyond. The Lender Narrative must also include a discussion on the available working capital of this party and the party's ability to support the project over the long term. In cases where a group of individuals come together on one project to meet the cash requirement, a HUD-92417, Personal Financial and Credit Statement, covering one full year for each member of the group will be satisfactory.*

1. Individuals must submit either:
    a. a complete Personal Financial and Credit Statement (Form HUD-92417):
        i. the spouse of married sponsors or principals must also sign the form.
        ii. if a spouse's signature cannot be obtained, the principal must prepare the form reflecting only those assets that are solely in the principal's name and any liability, including those joint liabilities, for which the principal is responsible; or
    b. a substitute statement that contains, at a minimum, the information contained on the Personal Financial and Credit Statement. The statement must contain the following certifications and criminal warning:

    I HEREBY CERTIFY that the foregoing figures and statements contained herein submitted by me as agent of the Borrower [owner] for the purpose of obtaining mortgage insurance under the National Housing Act are true and give a correct showing of _____'s (Name of Borrower or owner) financial position as of _____ (date of financial statement). Signed this ____ day of _____, 20___. Signature of authorized agent with name printed or typed under signature _____. Warning – HUD will prosecute false claims and statements. Conviction may result in criminal and/or civil penalties. (18 U.S.C. 1001, 1010, 1012; 31 U.S.C. 3729, 3802)

    For married individuals, the spouse also must sign the certification.

2. Business entities must submit separate statements and supporting documents, set forth below, for the last three (3) years or the length of their existence. If the entity has been in existence less than three (3) 3 years, an authorized officer of the organization must provide the statements and supporting documents with a signed statement that there has been no material adverse change since the date of the statements.
    a. Balance Sheet that:
        i. provides a breakdown of current and non-current assets;
        ii. identifies restricted and non-restricted funds;
        iii. provides a breakdown of current and non-current liabilities;
        iv. identifies the current portion of long-term debt; contingent liabilities, including debts under secured or unsecured lines of credit or letters of credit, personal guaranties, obligations to limited partnerships and other obligations payable in the future, including the amount and duration of the obligation; and
        v. lists details of any factors that may materially affect the Borrower's or sponsor's financial position now or during the term of the proposed FHA-insured mortgage.
    b. Income and expense statement that reflects:
        i. income from normal operations;
        ii. investment income;
        iii. other income; and
        iv. total expenses.
    c. If the financial statements are audited, a statement of changes in financial position; or if a fund accounting system is used, a statement of changes in fund balances, and all notes.
    d. Supporting Schedules:
        i. an aging schedule of accounts receivable that provides the name, type of account (trade, affiliate, employee, relative or other), payment terms, amount and aging information.
        ii. an aging schedule of notes receivable that provides the name, type of account, payment terms, maturity date, current portion (due within one (1) year or one operating cycle of the business, whichever is less), past due amounts and non-current amounts.
        iii. schedule of pledged assets, if applicable, identifying each pledged asset, the amount pledged and the offsetting liability.
        iv. schedule of marketable securities that provides: name, number of shares, current market values as of the date of the statement, and the exchange where the shares are listed.
        v. schedule of accounts payable that provides: name, type of account (trade, affiliate, employee, relative or other), payment terms, amount and aging information.
        vi. schedule of notes and mortgages payable that provides: name, type of account, payment terms, maturity date, current portion (due within one (1) year or one operating cycle of the business, whichever is less), past due amounts and non-current amount.
        vii. schedule of legal proceedings, if applicable.

viii. in addition to the applicable schedules set forth in subparagraphs 1-7 above, general contractors must submit a schedule of jobs (work) in progress that identifies, for each job, the:

a. original contract price;
b. construction start date;
c. construction completion date; and
d. percentage of completion.
e. combined or consolidated financial statement(s), if applicable.

e. Other financial data necessary to determine the financial responsibility and capacity of the Borrower, Operator, parent of the Operator and their respective principals, and the general contractor,
f. The certification must be signed and dated by an authorized official of the company. The certifications must reference the name of the business and the date of the financial statement(s).

3. **Section 223(f) project financial statements:** The proposed Borrower must submit financial statements for the last three (3) fiscal year of the project and if more than three (3) months have expired since the closing date of the financial statements, a year-to-date balance sheet and operating statement. If financial statements are not available due to circumstances beyond the Borrower's control, the Borrower must submit:
   a. evidence satisfactory to the Lender that the financial statements are not obtainable;
   b. project financial statements that are available including an owner-certified balance sheet and operating statement and
   c. in all cases, the past three (3) years of tax returns for the property and the borrower entity.

4. The Borrower must certify any financial statement or balance sheet and operating statement, each of which must include the criminal warning set forth in Section 6.2.B.1.b(3) above.

C. If the financial statements are not available, the Lender's case file must contain a statement from the Borrower that explains why all the required records are not obtainable and a memorandum from the Lender to the ORCF stating that the Lender has evaluated the Borrower's statement and agrees that the information is not available. **Processing financial statements and other documents:** A financial statement is considered current if it is no more than three (3) months old when the application is submitted by the Lender for firm commitment review. The Lender must determine financial stability and financial strength, unless the Borrower and sponsor is a public company with an investment-grade credit rating. The Lender's review should take the following factors into account:

1. The credit investigation or other circumstances may warrant more current financial statements; therefore, the Lender should:

a. assess the adequacy of each participant's liquidity and ability to provide immediate and ongoing support to the project, as well as to any asset that is in financial difficulty.
b. review other sources of sponsor cash flow in the analysis, if the source and stability of the cash flow has been verified by reviewing historical tax returns. Interest income from notes receivable, real estate investment income, dividend income, and sponsor salaries should not be included.
c. review audited or reviewed financial statements prepared by a CPA or IPA that are up to one (1) year old. Audited or reviewed statements must be supplemented with updated interim financial statements and supporting documentation, which may be management-prepared, if more than six (6) months have lapsed since the closing date of the audited statement.

2. The Lender should review the financial statements of the participants and the general contractor to determine the amount of working capital available for the project. The net working capital should be adjusted to reflect contingent liabilities and the financial needs of other projects undertaken by the participants and the general contractor that are in the planning stage or under construction, as applicable.

3. The Lender should recommend that a loan be approved based on the "true net worth" of a participant rather than on working capital. Existing assets not working capital should be used to secure the FHA-insured mortgage loan. The Lender should review existing assets, loans and lines of credit. The Lender should require the participant to provide a commitment letter from a lending institution that states:
   a. the rate, amount, term and conditions, if any, of the loan that the lending institution is willing to provide.
   b. the date by which the commitment letter must be exercised; the date must extend at least to the anticipated date for initial endorsement.
   c. the party that will be responsible for repayment of the loan or line of credit, if the commitment is exercised. Note that: repayment may not be an obligation of the borrower entity.

   The letter must include a certification indicating that the lending institution will not make any claim against the mortgaged property, mortgage proceeds, any reserve or deposit required by ORCF, or against the rents or other income from the mortgaged property for payment of the loan or line of credit. This certification must contain the criminal certification set forth in Section 6.2.B.1.b (3) above.

4. Funds provided by a parent company or affiliate of the participant require a certification from the board of directors or an authorized agent that specifies the amount of funds that the parent company or affiliate will commit to the project. The Lender should determine the availability of funds from the parent company or affiliate and consider whether:
   a. individual corporations have any excess operating capital.
   b. the laws under which the entity is incorporated or its exiting lenders permit:
      i. withdrawals, loans or advances to owners or sponsors;
      ii. stock investment in affiliated corporations; and

iii. guarantee of debts of associated corporations.

5. Letters of intent and letters of credit cannot be used to establish financial capability. At initial endorsement, however, letters of credit may be substituted for cash to set up many of the escrows required at initial and final endorsement, or during construction. If a participant draws down cash at initial closing to satisfy escrow requirements, a letter of credit cannot be substituted to establish the same escrow requirements.

6. Individuals are prohibited from submitting financial statements as a participant and then abandoning the project and the Borrower after the firm commitment is issued. The Lender should require a certified statement from the participant stating the participant's commitment to the project and specifying the amount of funds that will be reserved for contingent needs through final closing and sustaining occupancy.

7. The submission of a financial statement that is used to influence Federal Officials concerning a mortgage insurance risk determination when the participant does not plan a continuing relationship with the Borrower could result in appropriate sanctions being taken against the sponsor including suspension or debarment.

8. General Contractor with adequate capital: The general contractor's adjusted working capital position should equal five percent (5%) or more of the estimated construction contract for the project.

   If the general contractor does not have an acceptable working capital position, the general contractor's fixed assets may be hypothecated. The general contractor's ability to obtain a performance and payment bond does not negate or lessen this requirement.
   a. The Lender should review the working capital that the general contractor has available for other projects in construction.
   b. If the general contractor does not have an acceptable working capital position or sufficient fixed assets that can be hypothecated, a joint venture may be established with a general contracting firm that is financially stronger, provided that, the combined working capital of the firms equals at least 5% of all construction contracts that the firms have in construction and development.

6.3 Evaluating Non-profit Borrowers and Participants

A. **General:** Non-profit Borrowers (whether national, regional, or local) must have the experience and financial strength appropriate for the development and ownership of the proposed property. This section of the Handbook sets forth the criteria for making an evaluation of the experience and strength of non-profit Borrowers. The non-profit Borrower being evaluated may not have equal strength in all categories. In transactions where the ownership structure involves multiple entities performing different functions, the Lender

should evaluate the non-profit Borrower and each of the other entities and their capacity to perform a particular function (e.g., ownership, property management, acquisition, development, resident services or asset management). Entity participants should have a prior acceptable history of successful development, ownership and management of assets that are similar in size, and complexity as the proposed project. Therefore, only the criteria for the areas for which the non-profit entity has direct responsibility or authority should be reviewed during the evaluation process. The Lender must include in the application:

1. the Developer's Agreement or any other document which shows the relationship and responsibilities of all parties associated with the transaction.

2. the housing consultant's contract, if applicable.

3. a memorandum of findings and recommendations which includes:
    a. a description of the relationship between the non-profit and any profit-motivated entities involved in the transaction;
    b. the determination of eligibility or ineligibility of the non-profit Borrower/sponsor must be approved by the ORCF Underwriter.
4. Lender's determination of experience and financial capacity of the non-profit Borrower and/or participants should include, but is not limited to, the following documentation:
    a. a detailed explanation of the motivation for sponsoring the project including a history of the organization's involvement in multifamily housing;
    b. a copy of the Borrower's charter and bylaws and all amendments;
    c. a copy of any ruling denying tax exemption;
    d. a verification from the Internal Revenue Service of the Borrower's tax-exempt status as a 501(c)(3) organization. If a ruling is pending, an explanation of the application's legal status;
    e. a list of corporate officers or officers of the board of directors of the sponsoring non-profit with decision-making authority over the subject property, including their titles or positions, addresses, and individual social security numbers;
        i. resumes for all principals and staff who will actively take part in the development of the proposed project
        ii. current financial statement (balance sheet, profit and loss statement, and supporting schedules) as well as financial statements for the past three (3) years. If available, audited statements should be submitted. Financial statements should conform with the following:
        iii. if the Borrower has existed less than three (3) years, the financial statements must be submitted from the date the group was formed.
        iv. Statements must identify restricted and unrestricted assets (liquidity) along with the related liabilities and must show no material, unmitigated contingent liabilities.
        v. an officer of the sponsoring non-profit must sign the financial statements.

vi. all statements must contain the certification of truth and accuracy and criminal certification identified in Section 6.2.B.1.b above. This certification must reference the name of the sponsor and the date of the financial statements.

vii. a signed written resolution of the non-profit's directors or trustees, acknowledging the responsibilities and obligations of sponsorship and continuing ownership, and that the subject proposal reflects the will of the membership.

viii. information contained in Section 6.1.K if the participant or any officer has a prior federal default or claim.

f. a detailed statement of the arrangements made or proposed for the following (listing principals involved, their relationship to the non-profit Borrower or other participant, the terms of the arrangements and the circumstances surrounding each):

i. land on which the project will be built

ii. project construction, including selection of general contractor, subcontractors, and architect

iii. legal and consulting services.

iv. project financing, including any discounts.

5. The non-profit sponsor must have diverse and stable funding sources with recurring revenue and, if required, a proven record of raising sufficient funds to meet its operating needs. The Lender must identify whether the non-profit sponsor 's primary funding sources are from fees on development projects or from sources such as public funding, public contracts, grants or donations that may be subject to budget or funding constraints.

a. ORCF underwriter review stage: ORCF will review whether the non-profit Borrower is qualified to start, complete and operate a project under the insured loan programs and determine that all of the following criteria are satisfied:

i. the non-profit Borrower is acting on its own behalf and is not, either knowingly or unwittingly, under the influence, control, or direction of any outside party seeking to derive a profit or gain from the proposed project (such as a landowner, real estate broker, contractor, architect, attorney, or consultant);

ii. the non-profit Borrower has continuity and a serious long-term commitment to supply housing for the intended resident population;

iii. the non-profit Borrower has continuity;

iv. the non-profit Borrower has strong roots in the neighborhood and local community and a good reputation for reliability, service, and commitment to the people for whom the housing is to be built;

v. the board of directors demonstrates ties to the local community served by the non-profit and includes representatives on the board from the local business community; and

a. the non-profit Borrower must fully understand the responsibilities and obligations of

b. developing a housing project and continuing its successful operation. This should be evidenced by:
    i. general knowledge of the factors that contribute to a project's success or failure;
    ii. familiarity with applicable healthcare facilities; and
    iii. prior successful experience developing, owning, and operating a healthcare facility similar to the subject.

b. The Borrower must acknowledge, by a resolution passed by the majority of its directors or trustees, the responsibilities and obligations of sponsorship to develop and manage the project. The non-profit Borrower must not have any unresolved or recent internal control or compliance findings; unresolved issues of integrity; or conflict of interest.

c. The Borrower and its principals must be reliable based on:
    i. reputation and past performance; and
    ii. success and the extent of previous experience, including the type of services furnished (financial, management, etc.), in providing senior housing or related social services.
    iii. The Borrower is providing or has arranged for the professional and management skills essential to the successful start, development, completion, and operation of the proposed project.

B. **Credit investigation:** The Lender must determine what individuals and entities have decision-making and operational authority over the project and provide an in-depth written analysis on the aspects of the mortgage credit review in the Lender Narrative. To conduct this credit investigation, the Lender must:

1. order data and/or commercial credit reports on the sponsor and Borrower, if formed, and residential credit reports for the officers of the borrower entity to determine basic acceptability of credit reputation and previous experience. A credit review of individual members of non-profit board of directors is not required unless a member is also a board officer;

2. check for the existence of any delinquent federal debt;

3. check that the Borrower and other participants have no unresolved issues related to payment history and credit references;

4. analyze financial data to determine:
    a. the amount of cash and liquid assets available for investment in the project
    b. whether the non-profit entity has used prudent judgment in its past and present business affairs;
    c. overall financial condition of the non-profit entity, particularly whether the financial statements indicate that income will be sufficient to meet the expenses incurred by the group and
    d. check for the presence of multiple fund accounts, such as general funds and building funds that are commonly maintained by many large non-profit

organizations. The Lender should be aware of interfund receivables and payables that cancel each other and must not consider restricted-use funds in the analysis. The Lender should review the public records section of the credit report to eliminate assets that were used as collateral for secured borrowings.

5. Carefully review the ability of the sponsoring organization to undertake a project of the size and complexity of the proposed project.

6. Review the developer's fee. Non-profits may earn a developer's fee on a new construction or substantial rehabilitation proposal.

   Note: The HUD Underwriter may check with applicable ORCF Account Executives or Multifamily Asset Management offices in the jurisdiction that the non-profit has done or now does business in order to ascertain the past experience and performance of the non-profit.

C. **Non-profit sponsor and a profit-motivated borrower entity:** A non-profit sponsor may establish a profit-motivated borrower entity for the purpose of owning a tax credit project or obtaining distributions from surplus cash. The formation of the profit-motivated entity may be approved provided that:

1. the HUD closing attorney determines that there is no legal impediment that would prohibit approval of the request;

2. the non-profit agrees to comply with the terms and conditions of the non-profit regulatory agreement applicable to a profit-motivated entity;

3. the non-profit is subject to the mortgage limitations applicable to a profit-motivated entity;

4. a working capital deposit is required (not applicable to Section 232 refinance projects);

5. a non-profit developer's fee is not paid with the proceeds of the FHA-insured mortgage loan;

6. if the non-profit provides evidence that it has obtained exemption from real estate taxes, the tax exemption must run with the real estate and not with the type of sponsorship;

7. the potential tax consequences, as well as the possible effect on the non-profit's Section 501(c)(3) status with the IRS is determined to be acceptable;

8. the entity may not make distributions to any individual member or shareholder except as may be authorized by HUD in its sole discretion for purposes related to the mission of the sponsoring organization.

Section II
Production

Appendix 6.1
Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care

Form Number	Form Name
HUD-92417	Personal Financial and Credit Statement
Notice H 2016-15	Processing Guide for Previous Participation Reviews of Prospective Multifamily Housing and Healthcare Programs' Participants (or successors thereto)

Section II
Production

Chapter 7
Environmental Review

7.1 Introduction

This chapter outlines the policies and procedures that must be followed to meet HUD's environmental responsibilities.

A. **Legal Authorities, Handbooks, and Forms**

1. All Federal agencies are required to comply with the National Environmental Policy Act of 1969 (42 U.S.C. 4321 et seq.) (NEPA), and the implementing procedures issued by the Council on Environmental Quality at 40 CFR Parts 1500-1508. U.S. Department of Housing and Urban Development (HUD) regulations implementing NEPA are contained in 24 CFR Part 50, "Protection and Enhancement of Environmental Quality". Related Federal laws and authorities are listed in 24 CFR 50.4 and 50.3(i). HUD may not delegate its environmental responsibilities to others; it is required to prepare the environmental assessment and make the appropriate environmental finding. (See 24 CFR 50.11.)

2. HUD has issued two handbooks covering environmental issues: Handbook 1390.2, "Environmental Assessment Guide for Housing Projects", and Handbook 1390.4, "A Guide to HUD Environmental Criteria and Standards Contained in 24 CFR 51". Guidebooks issued by HUD on environmental issues are cited in this chapter.

3. HUD has also established the HUD Environmental Review Online System (HEROS) – Form HUD 4128 to replace the paper HUD-4128 as the prescribed format for all HUD environmental reviews. HUD staff are required to use HEROS to document all Part 50 environmental reviews under 24 CFR 50.31. Further, as HEROS becomes accessible to the Section 232 lenders, those lenders are expected to use HEROS for inputting relevant environmental data for 232 transactions.

4. Existing projects to be refinanced or purchased under Section 232/223(f) and many rehabilitation projects are categorically excluded (CE) from NEPA compliance (see exclusions in 24 CFR 50.20(a)). Such projects do not require an environmental assessment under NEPA except in extraordinary circumstances (see 24 CFR 50.20(a) and (b)), but they must comply with the laws and authorities at 24 CFR 50.4. In addition, CE projects must document compliance with parameters related to

Nuisances and Hazards such as pipelines, fall hazards, and oil and gas wells, as described below.

5. Pursuant to 24 CFR 50.19(b)(21), "refinancing of FHA-insured mortgages that will not allow new construction or rehabilitation, nor result in any physical impacts or changes except for routine maintenance" are categorically excluded from the environmental assessment (EA) requirements of the National Environmental Policy Act (NEPA), except in extraordinary circumstances, and do not require compliance with the Federal laws and authorities specified at 24 CFR Part 50.4, other than for the flood insurance requirements specified at 24 CFR 50.4(b)(1). Thus, currently FHA-insured Section 223(f) and 223(a)(7) refinancing transactions that meet these criteria do not require an environmental review. However, the flood insurance requirements specified at 24 CFR 50.4(b)(1) are still applicable (Please refer to HUD Notice CPD-16-02 "Guidance for Categorizing an Activity as Maintenance for Compliance with HUD Environmental Regulations, 24 CFR Parts 50 and 58 or succeeding guidance. Note that this definition of maintenance is specifically for environmental review purposes and applies to all HUD programs.).

6. Refinances of currently FHA-insured mortgages under Sections 223(a)(7) and 223(f) require an environmental review utilizing HEROS-Form HUD 4128) when any of the conditions listed at 7.1.A.6.a., b., or c. below apply to the project. The review process and requirements include submission of a current Phase I Environmental Site Assessment and Vapor Encroachment Screen, HUD's consultation with the State Historic Preservation Officer (SHPO), compliance with floodplain management and wetlands regulations and all other applicable environmental requirements when:
    a. The facility has completed a building addition without having obtained HUD's approval;
    b. The project will acquire or has acquired land that was not insured under the original mortgage loan and the facility has yet to receive HUD's approval of the additional land; or
    c. The project will involve changes, improvements or repairs that do not qualify as routine maintenance (Please see HUD Notice CPD-16-02 "Guidance for Categorizing an Activity as Maintenance for Compliance with HUD Environmental Regulations, 24 CFR Parts 50 and 58" or succeeding guidance. Note that this definition of maintenance is specifically for environmental review purposes and applies to all HUD programs.).

7. HUD has determined that 223(f) refinance transactions of non-HUD insured mortgages that will not allow new construction or rehabilitation, nor result in any physical impacts or changes except for routine maintenance, have "no potential to cause effects" to historic properties, as described in 36 CFR 800.3(a)(1), and therefore have no further obligations under Section 106 of the Historic Preservation Act or 36 CFR Part 800. For such transactions, contact with the State Historic Preservation Officer (SHPO) or Tribal Historic Preservation Officer (THPO) is not required, and HUD staff responsibilities are limited to documenting this determination in HEROS-Form HUD 4128.

8. Requirements in this chapter may exceed those of many state agencies. One reason for this is if a Borrower defaults on an FHA-insured project, HUD may become the project owner. Under Section 120(h) of the Comprehensive Environmental Response and Liability Act (CERCLA), Federal agencies that own properties are required to take "all remedial action necessary to protect human health and the environment" with respect to known hazardous substances upon disposition of the property. This requirement is beyond any liability releases under State or Federal law and any due diligence requirements under CERCLA.

B. **Local, State, Tribal or Federal Laws (LSTF)**

1. The acronym LSTF as used in this chapter refers to "local, state, tribal or Federal".

2. In cases where state or local laws, tribal laws, ordinances, codes or regulations are more restrictive than Federal requirements, the applicant must comply with the stricter standard unless Federal law states otherwise. An application for Firm Commitment does not relieve an owner of responsibility for compliance with state or local requirements.

3. HUD will not assume any responsibility with respect to inspection, enforcement, interpretation or determination of compliance with such state or local requirements.

4. Where the project is located on a Native American reservation, the tribal authority may need to assume the responsibilities of the state or local environmental protection agencies.

5. This chapter is not a substitute for requirements in the laws, regulations, and Executive Orders regarding environmental analysis and mitigation.

7.2 Procedures

A. **Lender's Responsibilities:**

1. All projects (new construction, substantial rehabilitation, refinancing or purchase) submitted under Section 232, Section 232/223(f), Section 241(a), and Section 232/223(a)(7) require various submissions related to contamination as detailed in Section 7.3, unless the exemption for FHA-insured projects described at Section 7.1.A.5 applies.

2. The Lender will address NEPA environmental factors and the environmental laws and authorities at 24 CFR 50.4 within the Lender Narrative, and will provide supporting documentation as applicable.

3. HUD environmental policy requires that there be a limitation of certain activities or actions by any direct or indirect parties to the transaction, from the time of application submission until HUD has completed the environmental review process. Specifically, no action concerning the proposal shall be taken which would: (1) have an adverse environmental impact, (2) limit the choice of reasonable alternatives or (3) prejudice the ultimate decision on the proposal.
    a. Certain actions, such as development of plans or designs, or performance of other work necessary to support an application for Federal, state or local permits, do not fall within such limitations.
    b. Other actions, such as the acquisition, demolition or modification of a wetland, or actions significantly affecting a historic property, do fall within such limitations. Additionally, pursuant to the "anticipatory demolition" requirements of Section 110(k) of the National Historic Preservation Act (16 U.S.C. 470h-2(k)), with guidance provided by the Secretary of Interior at 63 FR 20496, even before application submission takes place, any action by a potential Lender or Borrower, or any action by another party that the Lender or Borrower has the legal power to prevent, that is taken with the intent to avoid Section 106 review and that significantly adversely affects a historic property, could result in eventual rejection of an application.
    c. If any party is unsure as to whether an action would fall within such limitations, they should seek advice, and possibly approval, from the Office of Residential Care Facilities (ORCF). These requirements are distinct and separate from any early start of contractually related construction activities.

B. **HUD Staff Responsibility:**

1. In accordance with 24 CFR 50.32, HUD, not the Lender, is responsible for performing the environmental review, completing the review in HEROS-Form HUD-4128, and determining that the project raises no environmental conditions prohibited by law, Executive Order, or regulation, or that would endanger health or safety, or that would put FHA mortgage insurance or the U.S. Government at financial risk or liability. The HUD reviewer will obtain interdisciplinary assistance from professional experts and other HUD staff as needed. The Lender/Borrower are expected to provide information needed for the review and, as HEROS becomes available, to input applicable data into that system. Additional information may also be requested of the Lender/Borrower.

2. HUD staff must review the Phase I Environmental Site Assessment (ESA) submitted by the Lender and will make a site visit for new construction and substantial rehabilitation projects. Other projects may be visited on a case by case basis. A site visit will help validate the information provided in the Phase I ESA, and it is useful for evaluating other environmental factors. The HUD reviewer will sign the completed review in HEROS - Form HUD-4128 as the preparer, and the form will be co-signed by a HUD approving official, consistent with the then-current Delegation of Authority.

3. Regulation 24 CFR 50.32 requires that a NEPA Environmental Assessment for a project with more than 200 dwelling units or 200 beds be sent for review and comment to the appropriate Field Environmental Officer. Projects such as Section 232/223(f), which are deemed categorically excluded from NEPA but require compliance with the Federal laws and authorities cited in 24 CFR 50.4 pursuant to 24 CFR 50.20(a), do not require review and comment from the FEO. However, it is recommended that FEOs be given the option to review and comment when special analysis is required under such laws and authorities.

4. Completed environmental records must be available for the FEO to review. Up to ten percent (10%) of files may be reviewed in any given year.

5. As part of its environmental review responsibilities, HUD may require additional environmental material from a Lender, such as a Phase II ESA, even when the Lender might not believe that such additional environmental material is necessary.

6. HUD staff should refer to the specific directions and guidance contained in Section 7.4 for projects that involve remediation and/or monitoring.

C. **When to Submit Required Exhibits to Resolve Environmental Issues:**

1. Lenders are required to submit all the exhibits necessary to resolve any environmental issues with the Firm Commitment application.

2. Any environmental problems present at the site will require a discussion of impacts to human health and appropriate mitigation measures. The Lender must provide mitigation plans for those environmental problems when the application for a Firm Commitment is submitted. Remediation of site contamination is discussed in Section 7.3 of this chapter, and requires that remediation plans and LSTF approval of those plans be submitted with the application for Firm Commitment. The implementation of mitigation and remediation plans may, with HUD approval, continue throughout the construction period. HUD will review the Lender's plan and make it a condition of the Firm Commitment, if HUD considers the plan acceptable. This would include any plans for remediation of site contamination, wetlands impacts, noise impacts, historic preservation, and/or floodplain management issues.

3. Removal or containment of lead-based paint or asbestos may continue beyond initial and final closing if HUD approves.

D. **Qualifications of Professionals:**

1. The Borrower may select the professionals to be used to prepare the Phase I ESA and the other required environmental information discussed in Sections 7.5, 7.6 and 7.7, but the Lender must verify that the professionals used are qualified for their assigned

responsibilities. It is recommended that the professionals have prior HUD experience, since the analyses of some related laws and authorities are unique to HUD.

2. The environmental professional preparing the Phase I ESA must meet all of the qualification requirements of Appendix X2 of ASTM E1527-13 (or similar section of the most recent edition). Additionally, the environmental professional must meet the license/certification, educational, and experiential requirements of Section X.2.1.1. (2)(i), (ii), or (iii), of Appendix X2 of ASTM E1527-13 (or similar section of the most recent edition). The environmental professional must describe how he or she meets these qualifications in the Qualification(s) of Environmental Professional(s) Section of the Phase I ESA. For "relevant experience" such discussion must be specific as to how the requirements of Section X.2.2 of Appendix X2 of ASTM E1527-13 (or similar section of the most recent edition) have been met. The Phase I ESA must clearly indicate that HUD is an authorized user of the report.

3. When a Phase II study is conducted, the "Phase II Assessor" must meet all of the qualification requirements of Section 3.1.33 of ASTM E1903-11 (or similar section of the most recent edition).

4. Other professionals may be required to evaluate technical areas, such as asbestos, radon, noise, fire safety, wetlands, flooding, historic preservation or soil stability conditions. The Lender should verify that these technicians are also qualified. When these professionals are required, the Lender may contract for those services if the Borrower has not done so.

E. **Consulting with ORCF:** Lenders are encouraged to consult early with ORCF on environmental requirements. Local conditions and interagency relations affecting environmental review requirements differ from state to state. For instance, coastal zone management requirements are not applicable in most states, but in states where they are applicable, compliance procedures differ. In some states, a letter from the state coastal zone management agency for projects in the coastal zone is required. In others, alternative review procedures make this unnecessary.

ORCF is available to review key environmental issues prior to application via its Lean Thinking email box. Lenders may submit questions on unusual site conditions, such as soil contamination, explosive hazards, unacceptable noise levels, fall hazards, etc., to LeanThinking@HUD.gov.

7.3 Contamination Analysis: Phase I and Phase II Environmental Site Assessments and Remediation

The purpose of this section is to first, identify any contamination on a site other than contamination from in-place building components such as asbestos containing materials (see

Section 7.7) and second, to ensure that any contamination so identified, is mitigated to the point where it would be unlikely to "affect the health and safety of occupants or conflict with the intended utilization of the property" as stated in HUD-wide policy at 24 CFR 50.3(i)(1).

Any potential contamination issues should be discussed with HUD as soon as possible. It is recommended that lenders consult with HUD before a Phase II ESA is prepared.

A. **Phase I Environmental Site Assessment (ESA):**

1. Submission: The Lender shall submit a complete Phase I ESA with the mortgage insurance application. A summary or "draft" submission is not acceptable. The Lender and/or the Borrower must inform the ESA preparer of all of the following Phase I ESA requirements:
    a. Purpose: The Phase I ESA will make an initial determination as to the presence of "hazardous substances" as defined by CERCLA, and of petroleum and petroleum products. In addition, a purpose of the Phase 1 ESA is to document compliance with 24 CFR 50.3(i), which states HUD's policy that all properties for use in HUD programs be free of hazardous materials, contamination, toxic chemicals and gases, and radioactive substances, where a hazard could affect the health and safety of occupants or conflict with the intended utilization of the property. This purpose must be described in the "Purpose" subsection of the required "Introduction" Section of the Phase I ESA. To meet this purpose, in addition to the standard Phase 1 determination of whether Recognized Environmental Conditions (RECs) have been identified in connection with the site, the Evaluation section's discussions on Findings, Opinions and Conclusions should state whether further investigations or corrective actions are recommended to meet 24 CFR 50.3(i).
    b. Phase I ESA Format: The Phase I ESA must be prepared in accordance with the requirements of ASTM E1527-13, "Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process" (or most recent edition), using the table of contents and report format specified in Appendix X4 therein. The Phase I ESA must incorporate a vapor encroachment screen performed in accordance with ASTM E 2600-10 (or most recent edition). The Phase I must clearly indicate that HUD is an authorized user of the report.
    c. Phase I ESA Timing: The Phase I ESA must be conducted (meaning the earliest of the date of the site visit, records review, or interviews) within one year of the mortgage insurance application's submission date to HUD. However, a Phase I ESA that was conducted more than 180 days prior to the submission date to HUD, but within the allowable one-year period, must be updated pursuant to Section 4.6 of ASTM E1527-13 (or similar section of the most recent edition). A Phase I ESA originally prepared more than one year prior to submission to HUD, even if updated within 180 days of submission to HUD, is not acceptable. The ESA timing requirements cannot be waived.

d. Phase I ESA Professional Preparers' Qualifications: The Qualifications of Environmental Professionals section of the Phase I ESA must describe the preparer's qualifications.
e. Vapor Encroachment Screen: The Phase I ESA must incorporate an initial vapor (a.k.a. gas) encroachment screen to determine if there is a potential for vapors to occur in the subsurface below existing and/or proposed on-site structures. Those hazardous substances may be petroleum and petroleum products that consist of volatile organic compounds (VOC), semi-volatile organic compounds (SVOC) and inorganic volatile compounds. The vapor encroachment screen shall be performed using Tier 1 "non-invasive" screening pursuant to ASTM E2600-10 "Standard Guide for Vapor Encroachment Screening on Property Involved in Real Estate Transactions," Section 8 (or similar section of the most recent edition). If the Tier 1 vapor encroachment screen determines that, as indicated in ASTM E2600-10 Section 8.7.1 (or similar section of the most recent edition), there is a "vapor encroachment condition" (VEC) which is the "presence or likely presence" of such vapors in the subsurface below existing and/or proposed on-site structures, a likely VEC, or that a VEC "cannot be ruled out", it shall also be deemed to be a REC for purposes of the Phase I ESA. Analyses regarding the VES must be integrated within the various sections of the Phase I ESA.
f. Findings Section: The Findings section of the Phase I ESA must list all known or suspect Recognized Environmental Conditions (REC), Controlled Recognized Environmental Conditions (CREC), Historical Recognized Environmental Conditions (HREC), and de minimis conditions (such as minor soil staining). The Findings section must also list VECs, likely VECs, and circumstances in which a VEC cannot be ruled out.
g. Opinions Section: The Opinions section, pursuant to section 12.6 of ASTM E1527-13 (or similar section of the most recent edition), must discuss the impact on the property of conditions identified in the Findings section, and provide rationale for concluding that a condition is or is not currently a REC. The justification for any Finding deemed not to be a REC must be included in the Opinions section. If the Phase I ESA preparer cannot make a statement as to whether a condition is or is not a REC, the Opinions section must state what information or further investigation— e.g. gaining access to a building (a so called "data gap" per section 12.7), but not including a Phase II ESA—would be deemed necessary to make such a determination. When previous remediation has been performed or is ongoing, i.e., not yet an HREC at the proposed site, the Phase I ESA must fully discuss the extent of such remediation in the Opinions section, including any involvement of LSTF Authorities. The Phase I ESA preparer must justify whether such ongoing remediation should resolve any RECs or undecided issues identified in the ESA. Note: Even if the environmental professional preparing the Phase I ESA

determines that a Finding does not rise to the level of a REC, HUD may nevertheless determine that there is a business environmental risk that requires testing and/or remediation.

h. Conclusions Section: The Conclusions Section must make a determination of whether a REC, including a CREC, exists on the site in accordance with one of the two statements at Section 12.8 of ASTM E1527-13 (or similar section of the most recent edition), i.e.:
   i. "We have performed a Phase I Environmental Site Assessment in conformance with the scope and limitations of ASTM Practice E 1527 of [insert address or legal description], the property. Any exceptions to, or deletions from, this practice are described in Section [ ] of this report. This assessment has revealed no evidence of recognized environmental conditions in connection with the property," or

   ii. "We have performed a Phase I Environmental Site Assessment in conformance with the scope and limitations of ASTM Practice E 1527 of [insert address or legal description], the property. Any exceptions to, or deletions from, this practice are described in Section [ ] of this report. This assessment has revealed no evidence of recognized environmental conditions in connection with the property except for the following: (list)."

i. User Provided Information Section: The Borrower and the current property owner, if different from the Borrower, shall complete the User Questionnaire(s) according to Appendix X3 of ASTM E1527-13 (or similar section of the most recent edition). The User Questionnaire(s) must be included in the "User Provided Information Section" of the Phase I ESA and the preparer must take into account any information provided in the User Questionnaire(s) in the preparation of the Phase I ESA.

j. Testing Not Required: The Phase I ESA does not require sampling and testing, which will be performed during the course of a Phase II ESA or as part of a remediation plan. However, the Phase I ESA may reference and discuss a prior Phase II ESA performed in general accordance with ASTM E1903-11 (or most recent edition), including whether a condition is a REC.

k. Lead-based Paint (LBP): During any proposed repair work, the removal and disposal of LBP must be performed in accordance with regulations as published and enforced by the State and the Department of Labor - Occupational Safety and Health Administration (OSHA).

   LBP chips that are not inside or part of a structure may be deemed to be a hazardous substance under CERCLA (see EPA document referenced at Section 7.3.C.1.c.(5) below). Therefore, if there is or was a structure on the site that was built prior to 1978 (when the use of LBP was discontinued), any evidence of paint chips not inside or part of any

current structures must be discussed in the "Site Reconnaissance" section of the Phase I ESA, must be listed in the Findings Section, and must be discussed further as to whether the paint chips are either a REC or a de minimis condition in the Opinions section.

l. Previous Remediation: When previous remediation has been performed, or remediation is currently taking place, the Phase I ESA must fully document the status of such remediation, including any involvement from local, state, tribal, or Federal (LSTF) authorities.

m. Evaluation of the Phase I ESA: The Phase I ESA will be evaluated by HUD. HUD may require additional information or a Phase II ESA based on Findings that indicate an unacceptable business environmental risk. Any Phase I ESA that identifies a Recognized Environmental Condition requires a Phase II ESA, unless it can be determined from the Phase I ESA that corrective action is not feasible. If no corrective action is feasible, HUD may reject the property.

B. **Phase II ESA:**

1. Purpose: The purpose of the Phase II ESA is to ascertain by chemical testing of samples and within the requirements of ASTM E1903-11, "Environmental Site Assessments: Phase II Environmental Site Assessment Process," (or most recent edition) whether the RECs and/or business environmental risks identified from the Phase I ESA have resulted in the presence of "hazardous substances" as defined by CERCLA, and/or of petroleum and petroleum products at levels that would exceed the Statewide, non-site specific criteria (de minimis levels).

2. Timing: The Phase II ESA shall be submitted at the same time as the Phase I ESA. For new construction or substantial rehabilitation using the initial stage of processing, the Phase II ESA, if required, must be submitted by the Lender at the initial stage of submission.

3. When Required: A Phase II ESA is required if:
   a. The Phase I ESA indicates that there is a REC and corrective action is potentially feasible,
   b. The Phase I ESA comes to no definite conclusion regarding the presence of a REC, or
   c. HUD requires a Phase II ESA for business environmental risk reasons that are described to the Lender.

4. Exception to the Phase II Submission Requirement: In cases where it is obvious that remediation will be required, with HUD's permission, a separate Phase II ESA may be bypassed and instead incorporated within the "site characterization" segment of the remediation plan referenced in Section 7.3.C.1 below.

5. Standards to Use: The Phase II ESA is to be performed pursuant to the logic model of ASTM E1903-11, Section 7 (or similar section of the most recent edition), including developing the conceptual model and validation.

6. Report Format: The Phase II ESA must be prepared in accordance with the requirements of ASTM E1903-11, using the table of contents and report format specified in Appendix X3.2 as amended by X3.3 (or similar section of the most recent edition). Some of the steps that a Phase II assessor might perform may be intuitive in nature, but they nevertheless must be included in the report so as to ensure its scientific validity.

7. Historical Recognized Environmental Conditions (HREC): If the Phase I ESA indicates that there is a HREC as described in ASTM E1527-13 (or most recent edition), i.e., a hazard has been remedied and an LSTF Authority has issued a No Further Action (NFA) letter or similar approval, HUD may either deem the NFA letter as the completion of the remediation or it may require a Phase II ESA and/or further remediation.

8. Nature and Extent of the Study: The Phase II ESA need not necessarily be a complete site characterization (total nature and distribution) of contamination, but must proceed to a point where it indicates the location of greatest concentration and risk. However, when the existence of elevated levels of contaminants is confirmed, a complete site characterization will be required as a first step in remediation per Section 7.3.C.1 below.

9. Vapor Encroachment/Vapor Intrusion: If it is determined that there is a potential for vapors to occur in the subsurface below existing and/or proposed on-site structures, either identified from the Phase I ESA as a REC or from this or a prior Phase II ESA, the Phase II ESA shall include either a Tier 2 vapor encroachment screen (per ASTM E2600-10, Section 9 (or similar section of the most recent edition)), a vapor intrusion assessment (VIA) pursuant to LSTF policy and/or procedure (as discussed in ASTM E2600-10, Appendix X7.1 (or similar section of the most recent edition)), or go directly to a Tier 4 “mitigation” (per ASTM E2600-10, Appendix X7.1 or 7.2 (or similar section of the most recent edition)).

   If a Tier 2 screen was performed and it determined that there was a VEC, a likely VEC, or that a VEC could not be ruled out, either a VIA pursuant to LSTF policy and/or procedure or Tier 4 “mitigation” (per ASTM E2600-10, Appendix X7.1 or X7.2 (or similar section of the most recent edition)) is required.

   If a VIA was performed, any mitigation (remediation) deemed necessary must follow LSTF policy and/or procedures.

10. Phase II Conclusion. The Phase II ESA must conclude that:

a. There are “hazardous substances” as defined by CERCLA, and/or petroleum and/or petroleum products at levels that exceed the Statewide, non-site specific criteria and list any chemicals so found, or
b. No hazardous substances, petroleum or petroleum products have been identified above de minimis levels.

11. Off-site contamination conclusion: The Phase II ESA must address the risk of off-site contamination migrating on to the proposed site including if:
    a. There is no known or perceived off-site contamination in the vicinity of the proposed site,
    b. It is unlikely that any known or perceived off-site contamination will migrate on to the site, or,
    c. It is likely that known or perceived off-site contamination will migrate on to the site.

12. LSTF Requirements: The Phase II ESA written report must describe how it conforms to any applicable LSTF requirements and must include a detailed, common language summary.

13. Exception of requirement for Phase II preparation and submission for ongoing remediation: A Phase II ESA is not required when remediation is ongoing to the point of not yet being an HREC (see Section 7.3.A.1.f, above), if the Phase I ESA preparer states that such remediation should resolve any RECs and undecided Phase I ESA issues (see Section 7.3.A.1.g, above), and if the remediation plan preparer indicates that all of the Phase II ESA requirements have been met.

C. **Remediation Plans – General:**
Remediation plans are required if the Phase II ESA cannot make the determinations required by Section 7.3.B.10.b, and B.11.a or B.11.b. The following requirements apply to all remediation plans:

1. Complete site characterization.
    a. Anytime a site has been identified from a Phase I or Phase II ESA as having contamination (or contamination exposure pathways), be it vapor (gas), liquid, solid, dissolved, or non-aqueous phase liquid (NAPL), above de minimis levels, a complete site characterization (sometimes known as special site assessment report, a detailed Phase II ESA, or a Phase III ESA) must be prepared as the initial step of any remediation plan.
    b. Such a report must determine the total horizontal and vertical extent of such contamination, exposure pathways, and potential receptors (a.k.a., conceptual site model). However, if the remediation plan preparer determines that the Phase II ESA preparer has already determined the total nature and distribution of such contamination, exposure pathways and potential receptors, then such determination shall be so indicated and the Phase II ESA shall be made a part of the remediation plan.

c. The report must also be based on the appropriate combination of the following ASTM Practices and Guides (or similar section of the most recent edition), as amended, as determined by the remediator's environmental investigator. Lesser degrees of site assessments or non-conformance are not acceptable. For lead contaminated sites, refer to the listed EPA Handbook.
    i. D6235-04, "Practice for Expedited Site Characterization of Vadose Zone and Groundwater Contamination at Hazardous Waste Contaminated Sites"
    ii. E1689-95, "Standard Guide for Developing Conceptual Site Models for Contaminated Sites"
    iii. E1903-11, "Standard Guide for Environmental Site Assessments: Phase II Environmental Site Assessment Process", as amended
    iv. E1912-98, "Guide for Accelerated Site Characterization for Confirmed or Suspected Petroleum Releases"
    v. EPA, Superfund Lead-Contaminated Residential Sites Handbook, 2003
d. All of the requirements of Sections 7.3.C.2, 3, and 4 below must be met.
e. The report must discuss how it complies with the listed Practices or Guides and/or the appropriate LSTF procedures.
f. The report must indicate how it meets the requirements of any applicable LSTF regulatory procedures.

2. Any remediation studies and plans must be in the form of a report that includes a detailed, common language summary and discusses how it meets the listed Practices or Guides and/or the appropriate LSTF procedures.

3. Any remediation studies and plans, including the site characterization as described in Section 7.3.C.1, above, must be presented to HUD at the same time as the Phase I ESA and, if applicable, the Phase II ESA. For new construction or substantial rehabilitation projects using the initial stage of Firm processing, the remediation plan and evidence of approval of the plan by the LSTF Authority must be submitted with the initial submission.

4. The remediation plan preparer's qualifications must be discussed in any remediation reports.

5. Evidence of approval of the remediation plan by the LSTF Authority must be submitted with the application submission.

6. The remediation plan must cover all relevant contaminant phases: vapor (gas), liquid, solid, dissolved, and NAPL.

7. The remediation plan must require either the removal of contamination (bringing the contamination to de minimis levels) pursuant to Section 7.3.D or incomplete removal of contamination in the form of a Risk-Based Corrective Action pursuant to section 7.3.E.

8. Remediation Timing - Uncertain Determination of Cost and/or Effectiveness of Remediation: If HUD determines that it is uncertain whether implementation of the remediation plan will meet the requirements of either 7.3.D or 7.3.E, the remedial work must be completed, including clearance testing, and the remediation itself must be approved by the LSTF authority, including issuance of any clearance and closure documents, prior to the issuance of the Firm Commitment.

9. Remediation Timing - Definitive Determination of Cost and Effectiveness of Remediation: If the extent of contamination can be definitively determined and the cost of removing that contamination can be specified pursuant to a contract for remediation (see Section 7.4), HUD may allow a remediation plan that has been approved by the LSTF authority that:
    a. permits the remediation including site testing, any clearance and closure documents, and the approval by the LSTF, prior to initial closing, or
    b. if the applicant can show cause why it would be impractical to complete the remediation prior to initial closing, permits the remediation including site testing, any clearance and closure documents, and final approval by the LSTF, prior to both final closing and initial occupancy.

10. Disclosure protection during the course of remediation activities. All persons living or regularly working on site while remediation is taking place shall be duly informed and protected from contamination. This requirement must be a part of the remediation plan.

11. Remediation contract insurance. Unless HUD determines otherwise, the remediation contract shall require cost cap and reopener insurance coverages, copies of which are to be included in the remediation plan.

12. Ongoing Remediation. If remediation is taking place, or has been completed but has yet to receive approval by the LSTF at the time of submission of the Phase I ESA, the remediation plan and all remediation studies shall be submitted, along with a detailed common language summary, at the same time as the Phase I ESA.

D. **Remediation Plans – Complete Removal of Contamination:**

1. General Requirements: Except for those situations where Section 7.3.E (Remediation Plans – Incomplete Removal of Contamination) below applies, the Lender must submit a remediation plan designed to bring the contamination identified by the complete site characterization per Section 7.3.C.1 to de minimis levels or eliminated to the extent necessary to meet the LSTF authority standards, with no active or passive remediation. There must not be any need for engineering controls, institutional controls, or monitoring wells.

2. All of the requirements of Section 7.3.C must be met.

3. Offsite Contamination, Groundwater Contamination and/or Vapor Intrusion Mitigation: A remediation plan that involves control of off-site contamination and/or vapor intrusion remediation is not permitted under this section but may be allowed under Section 7.3.E, "Remediation Plans – Incomplete Removal of Contamination," below.

E. **Remediation Plans – Incomplete Removal of Contamination:**

1. Justification: If the costs are deemed to be exorbitant and/or the feasibility is deemed impractical for remediation of on-site contamination to de minimis levels, or if there is known or expected offsite contamination that poses a risk to the project site, the remediation plan may allow for incomplete removal, as described below. Justification for such incomplete removal must be submitted along with the remediation plan. Such justification must include documentation that shows that the costs of the incomplete removal of contamination, including any life cycle costs for Operation and Maintenance, and any applicable enforcement requirements of LSTF authorities, are sufficiently below the costs of complete contamination removal. The extent of the contamination must be fully understood, including possible exposure pathways, as part of a Risk-Based Correction Action (RBCA).

2. All of the requirements of Section 7.3.C must be met.

3. The corrective action must be a Risk Based Corrective Action (RBCA) based on the appropriate combination of:
    a. The following ASTM Guides and Practices (or their most recent edition), as amended, as determined by the remediator's environmental investigator: (For lead contaminated sites, refer to the listed EPA Handbook.)
        i. E1689-95 (2014), "Standard Guide for Developing Conceptual Site Models for Contaminated Sites"
        ii. E1739-95 (2015), "Standard Guide for Risk-Based Corrective Action Applied at Petroleum Release Sites"
        iii. E1943-98 (2010), "Standard Guide for Remediation of Ground Water by Natural Attenuation at Petroleum Release Sites"
        iv. E2081-00 (2015), "Standard Guide for Risk-Based Corrective Action"
        v. E2091-11, "Standard Guide for Use of Activity and Use Limitations, Including Institutional and Engineering Controls"
        vi. E2435-05 (2015), "Standard Guide for Application of Engineering Controls to Facilitate Use or Redevelopment of Chemical-Affected Properties"
        vii. E 2616-09 (2014), "Standard Guide for Remedy Selection Integrating Risk-Based Corrective Action and Non-Risk Considerations"
        viii. E2600-10, "Standard Guide for Vapor Encroachment Screening on Property Involved in Real Estate Transactions"
        ix. For Lead Contaminated Sites. "EPA, Superfund Lead-Contaminated Residential Sites Handbook, 2003"

b. LSTF regulatory procedures may be followed in lieu of the ASTM Guides and Practices listed above, when the remediator's environmental investigator determines their equivalence or greater stringency.

4. LSTF requirements: The RBCA must always meet the requirements instituted by any applicable LSTF regulatory authority.

5. The RBCA report(s) must:
   a. meet all of the requirements for Section 7.3.C,
   b. discuss how the remediation plan meets with the applicable ASTM Guides and Practices and LSTF regulatory procedures as listed/discussed in Section 7.3.E.3 and 7.3.E.4 above,
   c. discuss how it meets or will meet all of the requirements of Section 7.3.E.6, and
   d. discuss how it meets or will meet all of the requirements of Section 7.3.F through J.

6. Risk-Based Corrective Action (RBCA): The corrective action must be a RBCA supported by the applicable combination of:
   a. Engineering and Institutional Controls (EC/IC).
      i. An appropriate mix of engineering controls, such as capping and slurry walls, and institutional controls such as protective covenants and access restrictions are usually required for all RBCAs, and shall follow the guidance in ASTMs E2435-05 and E2091-05 (or most recent editions). The RBCA must indicate how it met these Guides.

         LSTF regulatory provisions may be followed in lieu of these ASTM Guides, as amended, when the remediator's environmental professional determines their equivalence.

      ii. Operations and Maintenance Plan (O&M) Plan: Any time there is an EC/IC, there must also be an O&M plan which itself is an IC. The O&M plan must be approved by the LSTF authority, and must discuss any associated enforcement required by LSTF authorities. An O&M plan must be in place for management of all contamination remaining on the site and any controls thereof. If HUD determines that the Borrower does not have sufficient capacity to manage the O&M plan, the Borrower must contract with an appropriate servicer to do so. (See Section 7.4. for costing)
      iii. Hard/Soft Cap Engineering Control: A hard cap EC, such as concrete, generally is required if any contamination will remain on the site after final closing. Unless the applicant can justify why a lesser depth to contamination would be protective of the health and safety of occupants, the depth of any remaining contamination should be greater than:

- the depth of the foundations of any existing or proposed structures including sumps,
- the depth of any existing or proposed utilities on site, and
- five feet below the surface.

In certain situations, HUD may allow for a soft cap (e.g. dirt) if other engineering controls such as an impenetrable geotextile fabric are included. Even if engineering controls are not required for such RBCAs, institutional controls (IC) are still required.

iv. Slurry Wall or Equivalent Engineering Control: A slurry wall or equivalent type EC may be required to prevent offsite contamination from migrating onsite, or to prevent onsite contamination from migrating onsite or offsite. If the Phase I and/or Phase II ESA determines that the likely existence of off-site contamination presents a risk to the site, such a slurry wall or equivalent type EC will be required.

v. Monitored Natural Attenuation and Enhanced Passive Remediation (MNA/EPR): MNA/EPR such as by bio-augmentation where no additional active input is required and passive engineering controls such as a slurry wall may be allowed as part of the RBCA. In such cases the LSTF authority must issue a conditional No Further Action (NFA) Letter or similar approval. Monitoring wells pursuant to the above RBCAs and meeting the requirements of Section 7.3.F will be required to monitor the progress of the remediation. When MNA/EPR is part of the RBCA, the remediation may continue beyond initial endorsement provided that the LSTF authority has determined in writing that such undertakings would present no threat to health, safety or the environment.

vi. Vapor Encroachment/Vapor Intrusion Mitigation: If a VEC is present, a VEC is likely present, or a VEC cannot be ruled out, then mitigation as discussed in ASTM E2600-10, Section 7.2 (or similar section of the most recent edition)is required, unless a VIA performed pursuant to LSTF policy and/or procedure and in accordance with ASTM E2600-10, Appendix X7.1 (or similar section of the most recent edition)has determined that it is in compliance with such policy, or would be in compliance after instituting mitigation. When remediation goes directly from a Tier 1 screen or a Tier 2 screen, such controls shall, where feasible, consist of a poured-on vapor barrier to be used in conjunction with the active and passive venting systems.

vii. Institutional Controls (IC) regarding groundwater contamination, if applicable, must be put in place.

b. No Further Action Letter (NFA): The LSTF authority must issue an NFA, or similar approval, except that a conditional NFA may be allowed pursuant to MNA/EPR (see Section 7.3.E.6.a.5 above). The NFA or conditional NFA must be issued pursuant to the time lines stated earlier in Section 7.3.C.8 and 9. Additionally, the LSTF authority must indicate that the remediation that

has taken place, or will take place, is protective of health, safety and the environment.

c. Groundwater Requirement: A site that is/will be otherwise acceptable may be approved if contamination exists in the groundwater after completion of remediation, if:
   i. Institutional controls (ICs) regarding the groundwater are/will be put in place, along with an O&M plan, approval by the LSTF authority, and any applicable enforcement requirements of LSTF authorities. The ICs must prohibit any and all uses of the groundwater; and
   ii. The highest anticipated levels of groundwater based on high groundwater and/or100 year flooding events, are below the levels of any construction or potentially anticipated utility work, unless it can be shown how such high groundwater levels will not modify the nature and distribution of contamination to such a degree that it could affect the health and safety of residents and workers; and
   iii. Any vapors from groundwater and/or soils are shown not to present a significant risk pursuant to Tier 1 vapor encroachment assessment, Tier 2 vapor encroachment assessment, VIA, or mitigation.

d. Safety of and Disclosure to Residents and Workers: Any time contamination above de minimis levels is allowed to remain on site after initial occupancy and final closing, all construction workers who might perform activities that could compromise the EC and/or IC, as well as facility staff, and building residents, etc. are to be informed of the general nature and distribution of contamination and the protective measures that have been taken.

e. Hazardous Substance Quantification: If any RBCA plan identifies hazardous substances listed in 40 CFR 302.4 that will remain on the property after final closing, such plan shall determine the quantity of such hazardous substances and whether it exceeds the levels indicated at 40 CFR 373.2. (This is a requirement under CERCLA that would apply to HUD at any time that HUD might own the property or take over its management.)

F. **Monitoring Wells, Flushing Wells, or Testing Wells:**

1. General Requirements: The presence of a testing or monitoring well on the property does not bar the property from consideration for mortgage insurance. If a monitoring well is required or exists to confirm that contaminants have been removed to intended levels or to determine that an MNA/EPR is working properly, EC/IC will be required until such time as contaminants are reduced to de minimis levels and a Final NFA letter is issued by the LSTF Authority.

2. Monitoring Well Protocols: Monitoring protocols must be specified in the RBCA and monitoring must proceed to the point that indicates that contaminants have been removed to intended levels or that passive MNA/EPR is working properly.

3. Off-site Contamination – Acceptability: If a monitoring well is required or exists to determine if existing or assumed off-site contamination has migrated or might

migrate on-site, the site is generally not acceptable unless associated EC/IC are put in place pursuant to a RBCA or unless the LSTF authority provides a statement that such off-site-site contamination would not present a risk to the health of the project's occupants if it were to migrate on-site.

4. Flushing Wells – Unacceptable: In no case may final closing or initial occupancy take place when a flushing well is in operation or will be required.

5. Testing or Monitoring Wells Ordered by LSTF: A testing or monitoring well may also be placed on the property by order of the LSTF. The well may test or monitor contamination on the site or from a neighboring site. If a monitoring well would be required or exists solely to monitor the general health of an aquifer used as a water supply or potential water supply, but not in relation to an existing or potential hazardous condition, it is not a bar to environmental approval. However, the Lender must notify HUD if there is any current or intended placement of a monitoring or testing well on the site.

6. Non-operating Wells: Non-operating wells are not a barrier to environmental approval, but must be capped over and closed out by the appropriate LSTF authority.

G. **Off-site Contamination:** If the Phase I and/or Phase II ESA determines that the existence of off-site contamination presents a risk to the site or the residents of the project and the Borrower has no management control over the offsite locations of the contamination, the site is not acceptable unless such off-site contamination is subject to a RBCA meeting all of the requirements of Sections 7.3.C and E.

H. **Escrow:** An escrow account must be set up and held by the Lender for the maintenance of any monitoring wells and engineering controls, such as caps or slurry walls.

I. **Waivers:** If ORCF intends to waive any of the requirements in this Section 7.3 that are not regulatory in nature, the advice of the Housing Environmental Clearance Officer shall be obtained before the waiver is granted to ensure that such waiver is in compliance with the environmental requirements of 24 CFR 50.3(i).

J. **LSTF Approvals and Reviews:** Any approvals by an LSTF authority must be given directly by that authority and may not be given by a third party approved by that authority to act in lieu of the authority itself. Approvals by local authorities are only acceptable when such authority is acting under delegation from the State.

K. **Unacceptable Sites**: A site over a former solid waste landfill/dump and/or Superfund (National Priorities List (NPL)) site generally is not acceptable for development unless the hazardous substances, petroleum, and petroleum products are completely removed, the site is delisted, or for an NPL site only, the Federal Agency with management authority over the site gives approval of the site for residential usage.

7.4 HUD Responsibilities in Reviewing Cases Requiring Remediation

A. **General Responsibilities**

The Department assumes greater risk anytime that a Firm Commitment is issued on a contaminated site. The risk is even greater when a loan is closed on a site where complete removal of contamination is not possible, requiring monitoring possibly with continuous remediation techniques such as Monitored Natural Attenuation and Enhanced Passive Remediation (MNA/EPR). Therefore, HUD staff must exercise great care in the review process to assure that all reasonable measures are taken to mitigate HUD's exposure and that an accurate determination is made of any remediation costs that are included in the FHA-insured mortgage. Any special site assessment reports, Phase II or Phase III ESAs should be reviewed so that the extent of the contamination is fully understood. Although the Lender is responsible for assuring that environmental remediation contractors are qualified and experienced, HUD staff must still review references and qualifications, and are strongly encouraged to consult with an Environmental Officer.

B. **Complete Removal of Site Contamination Valuation**

1. The HUD staff preparing the environmental review in HEROS – Form 4128 is generally responsible for reviewing and documenting the adequacy of the proposed remediation plan.

   Any estimates of value or rents should be made as if the project is unaffected by contamination and conditioned on successful removal. The appraisal must address any effect on marketability that may be present due to the prior environmental history.

   If an environmental issue involves areas of special engineering expertise, environmental science, or State and local procedure, the HUD reviewer may request technical assistance from the Field Environmental Officer (FEO) assigned in that jurisdiction, and defer to their guidance and judgment in the matter. HUD reviewers may also request the attention of HUD Regional Environmental Officers (REO) or the Program Environmental Clearance Officers and/or Specialists when unusual or controversial issues arise.

2. Underwriting: The ORCF Underwriter is responsible for determining if the cost estimate of the remediation plan is reasonable and if the remediation and removal contractor is appropriately bonded and qualified. The ORCF Underwriter may consult with HUD Architectural/Engineering and Cost staff, and with local environmental remediation professionals about costs for similar work. Cost data for remediation is not as plentiful as with more routine construction tasks. "Environmental Remediation Estimating Methods" might be helpful in some cases and is available through RS Means (Please see ORCF Environmental Resource Page located on the Section 232 Program website).

The amount of escrow or bond shall be based on the estimated cost of the mitigation work from the contractor. The bond should be for 150% of the estimated cost, or in an escrow established for the same amount. Higher escrow or bonding requirements will be necessary if HUD staff determines that there is a greater than average risk that unforeseen problems may arise, resulting in increased cost. This determination should be based on previous experience with similar work and/or research through local environmental remediation contractors about their experience in containing the cost within their stated estimate.

3. Account Executive: The Account Executive shall administer the escrow, performance, and bond payment requirements. The cash requirements for the escrow or bond, and the Lender and Account Executive's procedures for administering the escrow, shall be in accordance with existing instructions in the Office of General Counsel's Closing Guide.

C. **Incomplete Removal of Site Contamination:**

1. All disciplines should follow the guidance in Section 7.4.B above regarding initial remediation costs.

2. A HUD Staff Appraiser must assure that the annual operating expenses concluded by the Contract Appraiser and the Lender includes the cost of any requirement for continuous monitoring and/or ongoing mitigation. It may be categorized as a maintenance expense, and would include fees charged by service providers who are engaged to perform monitoring. If an expense is for actual or anticipated replacement of a component such as a pump, it should be added to the Reserves for Replacement. The basis for the expense or additional replacement reserve will be obtained from a qualified engineer and/or contractor. The engineer/contractor's estimate should be sufficiently detailed and supported to allow review by HUD staff.
Any effect on marketability, income or value related to the need for continuous monitoring/mitigation must be quantified and thoroughly discussed in the appraisal.

D. **Management, Coordination and Communication:**

The Department assumes greater risk in cases involving environmental mitigation that will occur after Initial Closing, especially when mortgage proceeds are used to fund the cost of remediation. Extra attention must be given to the need for frequent communication between technical disciplines, preferably with written documentation, relating to levels of contamination, cost estimates, and the certainty of the effectiveness of mitigation.

E. **Insurance/Guarantee Requirements**:

Borrowers are required to obtain separate insurance for environmental hazards from an insurer acceptable to HUD if remediation work will be done on the site during the insured loan period, if such coverage is available. The insurance typically covers liability and cost of

completion.

The environmental remediation contractor will almost always be different from the project's general contractor. Aside from the contractor qualifications and bonding requirements addressed above, the remediation contractor must also provide HUD a separate guarantee of completion for their work.

7.5 Environmental Information for the Lender Narrative

In addition to the reports and submission requirements discussed above, ORCF requires the Lender to provide a Lender Narrative with environmental issues discussed, along with any available supporting documentation for the project in the application submission. Supporting documentation may be included in the Phase I ESA report or it may be submitted separately within the application to HUD.

The following important environmental issues must be discussed in the Lender Narrative when applicable:

1. Coastal Zone Management (24 CFR 50.4(c)(2))
2. Coastal Barrier Resources (24 CFR 50.4(c)(1))
3. Floodplain Management (24 CFR 50.4(b)(2))
4. Historic Preservation (24 CFR 50.4(a))
5. Noise Analysis (24 CFR Part 50.4(k))
6. Explosive/Flammable Hazards (24 CFR 50.4(k))
7. Airport Clear Zones (24 CFR 50.4(k))
8. Wetlands Protection (24 CFR 50.4(b)(3))
9. Toxic Chemicals and Radioactive Materials (24 CFR 50.3(i))
10. Other Applicable Federal Laws
    a. Endangered Species (24 CFR 50.4(e))
    b. Sole Source Aquifers (24 CFR 50.4(d))
    c. Farmlands Protection (24 CFR 50.4(j))
    d. Flood Insurance (24 CFR 50.4(b)(1))
    e. Environmental Justice (24 CFR 50.4(l))
11. Additional Hazards and Nuisances (radon, pipelines, vibrations, fall hazards, etc.)

The existence of mold in a structure is not a topic that is covered during the environmental review. It is addressed in the Project Capital Needs Assessment (PCNA) as part of the building inspection. Lenders and ORCF underwriters will refer to the PCNA to determine if mold assessment and remediation is required.

The issues discussed below must be analyzed by HUD staff during their preparation of the environmental review in HEROS - Form HUD-4128 and provide guidance by which the Lender can assist HUD. These brief descriptions are not substitutes for the requirements in the statutes,

regulations, Executive Orders, notices and handbooks.

A. **Coastal Zone Management** (24 CFR 50.4(c)(2))**:** Projects located within a state's coastal management zone must be found consistent with the approved state Coastal Zone Management program. In many states, HUD will require a letter from the State Coastal Zone Management Agency confirming consistency with the approved program. Lenders should be aware of the extent of coastal management zones in coastal states and contact HUD early when examining a proposal in a coastal zone.

B. **Coastal Barriers** (24 CFR 50.4(c)(1))**:** Under the Coastal Barriers Resources Act cited in 24 CFR 50.4(c), HUD is prohibited from insuring a project located within designated coastal barriers of the Atlantic Ocean, Gulf of Mexico, or the Great Lakes, known as Coastal Barrier Resource System (CBRS) units, and shown on associated Fish and Wildlife Service maps. A project located within a CBRS unit, or that includes a facility (such as a water main) to a CBRS unit, will not be eligible for application processing.

C. **Floodplain Management** (24 CFR 50.4(b)(2))**:**

1. Applications for Firm Commitment for mortgage insurance are subject to regulations regarding floodplain management found at 24 CFR Part 55 which implements Executive Order 11988 (Floodplain Management).

2. All Section 232 projects are considered "critical actions" as defined in 24 CFR 55.2(b)(3).

3. The Lender must utilize the Federal Emergency Management Agency's best available data to comply with Floodplain Management requirements, which is the latest Advisory Base Flood Elevations (ABFEs), Preliminary Flood Insurance Rate Maps (P-FIRMs), or Flood Insurance Rate Maps (FIRMs). However, base flood elevations from an advisory or preliminary map may not be used if the elevations are lower than the elevations on the current FIRM used for ratemaking purposes. An online resource for finding the relevant FIRM and ABFE may be found on the ORCF Environmental Resource Page located on the Section 232 Program website. If any part of the site or integral offsite development is located within the 500-year floodplain (0.2% chance of annual flood) according to the best available data, the project must comply with HUD's floodplain management regulations. Note: the 500-year floodplain includes the 100-year floodplain (1% chance or greater chance of flood in any given year, known as the Special Flood Hazard area). The project will need to comply with current standards in 24 CFR part 55 if they are more restrictive than this handbook. Visit the ORCF Environmental Resource Page for the latest guidance.

4. Mortgage insurance shall not be approved for a property located in (a) a floodway, (b) a coastal high hazard area, or (c) a FEMA identified Special Flood Hazard Area (SFHA) in which the community has been suspended from or does not participate in the National Flood Insurance Program. The terms "coastal high hazard area", "floodway", and "functionally dependent use" are defined in 24 CFR 55.2.

Exceptions: 24 CFR 55.12 lists categories of proposed actions to which the floodplain management requirements in 24 CFR 55 are not applicable. As such, the floodway and coastal high hazard area prohibitions do not apply to Section 232 projects if only an incidental portion of the project site is in the 100-year or 500-year floodplain, and the following conditions are met:

a. All construction (including existing improvements) or landscaping activities (except for minor grubbing, clearing of debris, pruning, sodding, seeding, etc.) must not occupy or modify the relevant floodplain. Due to the constraint that activities must "not occupy or modify" the floodplain, the 100-year or 500-year floodplain cannot be utilized in the development or support of any project activity, except as passive open or green space. Open space is a portion of a development site that is permanently set aside for public or private use and will not be developed. Green space is considered to be undeveloped land or land restored to its natural state.
b. Appropriate provision is made for site drainage; and

c. In accordance with 24 CFR 55.12(c)(7)(iii), a protective covenant or comparable restriction must be placed on the property's continued use to preserve the 100-year or 500-year floodplain. The covenant or comparable restriction must run with the land to provide for permanent preservation of the floodplain, and must not be dependent on the mortgage instrument.

5. If a stream coursing through a proposed site is designated as being in the 100-year floodplain according to FEMA's best available data, but there is no designated floodway area (a so-called "regulatory floodway"), development will be prohibited in the channel of the stream.

6. HUD strongly discourages new construction projects in mapped 100-year floodplains. This flood buffer zone is extended to the 500-year floodplain for Section 232 projects. Section 232 project sites for new construction, and for rehabilitation activities not meeting the criteria at 24 CFR 55.12(a)(3), which are in the 100-year or 500-year floodplain according to the FEMA Flood Insurance Rate Map, Advisory Base Flood Elevation Map, Preliminary FIRM, or any of their official FEMA digitized equivalents, will not be considered for mortgage insurance unless one of the following steps is taken:

a. A Conditional Letter of Map Amendment (CLOMA) or Conditional Letter of Map Revision (CLOMR) removing the entire site from the floodplain (100-year and 500-year) has been obtained from FEMA prior to the initial submission or, in the absence of an initial submission, prior to submission of the application for Firm Commitment. In cases where the applicant has a CLOMA or CLOMR, HUD approval for a Firm Commitment will be conditioned on the Borrower: (1) meeting the requirements of the CLOMA or CLOMR; (2) obtaining a Final Letter of Map Amendment (FLOMA) or Final Letter of MAP Revision (FLOMR) removing the entire site from the

applicable floodplain prior to final endorsement; and (3) maintaining flood insurance on any building in the 100-year floodplain during the construction period until the FLOMA or FLOMR is issued; or

b. If Section 7.5.C.6.a does not apply, HUD must determine if there may be extraordinary circumstances leading to the conclusion that there are no practicable alternatives to the project site being in the floodplain. In order to make this determination, HUD must conduct an 8-step decision-making process that includes publishing two public notices and taking comments, as summarized in 24 CFR 55.20. In such instances, prior to issuing the first public notice, HUD will need detailed information regarding how the property will be altered and the improvements designed. This information includes the elevation of the property, the elevation of the floodplain, and the location of life support systems.

   Except in circumstances where it would not be practicable, in order to minimize adverse impacts, the 8-step process shall require as a condition of any project approval that a CLOMA or CLOMR be issued prior to initial closing, and a FLOMA or FLOMR be issued prior to final closing.

   The 8-step process shall require that new construction in a floodplain be elevated to the 100-year floodplain according to FEMA's best available data. If higher elevations are required by locally adopted code or standards, those higher standards would apply. The 8-step process shall also require that any new construction in Coastal A zones must utilize Zone VE construction practices in accordance with the FEMA Coastal Construction Manual, as recommended by FEMA. Information on those construction practices can be found on the ORCF Environmental Resource Page.

   The 8-step process shall be completed before issuance of the Firm Commitment. HUD must develop the two notices but the costs of publication will be borne by the Borrower. HUD approval for a Firm Commitment will be conditioned on the Borrower maintaining flood insurance on any building located in the 100-year floodplain until the issuance of the FLOMA or FLOMR.

7. As required by 24 CFR 55.20(e), all critical actions in the 100-year or 500-year floodplain shall be designed and built at or above the 100-year floodplain (in the case of new construction) according to FEMA's best available data or as otherwise required by current standards in 24 CFR part 55, and modified to include:
   a. Preparation of and participation in an early warning system;
   b. An emergency evacuation and relocation plan;
   c. Identification of evacuation route(s) out of the 500-year floodplain; and

d. Identification marks of past or estimated flood levels on all structures.

8. Projects that are converting from a non-residential use to a residential use are considered the same as "new construction" for floodplain management purposes.

9. For Section 223(f) purchase or refinancing actions described in 24 CFR 55.12(a)(2), or repair, rehabilitation, modernization, weatherization or improvement actions described in 24 CFR 55.12(a)(3), an abbreviated decision-making process pursuant to 24 CFR 55.12(a) may be used by HUD to determine their acceptability. The Department will evaluate risks and mitigation measures in making its decision but it discourages these actions if either the lowest floor, or the life support facilities, or egress and ingress of the existing building, are below the 100-year floodplain line.

10. Where a site does not appear to be located in the floodplain on official FEMA maps, but shows evidence of flooding, HUD is not precluded from qualitatively evaluating the acceptability of the site. Lenders will be required to provide extensive data to aid HUD in evaluating floodplain sites.

11. At the time of the application for Firm Commitment, the Lender must submit a completed Standard Flood Hazard Determination Form (FEMA Form 086-0-32).

12. Any building accepted for mortgage insurance that is located within a FEMA mapped 100-year floodplain is required to carry flood insurance. General flood insurance requirements as well as required insurance coverage amounts are set forth in Production, Chapter 14.7.H. When the facility's contents such as major movables are part of the mortgage security, the maximum available coverage amount consists of the total available for both the building and contents. Whenever flood insurance is required for a project, proof that the Borrower has a commitment for flood insurance effective as of the loan closing must be submitted with the mortgage insurance application.

13. All new and renewal leases must contain acknowledgements signed by the residents indicating that they have been advised that the property is in a floodplain and flood insurance is available for their personal property. This applies to all Section 232 properties within the 100-year and 500-year floodplains.

14. Section 232/223(a)(7) and FHA-insured Section 232/223(f) refinances: Pursuant to 24 CFR 50.19(b) (21), refinances of currently FHA-insured mortgages are exempt from the 8-step decision making process when the refinance will not result in any physical impacts or changes except for routine maintenance. Guidance for clarifying the difference between routine maintenance and repair is available on the on the ORCF Environmental Resource Page. All other requirements discussed in this section are being

extended by HUD to such §50.19 Categorical Exclusions. In particular, the following are required for all Section 232 applications when the project is located in a 100-year or 500-year floodplain:

a. Preparation of and participation in an early warning system;
b. An emergency evacuation and relocation plan;
c. Identification of evacuation route(s) out of the 500-year floodplain; and
d. Identification marks of past or estimated flood levels on all structures.

15. In considering the safety of residents, offsite floodways and other flood hazards will be evaluated in terms of separation distance, elevation differences, and the nature of the hazard in question. Unacceptable proximity to hazards may result in rejection of the application. Pre-submission guidance can be requested through LEANThinking@hud.gov.

D. **Flood Insurance:** In accordance with 24 CFR 50.4(b)(1), and as described in Section 7.5.C.12 above, flood insurance is required when any portion of a structure is located in a 100-year floodplain.

E. **Historic Preservation** (24 CFR 50.4(a))**:**

HUD must follow the procedures implementing the National Historic Preservation Act (54 U.S.C. § 300101 et seq.) with regulations found at 36 CFR Part 800. Section 106 of the National Historic Preservation Act (NHPA) requires Federal agencies to take into account the effects of their undertakings on historic properties and to afford the Advisory Council on Historic Preservation a reasonable opportunity to comment. All applications for Firm Commitment for HUD mortgage insurance, whether new construction, rehabilitation, refinancing or conversion from non-residential to residential property, except those categorically excluded under 24 CFR 50.19(b) (21), are considered "federal undertakings" that require HUD to make a determination of no historic properties affected, no adverse effect, or adverse effect upon historic properties. A historic property means any prehistoric or historic district, site, building, structure, object, or traditional cultural property or landscape included in, or eligible for inclusion in, the National Register of Historic Places maintained by the Secretary of the Interior.

1. Defining the Area of Potential Effects (APE): HUD must consider the Area of Potential Effects (APE). Establishing a project's APE is part of a 'reasonable and good faith effort' to identify historic properties that may be affected by the project. The APE defines where to look for historic properties, based on where direct and indirect impacts of the project are anticipated. Sometimes the APE is simply the project parcel, and other times, it is a larger area, neighborhood, or historic district. The APE should be based on project activities, without regard to whether there actually are historic properties in the area. Identification of historic properties in the APE comes later. Establishing the APE requires consideration of the effects a project might have on and beyond its site. The effects of an interior rehabilitation project will likely be limited to the building footprint itself. The APE for a simple exterior rehabilitation would likely be the property parcel, including the building and its immediate setting. Substantial earthmoving on a site may indicate the need for a

vertical dimension to the APE. Direct effects may also occur outside a project site. A new construction project might have new roads and utility lines leading to the site and they might be included within the APE. In major infrastructure projects that require large amounts of fill, the source of the fill ("borrow area") may be included in the APE. Determination of the APE also needs to take into account possible indirect effects that might negatively alter the character or use of adjacent properties. For example, the review should consider whether the project will significantly increase traffic or change traffic patterns in the vicinity of the project, whether the project will introduce excessive light or noise in the area, and whether the project will have visual ramifications on the surrounding area through its relatively massive scale or height. If potential effects extend beyond the project site, the Section 106 documentation should delineate the larger APE on a map.

2. After the APE is defined, and historic properties within it are identified, the potential impacts to those historic properties may be evaluated. Because of the technical nature of historic property identification, evaluation and treatment, it may be appropriate to retain a qualified historic preservation professional to prepare the findings. Such consultant should meet the Secretary of the Interior's Professional Qualifications (36 CFR Part 61) and have experience in Section 106 reviews.

3. The Section 106 review must be completed before HUD approves and/or commits funds to a project.

4. All Section 232 new construction and substantial rehabilitation projects, and all non-excepted Section 232/223(f), 223(a)(7) and 241(a) applications require consultation with the State Historic Preservation Officer (SHPO) and with any applicable Tribal Historic Preservation Officer (THPO) and affected tribes.

   Exceptions**:**

   a. Projects that will not involve new construction or rehabilitation, nor result in any physical impacts or changes except for routine maintenance, have "no potential to cause effects" to historic properties, as described in 36 CFR 800.3(a)(1), and therefore HUD has no further obligations under Section 106 of the NHPA or 36 CFR Part 800. For such transactions there is no obligation to contact the SHPO or THPO/affected tribes, and HUD staff's historic preservation responsibilities are limited to documenting this determination in HEROS-Form HUD 4128). Guidance for clarifying the difference between routine maintenance (Please reference HUD Notice CPD-16-02 "Guidance for Categorizing an Activity as Maintenance for Compliance with HUD Environmental Regulations, 24 CFR Parts 50 and 58" or succeeding guidance. Note that this definition of maintenance is specifically for environmental review purposes and applies to all HUD programs.) and a repair is available on the ORCF Environmental Resource Page.
   b. Some states may have a Programmatic Agreement (PA) with HUD and the proposal may be part of a class of actions that do not require Section 106 consultation under the MOA or PA.

5. To assist HUD in making its historic preservation determination, the Borrower or Lender may submit a letter to the appropriate State Historic Preservation Officer (SHPO). Doing so may greatly expedite the Section 106 consultation process. The letter must consist of a narrative explaining the proposal, and should follow the procedures outlined by the individual state. The letter also should include a map identifying the site location, the APE, and an opinion as to whether the proposal would have any effect on historic properties. The letter to the SHPO, and the SHPO response, if any, must be included in the application submission. Lenders may obtain from HUD a sample letter as well as the name and address of the SHPO who has the right to comment on the proposal. If a response from the SHPO is not received within 30 days, the lender must alert HUD of this fact in their application. Some SHPOS will only respond to federal agencies. Note: HUD, not the Lender, is responsible for contacting the THPO and any affected tribes. The information contained in the letter that was submitted to the SHPO as described above will assist HUD in carrying out its tribal and THPO consultations.

6. The request from the Borrower or Lender to the SHPO should be made as early as possible in the application process. The response from the SHPO need not be received by HUD prior to the application submission, but must be received by HUD before a Firm Commitment is issued. Additional guidance on historic consultation is available on the ORCF Environmental Resource Page.

7. The SHPO/THPO is allowed 30 days from the receipt of sufficient information to reply to requests for consultation. If there is no reply within that time, and if there is no reason to anticipate an objection to the proposal, HUD may make a determination of no effect, and a Firm Commitment may be issued. Where an undertaking (such as HUD mortgage insurance) affects a historic property or historic district, the result of the consultation may be design change, research and preservation, salvage, or in rare cases, rejection of the application for Firm Commitment. Consultation for these procedures may take considerable time before a Firm Commitment can be issued. Note that a review of published historic listings does not provide a conclusive determination of a property's historic significance. The Section 106 review gives equal consideration to properties that have already been included on the National Register as well as those that have not been so included, but that meet the National Register criteria. A project whose historic significance is not initially apparent may still affect a historic property. While age and integrity are considerations for historic listing eligibility, additional criteria include significance in American history, architecture, archeology, engineering, and culture, which can apply to more modern properties. Therefore, SHPO consultation is required for all transactions other than the exceptions listed at Section 7.5.D.3.a above.

8. Tribal Consultation:
    a. When Section 106 consultation is required, consultation with federally recognized Indian tribes and Native Hawaiian Organizations may be required

as part of the Section 106 process. Not all projects that require Section 106 review require consultation with Indian tribes. Consultation with federally-recognized tribes is only required when a project includes activities that have the potential to affect historic properties of religious and cultural significance to tribes. These types of activities include:

i. ground disturbance (digging),
ii. new construction in undeveloped natural areas,
iii. introduction of incongruent visual, audible, or atmospheric changes,
iv. work on a building or structure with significant tribal association, or
v. transfer, lease or sale of historic properties of religious and cultural significance.

Further guidance may be found in HUD's Notice on Tribal Consultation can be found on the ORCF Environmental Resource Page.

b. When tribal consultation is required, the HUD reviewer will utilize the HUD Tribal Directory Assessment Tool (TDAT) (see the ORCR Environmental Resource Page) during the environmental review process to determine if the site is located in an area of tribal significance. The tribal consultation requirement applies to properties off tribal lands as well as on tribal lands. Properties with religious and cultural significance to native people may include ancestral archaeological sites and natural areas where traditional practices or ceremonies have been carried out as well as more familiar historic properties. Some traditionally used places have very strong religious associations, and it may be difficult or even inappropriate for native people to talk about their significance. If this situation arises, hiring a qualified professional with experience in tribal consultation may be required. The cost of such an interpreter shall be paid by the Borrower.
c. Pursuant to the "anticipatory demolition" requirements of Section 110(k) of the National Historic Preservation Act (54 U.S.C. 306113), even before the concept meeting or application submission takes place, any action by a potential lender or borrower, or any action by another party that the lender or borrower has the legal power to prevent, that is taken with the intent to circumvent Section 106 review and that significantly adversely affects a historic property, could result in rejection of an application.
d. The Section 106 review must be completed before HUD approves and/or commits funds to a project. Additional guidance on historic consultation is available on the ORCF Environmental Resource Page.

F. **Noise** (24 CFR 50.4(k))**:**

1. New Construction/Conversion Projects: HUD standards regarding the acceptability of noise impacts on residential property are found at 24 CFR Part 51, Subpart B., which standards must be met for new construction and conversion from

nonresidential to residential projects. Where a project is within the criteria on distance from noise generators, a noise analysis utilizing the methodology in the most current version of HUD's Noise Guidebook will be performed as part of HUD's environmental assessment. HUD's automated Day/Night Noise Level electronic assessment tool is available on the ORCR Environmental Resource Page.

a. Standards: The degree of acceptability of the noise environment at a site is determined by the sound levels external to buildings or other facilities containing noise sensitive uses. The standards shall usually apply at a location 2 meters (6.5 feet) from the building housing noise sensitive activities, in the direction of the predominant noise source. Where the building location is undetermined, the standards shall apply 2 meters (6.5 feet) from the building setback line nearest to the predominant noise source. The standards shall also apply at other locations where it is determined that quiet outdoor space is required in an area ancillary to the principal use on the site.
    i. Sites with a day-night average exterior noise level of 65 DNL (Day Night Level) and below are acceptable.
    ii. HUD assistance for the construction of new noise sensitive uses is discouraged for projects with normally unacceptable noise exposure (above 65 DNL but not exceeding 75 DNL) and is prohibited generally for projects with unacceptable noise exposures above 75 DNL.
    iii. New construction or conversions of existing structures to residential housing in the Unacceptable Noise Zone, where outdoor noise levels are above 75 dB, are generally prohibited. If the Regional Office wants to consider such a proposal, it must:
        1. Prepare an Environmental Impact Statement (EIS). If ORCF believes that the proposal is acceptable based on the EIS, it must then obtain project approval, including approval of noise mitigation measures, from the Assistant Secretary for Community Planning and Development but must also obtain project approval, including approval of noise mitigation measures, from the Assistant Secretary.
        2. If ORCF determines that noise is the only environmental issue and no outdoor noise sensitive activity that is not mitigated to below HUD's 65-decibel standard will take place on the site, it may request a waiver of the EIS Requirement by the Assistant Secretary for Community Planning and Development but must also obtain project approval, including approval of noise mitigation measures, from the Assistant Secretary.

b. Projections of Noise Exposure: In addition to assessing existing exposure, future conditions should be projected. To the extent possible, noise exposure shall be projected to be representative of conditions that

are expected to exist at a time at least 10 years beyond the project application date.

c. HUD should be consulted prior to designing mitigation measures.

2. Existing and Rehabilitation Projects: For rehabilitation and refinancing, noise exposure will be considered as a marketability factor. For rehabilitation projects, HUD will encourage appropriate noise attenuation measures for inclusion in the alterations.

3. Railroad Vibration, Noise, and Location:
   a. Buildings closer than 100 feet to a railroad track are often subject to excessive vibration transmitted through the ground. New construction at such sites is discouraged. For existing properties, the structure should be examined for damage caused by vibrations. A railroad vibration study may be required.
   b. For new construction applications, a noise study for the railroad should be projected out 10 years to cover increased usage of the railway tracks.
   c. A rail line may not bisect a property, nor should a rail line's right-of-way generally encroach upon the site. Whenever rail lines are less than 100 feet from a facility, approval should be obtained prior to the application submission.
   d. Railyards (areas of multiple track sections used for assembling and disassembling trains) have been determined to create loud, impulsive sounds. Projects adjacent or with a direct line-of-sight to railyards must add 8 decibels to the noise exposure.

G. **Explosive/Flammable Hazards** (24 CFR 50.4(k))**:** HUD will not insure a property where structures and residents will be exposed to unacceptable risks posed by proximity to explosive or flammable hazards.

1. For new construction projects, rehabilitation projects where residential density is increased, projects where there is a conversion from non-residential to residential use, or projects where a vacant building is made habitable:

   a. Aboveground storage facilities with explosive or flammable material contents must comply with the Acceptable Separation Distance (ASD) standards at 24 CFR Part 51 Subpart C. Analysis of sites near or in the vicinity of these types of facilities must be performed by HUD as part of the NEPA environmental assessment in accordance with the HUD guidebook: "Siting of HUD-Assisted Projects Near Hazardous Facilities (Form HUD-1060-CPD)".
   b. If a plan is agreed upon with HUD before the issuance of a Firm Commitment, these hazards may be mitigated during the construction period, if the work can be done on the subject property. In cases where off-site mitigation is required, the remediation must be completed prior to initial closing.

2. A useful tool for calculating ASDs can be found on the ORCF Environmental Resource Page.

3. If a barrier will be constructed as hazard mitigation, HUD's Barrier Design Guidance (Guidebook 6600.G) for flammable/explosive hazards mitigation is available on the ORCF Environmental Resource Page.

   As stated in the guidebook, only a licensed professional engineer (civil or structural) should design and oversee the construction of mitigation barriers.

4. For existing projects to be refinanced or purchased that do not involve an increase in residential density, HUD will substantively evaluate the risks associated with proximity to hazardous facilities. HUD reviews of existing projects will consider the potential danger presented by existing and proposed liquid fuel and gas storage tanks, and may require mitigation.
   a. Whenever aboveground tanks (ASTs) exist on site, whether containing liquid fuel (over 100 gallons in size), or containing pressurized gas (stationary tanks of any size), a conformance letter from the governing Fire Department/District is required. The letter must specifically address the safety of the AST(s).
   b. In cases where safety letters cannot be obtained for existing ASTs, where new ASTs are being added, or where off-site tanks are in close proximity to the existing subject building, an acceptable separation distance (ASD) calculation must be included in the application, and mitigation may be required.

H. **Runway Clear Zone, Runway Protection Zones, Clear Zone, or Accident Potential Zone** (24 CFR 50.4(k))**:**

1. HUD standards regarding the acceptability of property located in Runway Clear Zones (also known as Runway Protection Zones), Clear Zones, and Accident Potential Zones are found at 24 CFR Part 51 Subpart D. An Accident Potential Zone is an area at a military airfield that is beyond the Clear Zone.

2. Construction or major rehabilitation of any property located within a Clear Zone is prohibited. Acquisition, refinance, and minor rehabilitation which do not extend the physical or economic life of projects within Clear Zones are allowed. HUD must determine that projects located in Accident Potential Zones are generally consistent with Department of Defense land use compatibility guidelines for Accident Potential Zones.

3. In acquisition transactions, HUD, as part of its environmental review for an existing property, shall advise the Lender, who will inform the Borrower purchasing the property, that the property is in a Runway Protection Zone or Clear Zone. Furthermore, it shall be explained that the implications of such a location are an increased likelihood of airplane crashes on the property and the possibility that the airport operator will acquire the parcel. The buyer must sign a statement

acknowledging receipt of this information. HUD may reject applications for mortgage insurance on an existing property within a Runway Protection Zone or Clear Zone because of the possibility that the property may be acquired at a later date by the airport operator.

I. **Wetlands Protection** (24 CFR 50.4(b)(3))**:**

1. Applications for mortgage insurance for new construction as defined in Executive Order 11990 (Protection of Wetlands) are subject to regulations regarding wetlands in 24 CFR Part 55 that implement EO11990. EO 11990 prohibits the development or disturbance of wetlands unless there is no practicable alternative and the proposed action includes all practicable measures to minimize harm to the wetland. Proposals impacting wetlands must be reviewed by HUD under the 8 step process in Part 55 to determine consistency with requirements of EO 11990.

2. The process for identifying wetlands is set out in Part 55. As primary screening, HUD will verify whether the project area is located in proximity to wetlands identified on the National Wetlands Inventory maintained by the U.S. Fish and Wildlife Service (FWS); if so, HUD will attempt to consult with FWS. Construction projects that will result in new construction as defined in EO 11990in a wetland will be considered only after HUD conducts an eight-step decision-making process, which is the same as the decision making process used for floodplains and includes consultation, issuing two public notices and taking public comment. However, the first five steps are not required if the project involves new construction outside the 100-year floodplain or 500-year floodplain and the applicant has submitted with its application to HUD an individual Section 404 permit (including approval conditions) issued by the U.S. Army Corps of Engineers, or by a State or Tribal government under Section 404(h) of the Clean Water Act, and all wetlands adversely affected by the project are covered by the permit. Wetlands under local or state jurisdiction are subject to state or local review as appropriate. However, compliance with state or local requirements is not a substitute for the eight-step process.
3. The Lender must provide extensive data to aid HUD in evaluating wetland impacts. The Lender should consult early with HUD when a site could potentially impact a wetlands area.

4. Only in rare cases will rehabilitation, purchase, and refinancing proposals be permitted to involve wetlands impacts.

5. When on-site wetlands exist, HUD will require assurance from the Borrower that no activities that may impact a wetland will be undertaken without prior approval from HUD.

J. **Other Applicable Federal Laws** (24 CFR 50.4**):**

1. Endangered Species: Under Section 7 of the Endangered Species Act, HUD must consult with the U.S. Fish and Wildlife Service (FWS) and/or, the National Marine

Fisheries Service (NMFS), whenever a proposal may affect an endangered or threatened species or its habitat. A required consultation should be completed for any site within the critical habitat of a listed species, but consultation may also be required even if no critical habitat is. In areas where impacts on endangered or threatened species are a concern, all appropriate information and the results of research regarding possible impacts of the project should be included in the application submission. Lenders should not contact FWS or NMFS directly. Consultation under Section 7 may result in more stringent conservation measures than would otherwise be imposed.

2. Sole Source Aquifers: An aquifer is an underground body of water usually kept in place by rock, gravel, or sand. New construction and some rehabilitation projects located within the boundaries of the recharge area of a designated sole source aquifer must be reviewed by EPA for their potential to contaminate the sole source aquifer.

3. Farmlands Protection: If the site of a proposed new construction project has not been previously developed, the project must conform to the Farmland Protection Policy Act. The environmental review must determine if the proposed HUD assisted project site is located in an area committed to urban uses and if not, whether it includes Important Farmland as identified by the Natural Resources and Conservation Service (NRCS), Department of Agriculture. If the proposed project site includes Important Farmland, the environmental review must include an evaluation of the land using form AD 1006, "Farmland Conversion Impact Rating." This requirement applies only to new construction activities and the acquisition of undeveloped land.

4. Environmental Justice: HUD will also determine whether or not Executive Order 12898, "Federal Actions to Address Environmental Justice in Minority Populations and Low-Income Populations," is applicable to the project. This EO requires that federal actions not result in disproportionately high and adverse human health or environmental effects on minority populations and low-income populations. When a project impacts a minority or low-income population, or when siting of a project raises questions of discrimination, HUD will perform the necessary analysis before determining acceptability of the project. Whenever possible, the Environmental Justice review should reflect input from affected minority and low-income communities. For more information, see HUD's website at: https://www.hudexchange.info/environmental-review/environmental-justice.

   HUD will advise the Lender of any Environmental Justice concerns including recommendations for their resolution. In most cases the preferred resolution would be to modify the project to eliminate or at least reduce the adverse effects, when feasible.

5. Applications for Firm Commitment for mortgage insurance are also subject to provisions of other Federal authorities, including the Wild and Scenic Rivers Act, and regulations implementing the Clean Air Act. There are state regulations implementing air quality requirements. HUD may require mitigation of a variety of nuisances and

hazards on the property that would affect the health and safety of residents and the security of the collateral.

K. **Commonly Found or Observed Additional Nuisances and Hazards:**

The following requirements apply to existing projects as well as to new construction and substantial rehabilitation activities.

1. All parts of any structure must be at least 10 feet from the outer boundary of the easement for any high pressure gas or liquid petroleum transportation pipeline.

2. No structure shall be located within the easement of any overhead high voltage transmission line. In addition, all structures shall be located outside the engineered fall distance of any support structure for high voltage transmission lines, radio antennae, satellite towers, cellular towers, etc. This does not apply to local service electric lines and poles. This policy does not apply to water towers.

3. Compliance with HUD requirements regarding operating and/or abandoned oil or gas wells, sour gas wells, and slush pits is recorded.
    a. Operating or planned drilling site: No residential structures may be within 300 feet from the boundary of the drilling site.
    b. Operating well: No residential structures may be within 75 feet of an operating well unless the following mitigating measures are taken:
        i. Maintenance of nuisance controls,
        ii. Controls of noise levels caused by pumping,
        iii. Restrictions on hours of operation,
        iv. Limits on supporting truck traffic, and
        v. Spill controls to reduce risk of contamination.
    c. Abandoned well
        i. Confirmation by the State government that the well is safely and permanently abandoned and that no residential structures are within 10 feet must be obtained.
        ii. If there is no confirmation letter, no residential structures may be within 300 feet of an abandoned well.
    d. Sour gas (hydrogen sulfide bi-product) wells: Separation distance must be determined by a petroleum engineer, with concurrence by State government.
    e. Slush pits (used for drilling mud mixes for well lubrication):
        i. If on-site, hazards analysis is required to be performed pursuant to Section 7.3 above. Mitigation must include, but not necessarily be limited to, removal of all drilling mud from the site and backfilling with clean compacted material.
        ii. If offsite, an analysis must be performed pursuant to Section 7.3 regarding offsite hazards.

4. If any part of a site appears to be developed on filled ground, HUD may require that all grading be properly controlled to prevent differential earth movement, sliding,

erosion, and/or other occurrences which might damage dwellings, streets or other improvements. Soil boring samples from filled areas must be submitted, as well as any other documentation regarding soil fill composition and compaction, to satisfy HUD as to its stability in place, re-grading or re-use.

5. If an existing property has a legal non-conforming use/structure, and the current zoning regulations will not allow the property to be rebuilt to the current density, then the owners are required to purchase Ordinance and Law insurance coverage with their property insurance; see Production, Chapter 14.5.B.

6. HUD may adopt additional requirements to address unique local concerns in specific geographic areas, but if any local requirement is mandated, ORCF must inform the HUD Headquarters Housing Environmental Clearance Officer of the requirement.

7.6 Lead Based Paint

A. Lead-based paint (LBP) may be present in buildings built prior to 1978. During any proposed repair work, the removal and disposal of the LBP must be performed in accordance with regulations as published and enforced by the State and the Department of Labor - Occupational Safety and Health Administration (OSHA). If required, appropriate lead paint remediation can be a required Firm Commitment condition on the HEROS Form HUD-4128. LSTF lead based paint requirements must be complied with.

B. HUD's lead-based paint requirements at 24 CFR Part 35 are applicable to housing built before 1978, but do not apply to housing designated exclusively for the elderly or persons with disabilities, unless a child of less than 6 years of age resides or is expected to reside in such housing. In addition, the requirements do not apply to 0-bedroom dwelling units. With the exception of Section 7.6.A, the requirements are not applicable to rehabilitation, refinancing or purchase of health care facilities under Section 232.

7.7 Asbestos Report

A. While many uses of asbestos are technically allowed today, several uses of asbestos were banned starting in the early 1970s, and many commercial enterprises have stopped installing asbestos products as of the late 1970s. Some of the more common examples of asbestos-containing materials include insulation, sprayed-on finishes, ceilings, vinyl floor tile and the adhesive to fix the tile in place, siding, and roofing. For any proposed project site containing structures built before 1978, asbestos should be discussed in the Lender Narrative, and an asbestos survey per 7.7.B. or C. is required.

B. For any structures on the site built before 1978 that are to be demolished, a comprehensive building asbestos survey by a qualified asbestos inspector is required. It must be based on a thorough inspection to identify the location and condition of asbestos throughout any structures and performed pursuant to the "**pre-construction survey**" requirements of ASTM E2356-10 "Standard Practice for Comprehensive Building Asbestos Surveys" (or the most recent edition). The survey must be completed prior to HUD issuance of a Firm Commitment.

C. Other than for structures to be demolished per 7.7.B, a qualified asbestos inspector must perform a comprehensive building asbestos survey on any building that was in whole or part constructed prior to 1978, based on a thorough inspection, to identify the location and condition of any asbestos throughout any structures pursuant to the "**baseline survey**" requirements of ASTM E2356-10 (or the most recent edition). The survey must be completed prior to HUD issuance of a Firm Commitment. In those cases where suspect asbestos is found, it should either be assumed to be asbestos or confirmatory testing should be required. If the asbestos survey indicates the presence of asbestos or the presence of asbestos is assumed, and if the application for Firm Commitment is approved, HUD will condition the approval on an appropriate mix of asbestos abatement and an asbestos operations and maintenance plan (O&M plan). O&M programs which establish management protocols for asbestos containing materials should be accompanied with evidence of hazard awareness training for maintenance staff. Training is to include Local, State and Federal regulations, as applicable.

D. If Asbestos Containing Materials (ACMs) or suspect ACMs are identified at a facility, HUD requires that a response action be appropriate to address the hazard. Response actions may include complete removal, limited removal/repair, encapsulation, enclosure or management under an O&M Program, as recommended by an accredited professional. The following are examples for when certain response actions may be appropriate.

Removal
- Damaged friable materials
- Friable materials in good condition with high potential for disturbance (e.g., accessible pipe or tank insulation, ceiling tiles where air exchanges occur in plenum above, ceiling tiles that are required to be moved to access mechanical equipment or piping on a routine basis, etc.)

Limited removal/repair, encapsulation or enclosure
- Damaged non-friable materials (limited removal/repair)
- Limited damage to ceiling texture (limited removal/repair)
- More extensive wall and/or ceiling texture damage or highly friable texture
- Pipe insulation with limited damage but with limited potential for disturbance/impact (enclosure or removal)

O&M
- Non-friable materials in good condition
- Joint compound or wall and ceiling textures in good condition
- Adhesive ceiling tiles with no real potential for disturbance

- Friable pipe insulation materials in mechanical areas in good condition with limited potential for disturbance/impact by routine maintenance activities.

E. Other than for asbestos abatement on a structure that will be completely demolished, the cost of any asbestos abatement activities may be included in the proposed mortgage loan, with HUD approval. If required, appropriate asbestos remediation can be indicated as a required Firm Commitment condition if HUD approves.

F. All asbestos abatement shall be done in accordance with EPA requirements for air pollution prevention pursuant to 40 CFR subpart M, especially 40 CFR 61.145, and with OSHA requirements for Worker Protection, pursuant to 29 CFR 1926.1101. Any LSTF asbestos abatement and worker protection rules also apply. All asbestos abatement must be performed by a qualified asbestos abatement contractor.

7.8 Radon Report

A. Background. One common constituent of soil and rock is the unstable element uranium. One of the decay products of uranium is radon, a colorless, odorless gas. Under certain natural conditions, the radon gas can enter surface soils and become part of the "soil gas" environment, which then can enter the air, including air inside of buildings. When soil gas that contains radon enters a building, radon and its decay products are either directly inhaled, or attached to dust on walls, floors and in the air, which then can be inhaled. These decay products then undergo further decay, resulting in the release of subatomic alpha particles. This alpha particle radiation can cause mutations in lung tissue which can lead to lung cancer. The risk of contracting lung cancer from radon increases with an increase in the concentration of radon in the air that is breathed by building occupants. EPA recommends mitigation for residences with radon concentrations at or above 4 picocuries per liter of air (pCi/L). Please see EPA Radon Map on the Environmental Resource Page located on the Section 232 Program website.

B. General Requirements

1. Radon Report.
    a. The radon report is required for all mortgage insurance applications, unless an exception listed in Section 7.8.B.3 applies.
    b. The radon report shall be included in the application, or early commencement requests, as applicable.
    c. Contents. The radon report shall include the results of any testing performed, the details of any recommended mitigation, and the timing of any such mitigation. An amended radon report must be issued if the testing and/or mitigation must occur after application submittal according to the requirements below. The radon report must be signed and certified as to its compliance with the requirements of this section by a Radon Professional.

2. Radon Professional.
    a. All testing and mitigation must be performed under the direct supervision of a Radon Professional, in accordance with the protocols referenced in this section.
    b. Radon Certification/License of the Radon Professional is required as follows:
        i. Certification from either the American Association of Radon Scientists and Technologists (AARST) National Radon Proficiency Program (NRPP) or the National Radon Safety Board (NRSB); and
        ii. Certification/License from the state in which the testing or mitigation work is being conducted, if the state has this requirement.

3. Exceptions to Radon Report.
    a. A Radon Professional may conclude that neither testing nor mitigation is necessary based on a physical inspection of the property, the characteristics of the buildings, and other valid justifications. An example of a valid justification is having only a garage on the surface level that is open to the air and is fully ventilated. Any such justifications as to why neither testing nor mitigation is necessary must be provided by the Radon Professional (signed letter) and documented in the Environmental Report. Any waiver requests submitted for this section (7.8.) must be made in accordance with this exception. Requests for waiver of this section 7.8 that do not meet the requirements of this exception will not be granted.
    b. A radon report is not required for applications that are categorically excluded under 24 CFR 50.19(b) (21) (see 7.1.A.5, above).
    c. Applicants are encouraged to test for radon even if a radon report is not required per the exceptions above. Any such testing must follow the testing protocols and resident notification protocols below, and must then be incorporated within a radon report as described within this section. If the results of such testing indicate levels of radon above the threshold for unacceptability, mitigation as described in this section is required, with the mitigation requirements for Section 223(a)(7) projects the same as those for 223(f) projects.

4. Testing Protocols.
    a. Radon testing must follow the protocols set by the American Association of Radon Scientists and Technologists, Protocol for Conducting Measurements of Radon and Radon Decay Products in Schools and Large Buildings (ANSI-AARST MALB-2014, or most recent edition) (Please see ORCF Environmental Resource Page located on the Section 232 Program website). Applicant has the option to test 25% of ground level units/rooms in each building (sampling). If any of the sampled units/rooms is tested above the 4.0 picocuries per liter (4.0 pCi/L), then they have two options:
        i. Mitigation in 100% ground level units/rooms or
        ii. Test 100% ground level units/rooms. If during 100% ground level test, any units/rooms test above 4.0 pCi/L level, then follow the requirements of the standard above.

b. Threshold for unacceptability: 4.0 picocuries per liter (4.0 pCi/L) based on initial and any confirmatory testing, if performed.

5. Occupant Notification.
    a. Testing. Occupants of all new applications for OHP mortgage insurance programs shall be informed of forthcoming testing in the manner described in AARST MALB-2014.
    b. Mitigation. Occupants shall be informed both prior to and after mitigation activities. In the case of new construction, incoming occupants shall be informed of radon mitigation activities.

6. Mitigation Standards. Radon resistant construction is required for all new construction, and radon mitigation is required for existing construction where testing has revealed that radon levels exceed the threshold for unacceptability. The Radon Professional must assure that radon resistant construction or radon mitigation, when required, conforms to the following standards.
    a. Existing buildings:
    ANSI-AARST RMS-LB 2014, Radon Mitigation Standards for Schools and Large Buildings (Please see the ORCF Environmental Resource Page located on the Section 232 Program website).
    b. New construction: Radon Prevention in the Design and Construction of Schools and Other Large Buildings EPA 625-R-92-016, June 1994 (Please see the ORCF Environmental Resource Page located on the Section 232 Program website).

7. Mitigation Timing. For new construction and substantial rehabilitation properties, all mitigation, including follow-up testing, must be completed prior to Final Closing. Radon mitigation included as part of a Section 223(f) or 223(a)(7) project's repairs must be completed as quickly as practicable, and in any event, no later than 12 months after Closing.

8. Certificate of completion. A certificate of completion from the Radon Professional must be submitted and appended to the radon report once radon testing and/or mitigation is completed.

9. HUD requires an operation and maintenance (O+M) plan for any mitigation project that is active. A condition shall be attached to the Firm Commitment requiring that the borrower operate and maintain the property consistent with the referenced O+M plan(s) for the duration of the insured mortgage. Given the ongoing risk associated with radon, an O+M requirement for maintaining active mitigation systems should be implemented when an active mitigation system is present on the property.

10. Cost estimate. Use detailed plans and specifications supplied by the lender's architectural analyst as a basis for the cost estimate. Estimates must reflect the

general level of construction costs in the locality where construction takes place. Costs must be projected to the estimated construction start date.

C. Section 223(f) and Non-Excepted Section 223(a)(7).

1. All Section 223(f) and non-excepted 223(a)(7) projects must be tested for radon in accordance with 7.8.B.4, above. Testing must be performed no earlier than 1 year prior to application submission.

2. Mitigation. See requirements at 7.8.B.6. If estimated costs exceed the allowable cost for the Section 223(f) program, the application cannot be approved but may be considered under the substantial rehabilitation program.

D. Substantial Rehabilitation and Conversions. (Applies to all Radon Zones)

1. Testing prior to substantial rehabilitation or conversion.
    a. Early testing not feasible. For some proposals, such as a conversion of an existing building from non-residential to residential, the building envelope may change to such an extent that early testing would not be appropriate and in some cases not possible. If this is the case, proceed directly to mitigation as discussed at Section 7.8.D.2.
    b. Early testing when feasible.
        i. Must be performed no earlier than 1 year prior to application submission in accordance with 7.8.B.4.
        ii. If test results are below the threshold, no mitigation is required.
        iii. If test results are at or above the threshold, mitigation must be built into the project design per Section 7.8.D.2.a.

2. Mitigation.
    a. If mitigation is built into project design, it must be conducted in accordance with the requirements at 7.8.B.6.
    b. If mitigation is not built into project design, after construction is complete but prior to Final Closing, radon testing must be conducted. If testing results are above the threshold, retrofit pursuant to the requirements at 7.8.B.6 is required.

E. New Construction.

1. Radon resistant construction is required for all radon zones.

2. Radon Zone 1:
    a. Construction Requirements: All new construction in Radon Zone 1 must meet all of the requirements of ASTM E1465-08a for installation of passive systems.

b. Post-construction testing is required prior to Final Closing. If testing results are above the threshold, conversion from a passive system to a fan-powered system is required.

3. Radon Zones 2 and 3:
    a. Construction requirements.
        i. Gas permeable layer. The gas permeable layer must meet all of the requirements of ASTM E1465-08a, Section 6.4.
        ii. Ground cover. The concrete slabs and plastic membranes that seal the top of the gas permeable layer must meet all of the requirements of ASTM E 1465-08a, Section 6.2.
        iii. Foundation walls. Foundation walls must meet all of the requirements of ASTM E1465-08a, Section 6.3.
    b. Post construction testing is required, except as provided at 7.8.B.3.
        i. Radon testing must be performed after construction is complete, but prior to Final Closing.
        ii. If testing results are above the threshold, retrofit based on the applicable standard at 7.8.B.6 is required, with installation of a passive system. If testing results remain above threshold, a fan-powered system is required.

Section II
Production

Appendix 7.1

Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care

ORCF Environmental Resource Page:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care/environmental_resources

FEMA website:
www.fema.gov

Form Number	Form Name
HEROS	HUD Environmental Review Online System
FEMA Form 086-0-32	Standard Flood Hazard Determination Form

Section II
Production

Chapter 8
Operator and Management Agent Analysis

8.1 Introduction

Operators and Management Agents that operate FHA-insured residential healthcare facilities play a key role in providing quality housing and health services, critical to the success of the project over the life of the mortgage. To this end, ORCF requires that detailed Operator and/or Management Agent documents be submitted for approval with the application or when there is a proposed change in the Operator and/or Management Agent.

It is the Lender's responsibility to review whether the proposed Operator and/or Management Agent demonstrate the capability and track record to assure that the project will be operated in a prudent, efficient, and cost-effective manner, while providing excellent care to the residents.

ORCF holds the Borrower ultimately accountable for all functions and actions necessary to sustain an insured healthcare project. That ultimate project responsibility holds regardless of the Regulatory and/or Management Agreements the Operators and/or agents sign.

Once the Lender recommends approval, ORCF must also approve a proposed Operator and/or Management Agent prior to their involvement in a Section 232 project.

8.2 Operators

An "Operator," for purposes of projects insured under Section 232 of the National Housing Act, is the legal entity licensed by the applicable state licensing authority to "operate" a particular healthcare project. Thus, the state awards a particular entity the right to provide resident care services and to conduct the usual and necessary business matters of a healthcare provider at the designated project. Thereafter, the state holds the licensee accountable for its healthcare services provided and its business conduct in accordance with existing standards and regulations.
In certain jurisdictions, the state licensing authority may name more than one entity on the project operating license. For purposes of ORCF requirements, all such entities shall be

considered an Operator and shall be held to the same submission standards and regulatory requirements.

ORCF requires that an operator of an FHA-insured healthcare project be licensed as the project Operator by the state. ORCF also requires that the Operator be a single-asset entity acceptable to the Commissioner, and that it possess all powers necessary and incidental to operating the healthcare project. Occasional exceptions may be granted under such circumstances, terms and conditions determined and specified by the Commissioner. Circumstances under which exemption from this single asset operator entity requirement may be considered are set forth in Production, Chapter 2, at 2.5C.

In some cases, the licensed Operator of a healthcare project may also be the owner of the project. These circumstances, where the same entity is both Borrower and Operator, are acceptable to HUD and may be referred to by the terms "Owner/Operator" or "Borrower/Operator." In those instances, the same entity signs the Healthcare Regulatory Agreement-Borrower, Form HUD-92466-ORCF, and the separate Healthcare Regulator Agreement-Operator, Form HUD-92466A-ORCF. The same entity also signs the Security Instrument, Form HUD-94000-ORCF and the Operator Security Agreement, Form HUD-92323-ORCF. Both the Opinion of Borrower's Counsel, Form HUD-91725-ORCF and the Opinion of Operator's Counsel, Form 92325-ORCF are also required.

More common are arrangements in which the Borrower leases the project to a separate healthcare provider entity which is granted the operating license from the state and which is separately approved as the Operator by ORCF. In such cases, the Operator is usually not subject to Borrower oversight or limits on its powers required to operate the healthcare project. Such an entity may be referred to as a "lessee-operator." Under such circumstances, HUD requires that the operating lease between the Borrower and the ORCF approved Operator conform to HUD Program Obligations. In part, those obligations require the incorporation of the Operating Lease Addendum, Form HUD-91116-ORCF, which ensures that the Operator is held accountable for all business and healthcare services and the related cash flows from providing those services.

In yet another circumstance, a licensed Operator, rather than leasing the project, contracts with the Borrower to operate the project for a negotiated fee (through, for example, an "Operating Agreement" or a "Management Agreement"). In such circumstances, including those in which a Management Agent is the co-licensee for a healthcare project, such entity shall be subject to the same requirements as an Operator. In these instances, the contract made between the Borrower and approved Operator requires ORCF approval. In any case HUD ORCF enforces the Operator's responsibilities via the Healthcare Regulatory Agreement-Operator.

In some situations, the managing entity may be contractually defined as a Management Agent, but ORCF would deem that entity to be the Operator (and thus would require the Healthcare Regulatory Agreement-Operator) if any of the following apply:

A. the entity's name appears on the state-issued facility operating license;
B. the entity holds the Provider Agreements with CMS;
C. the entity contracts to provide patient services (Admissions Agreement); or

D. the entity holds the state awarded Certificate of Need (if applicable).

In some circumstances one or more of these criteria may apply and yet some substantial provisions of the Healthcare Regulatory Agreement—Operator may not apply to the party. In those situations, HUD will evaluate the circumstances and consider the sufficiency and appropriateness of using the Management Certification – Residential Care Facility (Form HUD-9839-ORCF) as an alternative controlling document with that party, including the use of an addendum thereto if appropriate to the particular transaction. Assuring that HUD's interests--including but not limited to its security interest in the license--are fully protected would remain paramount.

Additionally, the licensed Operator, whether or not that Operator is also the Borrower, sometimes itself enters into a further contractual agreement with yet another party with respect to management. ORCF requires that a licensed Operator execute a Healthcare Regulatory Agreement-Operator, regardless of whether the Operator's contract with the project is a Lease, an Operating Agreement, a Management Agreement, or in the case of a Borrower/Operator, as the borrower entity itself. Further, if a party other than the licensed Operator is exercising a managerial role pursuant to a Management Agreement, then that party must execute an ORCF Management Certification-Residential Care Facility.

8.3 Management Agents

A "Management Agent" for purposes of projects insured under Section 232 of the National Housing Act, is an entity that directs the day-to-day functions of a healthcare project as a contracted agent for either the Borrower or the Operator. A Management Agent performs its duties under the oversight of either the Borrower or Operator, as applicable, and is thereupon limited in powers and project authority to the levels expressed by the Borrower and/or Operator in accordance with a negotiated "management agreement." The Management Agent must be approved by ORCF prior to participation, and the management agreement must be approved by HUD prior to execution. A Management Agent is regulated by the management agreement and by the terms of a Management Certification-Residential Care Facility.

The specific duties and restrictions of the Management Agent must be described in the HUD-approved management agreement negotiated between the Borrower and/or the Operator, and such Management Agent. A Management Agent is typically paid a negotiated fee for services provided, often in an amount based on a percentage of gross receipts of the project. All such fees must be sufficiently described in the management agreement. A Management Agent's authority to make expenditures from project accounts must also be defined in the management agreement.

8.4 Operator and Management Agent Qualifications

The Lender must ensure that the proposed Operator and/or Management Agent have the business and healthcare expertise to market and operate the proposed project. Inherent in this expertise is knowledge of the intended clientele, their specific health-related and hospitality needs, and the best approach to meeting these needs. At least one principal or entity of the proposed Operator or Management Agent must have a proven track record of successful operations in the type of project proposed (e.g. Nursing Home, Assisted Living, Memory Care or Board & Care). Principals must have at least 3 years of experience participating in multiple properties. Longer operating histories may be required for participants with only one project. Experience must include developing, marketing, operating, and, as applicable, lease-up of the type of project proposed. Evidence of appropriate experience must be provided that includes specific project examples including project name, type of care provided, location, and unit/bed count. For projects adding units to a market, evidence must also include year opened and key operating metrics (fill pace, occupancy, net operating income margins), and specific responsibilities for the management and operation of the example healthcare project. ORCF is seeking assurance that the Operators and Management Agents are committed to the long-term success of the project and have the requisite experience to operate and manage the project.

8.5 Expectations for Consultant and Contractor Performance

Borrowers, Operators and/or Management Agents may, without ORCF's consent, (but as limited by Program Obligations, the operating lease and the management agreement, as applicable), engage consultants or contractors to provide assistance and/or guidance in specialized areas. Certain engagements of consultant services, such as the hiring of legal counsel, are for services clearly beyond the traditional scope of managerial expertise. Other such engagements may be for consultants that offer a highly specialized skill in a narrow area of project operations, such as pharmacy, psychiatry, rehabilitation management and case coding, and are generally advisory in scope and for a negotiated fee over a limited period of time.

Consultants are distinguished from Management Agents as follows:

A. Consultants make recommendations and have no contractual or other authority to commit or exact resolutions of their own.
B. Consultants advise on matters within specific areas of expertise for a specific time frame.

If an entity, which was presented by the Borrower or Operator to be a consultant, is found by HUD to have project commitment authorities or to be providing a wide scope of managerial services over an extended time period, ORCF may deem the consultant to be a Management Agent and will require that the entity be reviewed and approved as a Management Agent.

8.6 Operating Lease Requirements

For projects in which the Borrower is not the licensed Operator of the healthcare project, the licensed Operator must have a contractual obligation with the Borrower. In the event that this contractual obligation is a lease, the following requirements apply.

The lease payments must be sufficient to (1) enable the Borrower to meet debt service and impound requirements and (2) enable the Operator to properly maintain the project and cover operating expenses. The minimum annual lease payment must be at least 1.05 times the sum of the annual principal, interest, mortgage insurance premium, Reserve for Replacement (R4R) deposit, property insurance and property taxes.

The minimum operating lease term is five years; however, in the event that ORCF is relying on the Operator for experience, a longer term may be required. Amendments for substantive matters may be made during the term of the lease with HUD's prior approval.

The lease must provide a description of the responsibilities of the Borrower and Operator under the terms of the lease including, but not limited to, the following: payment of real estate taxes; maintenance of building; capital improvements; replacement of equipment; property insurance; and fidelity bond coverage.

A. All ORCF leases must incorporate by reference the HUD-required lease addendum

B. **Additional Master Lease Requirements.** Operators that sublease the healthcare project from a master tenant are also subject to those additional operating lease requirements described in detail in Production, Chapter 13.

8.7 Management Agreement Requirements

Either an Operator or Management Agent may have a management agreement. If the contractual obligation between the Borrower and Operator is termed a management agreement, then the management agreement must comply with ORCF's management agreement requirements and Management Agent must execute a management certification.

A. **Required Content:** The parties shall negotiate their own form of agreement provided that it contains language to meet the following HUD requirements:

   1. **Scope of service:** The proposed management agreement shall describe all services the Management Agent will be responsible for performing and for which the Management Agent will be paid management fees. Such description of services shall include an explanation of employee salaries covered by the respective management fees.

2. **Project Authority Limitations:** The management agreement shall define the expenditure limits granted to the Management Agent by the Borrower or Operator.

3. **Required HUD provisions:** All agreements shall provide the following:
    a. Upon failure to comply with the provisions of Management Certification to HUD, or for other good cause, including without limitation for violations of the Borrower's Regulatory Agreement, Operator's Regulatory Agreement, and/or Master Tenant's Regulatory Agreement, if any, thirty (30) days after HUD has mailed to Borrower, or Operator, as applicable, a written notice of its desire to terminate the Management Agreement.
    b. In the event that HUD determines that any of the Permits and Approvals reasonably necessary to operate the Healthcare Facility is at substantial and imminent risk of being terminated, suspended or otherwise restricted, if such termination, suspension or other restriction would have a materially adverse effect on the Project, the Management Agreement shall terminate immediately without penalty upon HUD's issuance of a notice of termination to Borrower, or Operator, as applicable, and such management agent.
    c. The Management Agreement may not be assigned without the prior written approval of HUD.
    d. Upon HUD's request for termination, Borrower, or Operator, as applicable, shall immediately arrange to terminate any such Management Agreement and shall make arrangements satisfactory to HUD for the continuing proper management of the Healthcare Facility and the Project.
    e. If the Management Agreement is terminated the Agent will immediately, not later than thirty (30) calendar days from the effective date of the termination, give to the Borrower (or Operator, if applicable) all of the real and personal property in the Agent's possession or control, including without limitation any of the Project's cash, trust accounts, investments, books and/or records.
    f. The Management Agent cannot be indemnified from liability for gross negligence and/or willful misconduct.
    g. ORCF's rights and requirements will prevail in the event of conflicts between the Management Agreement and program requirements.
    h. Any material amendment to the management agreement must be acceptable to HUD, in accordance with Program Obligations.

4. **Length/term of the agreement.** The length and/or term of the management agreement are to be negotiated amongst the respective parties to such agreement. However, ORCF may require that the term be amended based on the circumstances of a particular approval.
    a. The contract may provide for a fixed term or an open-ended term (e.g., automatically renewable to remain in effect until cancelled by ORCF, and/or the participant parties).
    b. If the length/term of the Agreement changes, ORCF requires the submission of a new Management Certification.

If the project has a Management Agreement with an original fixed term of less than five years, the request needs to include a plan for transitioning to a qualified replacement Management Agent.

5. **Management Fee.** Management agents may be compensated either based on a percentage of project receipts or as a negotiated flat rate on a designated, recurring basis (usually on a monthly basis). However, such fees, incentives, bonuses and other considerations must be clearly designated in the management agreement, must be computed and paid in accordance with HUD Program Obligations, and must be approved by ORCF. The management agreement must describe in sufficient detail all specifics of the Management Agent compensation, including how the management fee will be calculated and whether any incentive or other fees will be paid from surplus cash. ORCF will consider whether such fees are adequate and reasonable for the scope of services proposed. ORCF may require the proposed Management Agent to submit evidence that certain fees are reasonable and customary.

8.8 Lender Responsibilities

The Lender is responsible for reviewing the qualifications of the proposed Operator and/or Management Agent to assess their ability to operate the project effectively and in compliance with ORCF requirements. The Lender must consider each of the below factors in reviewing an Operator and/or Management Agent's qualifications paying particular attention to the Operator and/or Management Agent's past and current experience. In addition, the Lender must review whether a Healthcare Regulatory Agreement-Operator or Management Certification-Residential Care Facility is required for each entity.

A. **Experience:** Experience with projects similar in scope and services to the subject.

B. **Track Record:** A positive track record of compliance with the regulatory requirements of the licensing authority and funders. This includes being in compliance with all laws, regulations and requirements of Federal, State and Local regulatory bodies.

C. **Operational History:** Operational history with regard to billing, controlling operating expenses, vacancy rates, resident turnover, rent collection and accounts receivable/accounts payable, physical security, physical condition and maintenance, resident relations, tenant income certification, and record keeping and reporting if the project is an affordable or subsidized project.

D. **Creditworthiness and Financial Strength:** Creditworthiness and financial strength of the Operator and/or Management Agent. See Production, Chapter 6 for a more detailed explanation of the review requirements.

E. **Previous HUD Experience:** The Lender must review the Previous Participation Certification, to determine whether there are any "Unsatisfactory Management Reviews" or Real Estate Assessment Center (REAC) scores lower than 60. The Lender must provide

ORCF with an explanation of any adverse scores. More information on the Previous Participation Certification is found in Production, Chapter 2, as well as in Housing Notice H 2016-15 (or successors thereto).

F. **Duties and Responsibilities:** Review the description of the duties and responsibilities of the Operator and/or Management Agent (i.e. who will control the operating accounts; contract for services; recruit, select or train employees; take responsibility for the management of the functional operation of the project or the execution of the day to day policies of the project; etc.). Those entities and people responsible for each duty must have sufficient experience carrying out that function.

G. **State Surveys:** Review State surveys for the last three years for all skilled nursing facilities owned/operated and/or managed by the Operator and/or Management Agent and for all skilled nursing facilities on the subject's Professional Liability Insurance policy. Check to see whether the surveys indicate any instances of actual harm and/or immediate jeopardy, or if there are open findings. If this is the case, provide a narrative explanation of the risk <u>and</u> how it will be mitigated.

The Lender must also check to see if any of the facilities owned, operated and/or managed by the Operator and/or Management Agent:

1. are on the Special Focus Facility list or have been notified of being a Special Focus Candidate;

2. have paid Civil Money Penalties above $10,000 and/or had a Ban or Hold on Admissions; or

3. have any pending, current or anticipated rate reductions.

H. **Centers for Medicare & Medicaid (CMS) Star Ratings:** The Lender must review the CMS Star Ratings for the subject and any other facilities that the Operator and/or Management Agent owns, operates or manages. The Lender must discuss the resident care issues for all facilities with one or two stars and remedial steps the participant has taken to date. The Lender must provide an explanation as to why the Operator and/or Management Agent should be allowed to participate in ORCF's programs despite the low scores.

I. **Staffing Levels:** The Lender must provide a listing of the staff whose salaries will be paid from the project's operating account. The list must include:

1. job titles and approximate salary, including hourly rates; and

2. a statement of each position's duties, if not obvious by title and whether the position is full or part-time; and

3. if the employee will be working for more than one project and/or working part-time for the agent in a non-supervisory capacity, a statement of how that person's time and salary will be allocated.

Note: Salaries of Management Agent supervisory staff not assigned to the project must be paid from the management fee. Only full-time, front-line supervisors may be paid from the project account.

The Lender must review job-titles, duties, and salaries of all employees to be working for the project to determine if the number, salaries, and duties of the proposed staff are reasonable for the size and type of the proposed project. The Lender must identify whether the proposed staffing levels are reasonable based on patient acuity, economies of scale of operations, state regulatory requirements, etc.

J. **Project Administrator**: Skilled Nursing Facilities require a licensed Nursing Home Administrator (Administrator). An administrator is an employee of the project or one of the participant entities, who is responsible for directing the day-to-day activities of a project designed for elderly, handicapped, or disabled residents. The administrator typically has a job description and may have an employment agreement, but receives a salary rather than a management fee. The Lender must ensure that the administrator is properly licensed and is qualified to act as administrator for the subject project. The administrator must have at least three years of experience. For existing facilities, the Lender must review the administrator's past performance.

K. **Marketing, Leasing, and (if applicable) Relocation Plan:** All projects which require absorption of beds/units to achieve break-even occupancy must submit a detailed marketing and leasing plan and budget that has been reviewed and confirmed by the proposed Operator and/or Management Agent. The plan must discuss when marketing efforts will begin, when the leasing office and model units will be opened, how the leasing office will be staffed, and the project's marketing and advertising strategy. The plan must address timing of the construction progress schedule with respect to egress and ingress into the project, landscaping, and access to amenities. For projects involving temporary relocation or displacement of existing residents, the plan must address details of timing, funding and management of the relocation process. A relocation budget must clearly identify fixed costs (administrative and other overhead) and variable costs (which vary by the number of residents to be relocated).

L. **Past Performance with Identity-of-Interest Contractors**: If the Borrower, Operator or Management Agent intends to acquire goods or services from identity-of-interest companies and has previously operated FHA-insured projects, the Lender must assess that party's past use of such companies and whether this use resulted in costs to the project that exceed the prices paid in arms–length transactions. The review must especially consider:

1. goods and services purchased through any "pass-through" arrangements;

2. evidence that the agent has compared prices and that the use of any identity-of-interest companies or pass-through arrangements has been more advantageous to the project than purchasing through arms-length transactions would have been; and

3. evidence that the Management Agent followed reasonable contracting and hiring procedures.

M. **Management Fee:** The Lender must review the management fee for adequacy and reasonableness for a project of the scope of services proposed. ORCF may require the Lender to submit evidence that the fee is reasonable and customary.

N. **Fidelity Bond Coverage:** The Lender must assure that the entity that contracts with Medicare and/or Medicaid and the entity that controls the project's operating accounts have Fidelity Bond Coverage of at least two months of underwritten or actual gross potential income, whichever is higher.

O. **Additional Documentation.** The Lender may also utilize the following additional sources, without limitation, to determine the capability and expertise of the proposed Management Agent and Operator:

1. ORCF/Lender on-site review reports;

2. correspondence;

3. resident complaint files;

4. previous management reviews; and

5. reviews from Federal, State or Local government agencies of the Management Agent or Operator's past experience with properties using affordable housing or subsidy programs, if applicable.

If problems are identified with any of the above indicators, the Lender must assess whether the Operator and/or Management Agent have adequately improved their procedures to prevent the recurrence of such problems or whether initiatives by the Operator and/or Management Agent are sufficient to correct the problems and their causes. In addition, the Lender must submit relevant documentation for identified problem areas including letters from Federal/State/Local agencies and plans of action to support their conclusion.

8.9 ORCF Underwriter Review

ORCF will review the Lender's recommendation and application documentation and will make the final determination to accept or reject the proposed Operator and/or Management Agent.

A. **Management Agent Forms:** The ORCF Underwriter will review the Management Certification-Residential Care Facility and the Management Agreement for projects with a Management Agent to assure they meet ORCF requirements and are consistent with the application.

B. **Management Fee:** The ORCF Underwriter will review the Lender's determination regarding the reasonableness of the management fee. ORCF will approve the Management Certification if the management fee is determined to be acceptable.

C. **State Surveys (Skilled Nursing Facilities only):** The ORCF underwriter will review state surveys for the last three years and the Lender's explanation for projects where there are instances of actual harm and/or immediate jeopardy, and for projects with open findings.

D. **Other:** ORCF may also review other pertinent information available. In the instance of existing Section 232 projects, this may include, but not be limited to, past REAC physical inspection scores (if applicable) and referrals to HUD's Departmental Enforcement Center.

Section II
Production

Appendix 8.1

Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care

Form Number	Form Name
HUD-92466-ORCF	Healthcare Regulatory Agreement-Borrower
HUD-92466A-ORCF	Healthcare Regulatory Agreement-Operator
HUD-91116-ORCF	Addendum to Operating Lease
HUD-9839-ORCF	Management Agent Certification-Residential Care Facility
Notice H 2016-15	Processing Guide for Previous Participation Reviews of Prospective Multifamily Housing and Healthcare Programs' Participants (or successors thereto)

Section II
Production

Chapter 9
Closings

9.1 Introduction

A. After the Firm Commitment is issued, the closing of a Section 232 project is a collaborative effort primarily among the ORCF Closing Coordinator (hereinafter referred to as the "Closer"), the HUD Closing Attorney (hereinafter referred to as the "HUD Attorney"), the Lender's Attorney, and the Lender. This Chapter focuses mostly on the closing roles and requirements of the Closer and the Lender. In addition to the requirements set forth in this Chapter, more detailed requirements for the Lender's Attorney and HUD Attorney are distributed by the HUD Office of General Counsel. The contents within this Chapter are not intended to be and must not be interpreted as legal guidance.

B. **Lender's Responsibilities.** Lenders are strongly encouraged to engage and be represented by competent legal counsel throughout the loan application and closing document preparation and submission process. Lenders should not rely on personnel other than their legal counsel, and legal support staff under the careful oversight of legal counsel, in preparing and submitting closing documents. It is HUD's experience that Lenders that rely on personnel other than those with proper legal training and experience often submit incomplete closing documents with numerous errors. This practice unnecessarily consumes HUD staff time and greatly increases the chances for disruptive and delayed closings, which ultimately becomes more expensive to the parties. At the HUD Closing Attorney's discretion and in accordance with professional responsibility standards, the HUD Closing Attorney may decline to communicate with anyone other than the Lender's attorney with respect to the transaction.

9.2 The ORCF Closer

ORCF utilizes a Closer for all of its closings. A Closer will be assigned to a project after the Firm Commitment has been issued. The Closer serves as the main point of contact for ORCF and will work closely with all of the parties to ensure that ORCF program and administrative requirements are satisfied prior to closing. The Closer's responsibilities include, but are not limited to, the following:

A. **Draft Closing Documents.**

1. Upon assignment, the Closer will send an introductory email to the Lender and the Lender's Attorney with directions on the delivery of the draft closing documents to the Closer. If the closing documents are incomplete or substantially incorrect, the project may be marked inactive, removed from the Closer's assignments, and placed back in the closing queue. Once a complete/acceptable closing package is received and verified, the project will be marked as active and reassigned to a Closer as availability allows.

2. The appropriate closing checklist must be placed in front, on top of the closing package. (Closing document checklists are referenced in Appendix 9.1.) Documents must be tabbed according to the corresponding number on the checklist. All documents must be submitted in one hard copy package. The closing package must also contain evidence that all Special Conditions have been satisfied.

3. HUD anticipates that the documents in every submission are the final drafts of documents that all parties to the transaction have agreed upon prior to submission. If documents need additional review by the parties or by third parties, then the submission must be held until all issues can be resolved and final draft versions of documents can be submitted for HUD review.

4. The closing package must include both a clean copy of each document and a redline of the document against the HUD form where applicable. If a document is being resubmitted in response to HUD comments, that second submission must include both a clean copy of the document and a redline against the earlier submission. All proposed changes must be approved by both the Closer and HUD Attorney.

5. The Closer will review the draft closing documents to ensure that all programmatic requirements are met, all Special Conditions have been satisfied, and any repairs have been acceptably completed with adequate evidence. The Closer will notify the Lender, the Lender's Attorney, and the HUD Attorney of any deficiencies. The HUD Attorney will perform a similar, but legal, review and will notify the Closer and Lender's Attorney of any deficiencies. All deficiencies must be cured prior to establishing a closing date. Failure to cure deficiencies will lead to a canceled or delayed closing.

6. Piece-meal deficiency responses will not be accepted. Instead, responses to deficiencies must be submitted together in one e-mail or package with a written explanation. The written explanation must clearly identify which documents are attached and what changes have been made.

B. **Amendments to the Firm Commitment.** Requests to amend the Firm Commitment must be submitted to the Closer on Lender letterhead; the request must list the proposed amendments and attach the proper documentation. The Closer will review and, if appropriate, prepare, execute, and distribute the amendment.

C. **Completion of Repairs.** If required by the Firm Commitment, the Closer will ensure that repairs are completed. The Closer will review evidence of completion, including supporting photographs and invoices, and the Borrower's Certification—Completion of Critical Repairs (Form HUD-91118-ORCF). For non-critical or Borrower elected repairs, the Closer will review the Escrow Agreement for Non-critical, Deferred Repairs (Form HUD-92476-ORCF) and list of repairs to be completed. For non-critical or Borrower elected repairs completed prior to closing, the Closer will review evidence of completion (photographs and invoices) and the Borrower's Certification-Full or Partial Completion of Non-Critical Repairs (Form HUD-92117-ORCF). If any remaining repair items are not completed, the Closer will review and approve a request for amendment to the Firm Commitment with a revised list of repairs.

D. **Survey and Title.** If necessary, the Closer will coordinate resolution of any issues related to the title and ALTA survey. ORCF expects covenants that run contrary to the Fair Housing Act or other civil rights laws to be removed. To avoid delays in closing, the parties should discern early whether such covenants exist and, if so, immediately commence necessary actions to remove them. Initiating this effort obviously involves having a title search conducted early in the application process. In the event that, despite such timely and ardent effort, the parties are not able to timely obtain removal of the covenant, then, in order to avoid a closing delay, ORCF would expect those efforts to be clearly documented and would expect documents to be executed affirmatively acknowledging the unenforceability of such provisions and repudiating them.

E. **Management Conference Call.** If applicable, the Closer will ensure that a conference call between the ORCF servicing Account Executive for the project and the Borrower occurs prior to closing.

F. **Closing Statements and Cost Certifications.** The Closer will review and examine all closing statements and, if applicable, cost certifications (e.g., the Borrower's Certificate of Actual Cost (Form HUD-2205A-ORCF). The Closer will review all supporting documents such as the payoff letters and invoices.

G. **Execution of ORCF Closing Documents.** Once all program and legal requirements are met, the Closer will work with the Lender's Attorney, the Lender, and the HUD Attorney to ensure that HUD signatory closing documents are signed by the appropriate ORCF Authorized Agent in advance of the closing. Documents must not be sent for ORCF's signature without prior, express approval from the Closer.

H. **Closing Date.** The Closer will work with the HUD Attorney and the other parties to help determine a closing date. A closing date may be canceled or delayed if program or legal requirements are not fully satisfied.

I. **Amounts Due to HUD.** The Closer will confirm the correct amount of the Mortgage Insurance Premium (MIP) due at closing and, if applicable, the Inspection Fee, and/or an additional Application Fee. All such payments shall be made through Pay.gov prior to

closing and evidenced by appropriate receipts. See Section 9.5 below for more information on required fees and refunds.

9.3 The Lender

The following are key responsibilities of the Lender in the closing process. In addition, it is the Lender's duty to keep the Closer informed of any special circumstances related to the closing.

A. **Execution of Firm Commitment.** The Lender should execute and have the Borrower execute the Firm Commitment within 10 business days of receiving the Firm Commitment. Acceptance of Firm Commitments executed beyond 10 business days is subject to ORCF approval.

B. **Amendments to the Firm Commitment.** Material changes to a transaction may require amendments to the Firm Commitment. Any material adverse conditions or changes to any facts or circumstances that would make any information submitted, or which should have been submitted, with the application for mortgage insurance (including without limitation any such information relating financial statements, rent rolls, reports, investigations or other credit risks) incomplete or inaccurate must be disclosed to ORCF. ORCF considers such information to determine whether an amendment to the Firm Commitment is required and/or whether the deal may proceed. No part of the Firm Commitment may be amended without the prior approval of ORCF. To amend the Firm Commitment, the Lender must submit a written request on letterhead to the Closer setting forth the specific changes requested. This request must include documentation to support the requested change(s). When possible, all requested changes to a Firm Commitment must be combined into one request in order to minimize the number of amendments.

    1. **Extensions.** Firm Commitments may be extended for periods of time depending on project type; however, processing and underwriting conclusions must be current at the time of any extension. For 223(f) projects, the Closer may extend the Firm Commitment for one 60-day period. For 223(a)(7) projects, the Closer may extend the Firm Commitment for one 90-day period. For new construction projects, the Closer may extend the Firm Commitment in 30-day increments. Extension requests beyond these periods require review and approval by the assigned project ORCF Workload Manager. The Lender's request to amend the Firm Commitment must provide a justification acceptable to HUD that the extension of the Firm Commitment is warranted and necessary in order to accomplish closing by the end of the extension period. Requests for extension must include the following statement (if true): "*The requested delay is not likely to change significantly the underwriting data on which the commitment was based or to undermine the feasibility of the project due to a change in the market, inflation, or other factors affecting cost*." If, at the expiration of the extension period, the closing fails to occur, HUD reserves the right to consider the application withdrawn. In that case, the application must be updated and submitted as a new application in order to receive further consideration.

2. **Interest Rate Changes**. ORCF suggests that the interest rate not be locked without confirmation that the closing is moving forward. Locking the interest rate prior to such confirmation will be at the Lender and Borrower's own risk. HUD will not close a transaction without all program and legal requirements being fully satisfied solely to accommodate a security delivery or obligation deadline. Once the interest rate has been locked, a request to amend the Firm Commitment must be submitted. Such a request must include a revised, signed Maximum Insurable Loan Calculation (Form HUD-92264A-ORCF).

C. **Satisfaction of Special Conditions.** Evidence of satisfaction of all Special Conditions listed in the Firm Commitment must be provided prior to closing and must be submitted with the draft closing document package. The Closer will provide a Special Conditions Matrix to keep track of the status and documentation related to each Special Condition. The following apply to 232 New Construction, Substantial Rehabilitation and 241:

1. Deferred Submission items (see the Lender's Architectural Reviewer and Cost Analyst's Statement of Work, Section IV.A.12) and/or any additional changes must be identified by addendum(s), must be reviewed by the underwriter of record and approved by HUD 15 days prior to Initial Closing.

2. The addendum(s) must include a list of drawing numbers and page numbers with a description of the change(s). Addendum(s) must be clearly noted and all drawings and specifications affected must have sheets and pages revised and replaced. Addendum(s) shall have no effect on cost or value. The Architect of record and the Lender's construction analyst must review the addendum(s) for acceptability.

D. **Evidence of Completion of Repairs.**

1. Critical Repairs: All critical repairs must be completed prior to closing. Evidence of completion includes a signed and dated Borrower's Certification – Completion of Critical Repairs along with clear, supporting photographs and invoices. Other items may be requested by the Closer as needed in order to verify that all repairs have been completed.

2. Non-Critical or Borrower Elected Repairs: Completion of non-critical repairs prior to closing is encouraged. If the non-critical/Borrower elected repairs are not completed by closing, they must be completed within 12 months of closing. An Escrow Agreement for Non-critical, Deferred Repairs must be established, which includes the list of repairs.
   If all, or a portion of, the non-critical/Borrower elected repairs have been completed prior to closing, the Lender must submit a signed Borrower's Certification-Full or Partial Completion of Non-Critical Repairs. As with critical repairs, clear, supporting photographs and invoices demonstrating proof of completion must be attached. For the remaining repair items, a request to amend the Firm Commitment must be submitted with an attached, revised list of repairs. See above for more information on amendments.

3. See Production, Chapter 10.16 for more information on repairs.

E. **Evidence of Insurance.** Prior to closing, evidence must be provided showing that the project has all required fidelity, property, and professional liability insurance coverages. The insurance coverages must be current and in conformance with all ORCF requirements. If a policy will expire within one month of closing, proof of renewal will be required. See Production, Chapter 14, Insurance Requirements, for details on insurance coverage.

F. **Closing Statements and Cost Certifications.**

1. Closing statements, sometimes referred to as settlement statements, are required for all closings. The final version of the closing statement must be signed by both the Lender and the Borrower and presented prior to closing. At a minimum, the statements must include the following: amounts to be paid to satisfy Borrower's obligations for existing indebtedness; repairs, if any; financing fees; HUD fees; legal expenses; title and recording costs; third party costs; interest rate premium payments, if any; bond premium payments; other allowable costs; and any Lender-required escrows for taxes, insurance or other items. The statement must also include any cash contribution by the Borrower. For Section 223(a)(7) projects, the closing statement must be supported by current payoff letter(s) and invoices. The closing statement must show the transfer amount of the Reserve Fund for Replacement and any additional initial deposit amount, if required. Also for Section 223(a)(7) projects, the Closer will compare the amount of the transfer of the current replacement reserves on the Closing Statement to the amount in the Lender Narrative. If the amount has decreased by $20,000 or 20%, the Lender will be asked to recalculate the necessary reserve for replacement deposits. The Lender must provide a letter certifying that the Lender has recalculated the necessary reserve for replacement deposits, considered any changes to the current reserve for replacement since the time of the original firm application, and, that based upon that review, the Lender has notified the Closer of any necessary increases to the initial deposit to the reserve for replacement account or monthly deposit. The ORCF Underwriter must approve any changes to the reserve for replacement requirements. For changes to Reserve amounts, a revised Reserve for Replacement Funding Schedule may be required. Note: security extension fees are not an allowable mortgageable cost.

2. If a Borrower's Certificate of Actual Cost (also known as a "Cost Certification") is required, it must include the supporting documents such as current payoff letter(s) and invoices. The Cost Certification must be signed by the Borrower and will be reviewed and approved by ORCF. See Production, Chapter 11.15 for more information.

G. **Fees.** The Lender must ensure that all fees due at closing are properly prepared and delivered at closing. Any missing or incorrect fee may result in a delayed closing. See Section 9.5 on Fees Due.

H. **Lender and Lender's Attorney.** The Lender must at all times work closely with its attorney to ensure all closing requirements are met in a timely manner.

I. **Lender's Certificate/Request for Endorsement.** The Lender will be required to execute either a Lender's Certificate or a Request for Endorsement, which include several certifications. It is the Lender's responsibility to perform any necessary due diligence to allow the Lender to make such certifications accurately.

9.4 General Closing Logistics

A. **Type of Closing.** ORCF closings may take place with all parties present, a "table closing," or remotely, a "by mail closing." There may also be a "skeleton closing," wherein only one or some of the parties attend. Although "by mail" or "skeleton" closings are encouraged, the HUD Attorney will make the final determination on the type of closing to conduct and will provide the Lender and Lender's Attorney appropriate instructions. By mail closings are conducted at the discretion of the HUD Attorney and may be limited in circumstances where incomplete or substantially incorrect documents are received or certain circumstances demonstrate the need to have a table closing. Under no circumstances should the endorsed note be provided to the FHA Lender prior to closing.

B. **Date of Closing.** The closing date will be set by the HUD Attorney after consultation with the Closer. The closing date will only be set once all programmatic and legal requirements have been fully satisfied. The closing may be cancelled if documents are not satisfactory or if any programmatic or legal requirement is not met.

C. **Documents to be signed by ORCF.** The documents to be signed by ORCF, such as the Healthcare Facility Note (Form HUD-94001-ORCF), the Healthcare Regulatory Agreement – Borrower (Form HUD-92466-ORCF), and any other documents required in the transaction, will be signed by ORCF in advance of the closing. Once the Closer has approved the documents for signature, the Closer will coordinate ORCF's execution of the documents. The Lender and Lender's Attorney must ensure that the documents have been properly prepared and are received by ORCF in sufficient time for execution and shipment. The documents must be in final form before sending them for ORCF signature, and the documents must be the exact versions approved by all parties, including HUD. ORCF will execute a maximum of four copies of the documents; however, to cut down on administrative time two copies are strongly encouraged.

D. **Recording Documents.** Documents may be recorded in advance of the closing with prior approval from the HUD Attorney.

E. **Closing Day.** The HUD Attorney will lead a "table" or "skeleton" closing. If closing "by mail," the Lender's Attorney, Lender, Owner, Borrower, Borrower's Attorney, Operator, Operator's Attorney, and other related parties must be readily available by telephone should any question or problem arise. All documents must be satisfactory to HUD, be in complete and final form, and be the exact same versions as previously submitted and approved. All

HUD requirements must be satisfied. At the conclusion of the closing, the HUD Attorney will deliver the endorsed Healthcare Facility Note to the Lender's Attorney either in person or by mail.

F. **Closing Document Copies.** After closing, the Lender's Attorney must provide a compact disk, or a Zip file, containing scanned copies of the documents accepted by the HUD Attorney at the closing. The Closer will provide the details on where to send the disk or file.

9.5 Fees Due and Refunds

A. **Mortgage Insurance Premium (MIP).** A first year MIP fee is due at closing. The amount of the fee is listed in the Federal Register, published annually on or about July 1, and varies per type of program under which the loan is insured and will be set forth in the Firm Commitment.

B. **Inspection Fee.** The Inspection Fee varies by program. See Production, Chapter 2, General Program Requirements, under each program section for specific amounts and formulas.

C. **Additional Application Fee.** If the mortgage amount has increased since the initial submission of the Application or the issuance of the Firm Commitment, an additional application fee will be required, which will be set forth in the Firm Commitment Amendment.

D. **HUD Application Fee Refunds.** If the mortgage amount has decreased since the initial submission of the Application or the issuance of the Firm Commitment, the Lender may request a refund of the application fee after closing. Requests for refunds must be sent to OHPrefunds@hud.gov and must include the project name and FHA number in the subject line with the Request of Overpayment of Firm Application Fee (Form HUD-91112-ORCF) attached. Refunds are sent via electronic transfer.

9.6 Closing Section 232/223(a)(7) and Section 232/223(f) Loans

There are several types of Section 232 pursuant to Section 223(a)(7) loans, which are refinances of existing FHA loans such as new construction, substantial rehabilitation, 223(f) and 241(a).

A loan insured under Section 232 pursuant to Section 223(f) is the refinance or purchase of a residential care facility project, which may or may not be currently FHA-insured.

The Closer checklists and to the HUD Attorney checklists which set forth the documents required to close these loans are identified in Appendix 9.1. When sending the draft closing documents for HUD review, place the appropriate checklist on top of the closing package; additionally, please tab and organize the corresponding documents to match the checklist.

The closings of these two types of loans are similar. A few key differences are:

1. No repair Inspection Fee is required for loans processed under Section 223(a)(7).

2. A cost certification, the Borrower's Certificate of Actual Cost, is required for all Section 223(f) loans. This document is only required for Section 223(a)(7) projects that have repairs but did not submit a PCNA. See Production, Chapter 11.15 for full details on cost certifications. All cost certifications will be reviewed and approved by ORCF.

3. A closing statement is required for all Section 223(a)(7) and Section 223(f) loans; however, for Section 223(f) loans, supporting documentation does not have to be attached to the closing statement if it is provided with the Borrower's Certificate of Actual Cost.

4. Total Lender's Fees are limited to 2.0% of the mortgage amount for a Section 223(a)(7) loan; they are limited to 3.5% for a Section 223(f) loan. Fees may be up to 5.5% for bond transactions.

5. The repair escrow overage for a Section 223(a)(7) loan is 10% of estimated costs; the overage is 20% for a Section 223(f) loan.

6. Prior to the closing of a Section 223(f) loan, a conference call between the Borrower and the servicing ORCF Account Executive must be scheduled. This is not required when the loan is insured under Section 223(a)(7).

9.7 Closing New Construction, Substantial Rehabilitation, Section 241(a) Loans

Loans insured under Section 232 for New Construction or Substantial Rehabilitation are for the complete construction of a project or for substantial repairs or improvements to an existing project.

A loan insured under Section 241(a) is a supplemental loan to an existing loan insured by FHA to allow for an addition or improvements to a project.

For the above loans, the closings are either Insured Advances or Insurance Upon Completion. If the loan is for Insured Advances, there are two closings: an initial closing prior to the start of work and a final closing after the completion of the work. If the loan is for Insurance Upon Completion, there is only one closing. Because of the complexities of these types of closings, the following sections provide more closing information.

9.8 Initial Closings: Required Forms and Documentation

In addition to the documents listed below, see Appendix 9.1 for the reference to the checklist of documents required to close these types of loans. Note: there is only one checklist for both the Closer and the HUD Attorney.

A. **Construction Contract** (Form HUD-92442-ORCF). These contracts may be either Lump Sum or Cost Plus. See Production, Chapter 11.13.A for more information on these contract requirements.

   1. Attach the Contractor's and/or Owner's Cost Breakdown (Form HUD-2328) as Exhibit A to the contract. This form must be approved and signed by ORCF with the Firm Commitment.

   2. Attach the Supplementary Conditions of the Contract for Construction (Form HUD-92554-ORCF). The Davis Bacon Wage Determination must be included in the specifications. The Closer will confirm with HUD's Office of Labor Standards and Enforcement that the Davis Bacon Wage Determination is current as of the date of initial endorsement. The Lender must certify that the most current and applicable wage decision has been incorporated in the Construction Contract and Specifications prior to closing. See Appendix 4.1, Labor Standards and Enforcement Protocol for information on coordinating with Labor Standards and Enforcement.

   3. Attach the Incentive Payment Addendum (Form HUD-92443), if the Borrower and contractor have agreed to such a payment, and there is no Identity-of-Interest between the Borrower and contractor.

B. **Owner-Architect Agreement** (AIA Document B108). The Agreement must include the HUD Amendment to the B108 (Form HUD-92408-ORCF), which contains a section for disclosing parties in an identity-of-interest relationship with the Architect. If there are no such parties, then the form should indicate "none.". See Production, Chapter 4.2, Exhibit C, for additional information. This form must be reviewed and accepted at the Firm Commitment stage.

C. **Assurance of Completion.** Documentation and HUD review will vary depending on the type of assurance of completion provided. Except for letters of credit, the HUD Attorney must review each type of Assurance of Completion, including the form of bonds where used.

   1. Letters of Credit. These may be used instead of cash for all assurances of completion and escrows required at initial and final closing, or during construction, except for up-front cash escrows.
      a. Acceptance of a letter of credit is at the Lender's discretion. However, the letter of credit must always be:
         i. Unconditional and irrevocable;
         ii. Issued by a banking institution; and

iii. Valid and collectible.

b. The Lender may not be the issuer of any letter of credit without prior written consent of ORCF.

c. HUD will neither look at the letter of credit nor render an opinion as to its enforceability or acceptability; letters of credit are accepted at the Lender's sole discretion.

2. Assurance of Completion for On-Site Improvements. The Lender or Borrower may impose higher requirements, but must require one of the following as a minimum:

   a. Surety Bonds. The Payment Bond (Form HUD-92452A-ORCF) must be used for payment bonds and the Performance Bond-Dual Obligee (Form HUD-92452-ORCF) must be used performance bonds. Each bond must equal 100% of the ORCF estimate of the total for all improvements (Line 53, Contractor's and/or Owner's Cost Breakdown). The following requirements must also be satisfied:

      i. The surety must be on the accredited U.S. Treasury list, Circular 570, published annually in the Federal Register on or about July 1;

      ii. The bonds must not exceed limits listed in Circular 570;

      iii. GNMA may also be named as an obligor if GNMA securities are being used;

      iv. An original power of attorney from the surety company to its agent must be attached to each bond and dated the same day as the bond; and

      v. Payment and Performance bonds are required for Assurance of Completion of on-site improvements where payment for components stored offsite has been approved.

   b. Completion Assurance Agreement (Form HUD-92450-ORCF). This agreement must be secured by a cash deposit (or unconditional, irrevocable letter of credit) for the appropriate percentage of the ORCF estimate of construction or rehabilitation cost, as described below:

      i. For projects of less than four stories, ORCF requires a deposit of 15% of the HUD estimate of construction or rehabilitation cost;

      ii. For large and elevator projects, ORCF requires a deposit of 25% of the HUD estimate of construction or rehabilitation cost for projects where the structure includes an elevator, or the structure is four or more stories.

3. Assurance of Completion for Off-Site Improvements. See Lender's Certificate (Form HUD-92434-ORCF) for requirements. To assure the completion of work which may not be financed with mortgage proceeds, one of the following is required:

   a. A Public Body Agreement acceptable to HUD from the controlling jurisdiction giving assurance for installation of utilities, streets or other facilities without cost to the Borrower. The Borrower's attorney's opinion as to whether the agreement is binding on the public body and succeeding administrations is required;

b. A cash escrow using an Escrow Agreement for Offsite Facilities, deposited with the Lender, a trustee or an escrow agent acceptable to HUD, or an unconditional, irrevocable letter of credit. The amount must equal or exceed ORCF's estimate of the cost of offsite facilities; or
c. Where additional assurance is deemed necessary by ORCF, one of the following will be required:
    i. Offsite Bond – Dual Obligee (Form HUD-92479-ORCF), or
    ii. A letter of credit.

D. **Building Loan Agreement** (Form HUD-92241-ORCF). This document sets out the responsibilities, conditions, and operating terms between the Lender and the Borrower, including the basis under which insured advances may be made during the construction period.

E. **Lender's Certificate** (Form HUD-92434-ORCF). All required escrows, deposits, fees, and other amounts must be properly reflected in the Lender's Certificate as well as information concerning other bond obligations, extension fee agreements, and permanent loan commitments. Where permissible prepayment lockout and/or penalty provisions are included in the Healthcare Facility Note, this form may include conditions under which HUD may consider an override of such provisions. An addendum to the Lender's Certificate may be used to clarify certain expenses.

F. **Agreement and Certification** (Form HUD-93305-ORCF). This obligates the Borrower to certify its actual costs of project construction or rehabilitation costs, and to disclose any identity of interest among project participants. It also obligates the Borrower to agree to a reduction of the mortgage amount in certain instances.

G. **Application for Insurance of Advance Mortgage Proceeds** (Form HUD-92403). An initial draw of loan proceeds may be made on the day of initial closing upon recordation of the Security Instrument, evidence it constitutes a first lien on the property, and HUD's delivery of the initially endorsed Note. This form must be submitted to ORCF for review and approval prior to closing. Supporting documentation including invoices, receipts, or cancelled checks organized with tabs and a summary sheet for each line item, must also be submitted with the draw. A final, fully executed copy of this form must be submitted no later than three (3) days prior to initial closing. See Production, Chapter 10, Construction Period, Appendix 10.2, Instructions for Approval, for additional details.

H. **Escrow Agreement for Operating Deficits** (Form HUD-92476B-ORCF). Any operating deficit escrow requirements prescribed in the Firm Commitment may be in the form of cash, and/or one or more unconditional and irrevocable letters of credit issued to the Lender by a banking institution.

I. **Escrow Agreement for Working Capital** (Form HUD-92412-ORCF). When the Firm Commitment requires a working capital deposit, the Borrower must deposit with the Lender a cash escrow or one or more unconditional and irrevocable letter(s) of credit at initial closing. See Production, Chapter 10.15.C.

J. **Minor Movable Equipment Escrow Agreement** (Form HUD-9443-ORCF). When the Firm Commitment requires an escrow for minor moveable equipment, the Borrower must deposit with the Lender a cash escrow or one or more unconditional and irrevocable letters of credit at initial closing.

K. **Other Escrows.** Other escrows may be required by the Firm Commitment. Examples include an Off-Site Escrow or a Demolition and Asbestos Removal Escrow.

L. **Fee Payment from Cash Available to Borrower.**

1. Fees Paid at Initial Closing. Excess mortgage proceeds may be used to pay construction costs, permanent loan discounts, and other fees recognized by HUD under paragraph 19 of the Lender's Certificate.

2. For New Construction, excess mortgage proceeds may also be allocated to the following items:
    a. ORCF's estimate of the "as-is" value of land or the actual latest arms' length purchase price, whichever is less. The latest arm's length purchase price may include the following connected costs:
        i. Legal fees associated with acquisition of land, zoning, examination of title on the purchase, or defense of title after the purchase;
        ii. Prepaid special assessments;
        iii. Interest on bridge loans to purchase property after the date of submission of the initial application for mortgage insurance;
        iv. Taxes;
        v. Cost of improvements made to the project site by the Borrower;
        vi. Cash escrow to cover offsite construction cost;
        vii. Cost of any demolition reflected in the fair market value of the land (note that payment is approved as demolition progresses);
        viii. Construction and/or permanent loan discounts required to be paid at initial closing; and
        ix. Interest shortfall escrow, working capital deposit, initial operating deposit, debt service reserve, non-realty items, and any permanent loan discounts not required to be paid at initial closing.
    b. The remaining balance may be used to fund approved change orders or be held until final closing.

3. For rehabilitation of existing construction, excess mortgage proceeds may also be allocated to ORCF's estimate of the "as-is" value of land or the Borrower's acquisition cost/existing indebtedness, whichever is less, and items listed in 2 above.

4. Restricted Excess Mortgage Proceeds. Restricted excess mortgage proceeds are those excess mortgage proceeds determined not to be available to the Borrower during construction.

a. These funds cannot be used to satisfy escrow requirements and must be held until final closing; and
b. These funds must be identified in an unused column of the Financial Record of Mortgage Loan Transaction (Form HUD-92451) as restricted funds.

5. Fees Paid After Initial Closing. Excess mortgage proceeds may be used to fund permanent loan discounts, including those for unitary loans, and construction and permanent loan extension fees for payment after initial closing to the extent recognized by ORCF under paragraphs 19(b), (c) and (d) of the Lender's Certificate. In these instances, loan documents approved by ORCF must provide for the payment of such fees after initial closing, subject to the following:
   a. The Lender is required to escrow sufficient funds on the Borrower's behalf to cover fees approved in the Lender's Certificate, paragraphs 9(b), for payment after initial closing;
   b. The Borrower is required to furnish a written agreement to ORCF that any disbursements from the escrow accounts must require ORCF written approval;
   c. A letter of credit will not be accepted at initial closing for any of the amounts to be satisfied from excess mortgage proceeds; and
   d. Such escrowed excess mortgage proceeds may be released when earned.

M. **Permits, Approvals and Plans.** All building and other permits, governmental approvals, and plans required to construct or to rehabilitate the Project improvements must be provided for ORCF review and approval prior to initial closing. Approvals and permits must be unconditional and consistent with the ORCF-approved plans and specifications.

N. **License.** Evidence must be provided at the initial closing that the application process for the facility license has begun, and upon completion of the project, as proposed, a license will be issued. The evidence must be confirmation from the appropriate governing authority.

O. **Easements and Use Agreements.** All easements and joint use agreements must be approved by ORCF and the HUD Attorney.

P. **Additional Agreements.** Any additional agreements that affect the property or financing of the project must be disclosed to ORCF, including, but not limited to, construction agreements; indemnifications, guarantees, and hold harmless agreements; and any other document or information that would require reprocessing of the Firm Commitment, increase Borrower's cash requirements, or increase the General Contractor's bond requirement.

Q. **Accounts Receivable Financing**. If there is to be accounts receivable financing on new construction projects, final draft versions of the documents will be due at 70% completion. In no event should Accounts Receivable documents be executed without prior HUD consent.

R. **Deposit Account Control Agreement (DACA) and Deposit Account Instruction Service Agreements (DAISA).** ORCF requires that all project Owners and/or Operators maintain appropriate agreements, approved by HUD, perfecting a security interest in project accounts.

9.9 Preconstruction Conference

A Preconstruction Conference is required prior to the start of construction. The Preconstruction Conference must be scheduled within one week of initial closing. The Lender is responsible for arranging and facilitating the Preconstruction Conference. The signing of the Plans and Specifications generally occurs at the Preconstruction Conference. The signing may also be conducted at Closing. See Production, Chapter 10, Construction Period, for more information.

9.10 Tax Credits

A. For more information, see Production, Chapter 12, LIHTC and Other Tax Credit Program Guidance.

Specific to loans involving tax credits, the initial closing documents must include:

1. A final detailed Sources and Uses statement of total development costs, reflecting any revisions to hard and soft costs as reflected on the Firm Commitment's Maximum Insurable Loan Calculation. If any funding sources have changed, a revised Applicant/Recipient Disclosure/Update Report is also required.

2. All documents must include conflict language giving the HUD documents supremacy over other documents. Documents may not include indemnification provisions, except as otherwise permitted by outstanding HUD guidance.

B. Tax Credit Equity Contribution:

1. The required initial equity investment will be reflected in the Firm Commitment as a Special Condition; the initial installment must be advanced at initial closing.

2. Application for Insurance of Advance Mortgage Proceeds**.** Approval of costs to be funded will be based on those approved in the Firm Commitment, or, if applicable, approved amended Sources and Uses Statement.

3. After the first installment of LIHTC Equity is distributed at initial closing, the subsequent contributions must be made at a time and in a manner during construction to ensure that the underwriting requirements in the Firm Commitment are maintained and met for actual costs.

C. Tax Credit Equity Bridge Loans:

1. Tax credit equity syndicators or investors (with or without an Identity of Interest with the Section 232 Lender) may make equity bridge loans to LIHTC, Historic, or New Markets Tax Credit projects during the construction or substantial rehabilitation period before the property's placed-in-service date. The bridge loan may be evidenced by a promissory note from the Borrower and may be secured by a pledge of the tax credits or of the limited partnership interest but may not be secured by a lien on the real estate. After the placed-in-service date, the bridge loan must be released and retired by the pay-in of the investor's equity.

2. An equity bridge loan is a means of securing the Borrower's cash contribution that is required to complete construction before the tax credits are available to be claimed by the equity investor. The placed-in-service date is the date when the newly constructed or rehabilitated property has been completed and its units have been occupied by income qualified tenants. This is also when the tax credits are officially able to be claimed by the equity investor, and, in the case of LIHTCs, is evidenced by issuance of Low-Income Housing Credit Allocation and Certification (IRS Form 8609). However, at Final Closing, all funds needed to meet the Borrower's cash contribution must be in the transaction so the sources and uses will balance and the tax credit investors will pay in the equity to retire the equity bridge loan.

9.11 Final Closings: Required Forms and Documentation

Once construction has been completed and the certification of costs has been approved by ORCF, the loan must proceed to final closing. ORCF will issue a Maximum Insurable Mortgage Letter providing the final mortgage determination. Once the letter is issued, immediate preparation for final closing must begin. Final closing documents are to be submitted within 30 days of the date of the Maximum Insurable Mortgage Letter. See Production, Chapter 11, Cost Certification, for complete information on cost certifications.

See Appendix 9.1 for the references to the checklist of required documents for a final closing. Note: there is only one checklist for both the Closer and the HUD Attorney.

A. **Deposit Account Control Agreement (DACA) and Deposit Account Instructions Service Agreement (DAISA).** For all Insurance of Advances projects where the DACA and/or the DAISA were not approved by HUD prior to initial closing, the final and executed DACA and/or the DAISA must be submitted to the Closer and the HUD Attorney when the project reaches 70% construction completion. The final and executed documents must be approved prior to HUD's approval of the Permission to Occupy.

B. **Title Evidence at Final Endorsement.**
Prior to final endorsement, the Lender must provide HUD with a new title policy, or, if approved by the HUD Attorney, a title endorsement covering the following matters:

1. Showing what, if any, matters have gone on record since the initial closing;

2. Changing the effective date of the title policy to the day of final closing;

3. If a Modification Agreement or Supplemental Mortgage and Consolidation Agreement are used, insuring that the mortgage, as modified, or as supplemented and consolidated, remains in a first lien position. Should the title insurance company be unable to provide such endorsement, or should the endorsement show any lien intervening between the recordation of the original insured mortgage and the Supplemental Mortgage, ORCF will not endorse the mortgage for insurance at the increased amount;

4. Deleting the pending disbursements clause; and

5. Increasing title coverage if the mortgage amount increased.

6. ORCF will examine any exception to title, not shown in the title evidence accepted at initial closing, to determine whether or not it affects the value and/or marketability of the project. Any exception which affects the value and/or marketability of the project as determined by ORCF must be removed from the title policy or its effect insured against by the appropriate endorsement to the title policy;

C. **Labor Standards and Enforcement Clearance.** The Office of Labor Standards and Enforcement must confirm that all Davis Bacon requirement have been satisfied. The Closer will request clearance for closing from the Office of Labor Standards and Enforcement. If there are outstanding Davis Bacon violations, the Labor Standards and Enforcement Specialist will inform the General Contractor, the Closer, and the ORCF Construction Manager that deposits to the U. S. Treasury must be established as a condition of closing to ensure payment of wages. Final closing cannot proceed until the violations have been cleared. The Office of Labor Standards and Enforcement will provide approval to proceed to final closing. See Appendix 4.1, Labor Standards and Enforcement Protocol, for more information.

D. **Incomplete On-site Facilities.**

1. Conditions for Approval. It is desirable that all on-site construction be 100% complete before approval of a final advance of mortgage proceeds. However, there may be circumstances where it is necessary that approval of a final advance be given before 100% completion of on-site construction.
    a. Approval of a final advance where minor items of on-site construction are incomplete will be given only in cases in which funds are placed in escrow to assure completion of such minor items, as provided in the Certificate of

Mortgage Insurance in the Application for Insurance of Advance Mortgage Proceeds, and in the footnote on Request for Final Endorsement (Form HUD-92023-ORCF).

b. Approval of a final advance of mortgage proceeds will be given only in those cases in which:
   i. The aggregate estimated cost of completing the items does not exceed 2% of the principal amount of the mortgage.
   ii. Funds must be placed in escrow for the completion of minor items when immediate completion is inadvisable or impossible, due to weather or other conditions beyond control.

2. Escrow for Completion. With respect to all incomplete items, the amount held in escrow for completion must be at least 1.5 times the estimated cost of completion. The amount of any escrow must be sufficient to assure an incentive to complete the work, taking into consideration a possible rise in cost. Such escrow will be held by the Lender in accordance with the terms of the Escrow Agreement for Incomplete Construction (Form HUD-92456-ORCF), and ORCF will ascertain that the items to be completed are properly identified by attachment to the Application for Insurance of Advance of Mortgage Proceeds. See Production, Chapter 10.8.I for additional information.

E. **Incomplete Off-Site Facilities.**

1. Approval of a final advance of mortgage proceeds will be given only in those cases in which: All off-site utilities such as sewer, water, electrical, and gas facilities are installed and connected, and the buildings are served by safe and adequate all-weather facilities, either permanent or temporary, for the ingress and egress of pedestrian and vehicular traffic, including fire apparatus, and all other construction requirements have been acceptably accomplished or acceptably assured.

2. Completion of Off-Site Utilities. Until all off-site facilities are completely installed and connected, as applicable, and the required ingress and egress is provided, HUD will not process a request for the final advance. In such cases:
   a. Any Application for Insurance of Advance of Mortgage Proceeds submitted for processing will not be treated as approval of a final advance, nor will the submission of Request for Final Endorsement. Instead, the Application for Insurance of Advance of Mortgage Proceeds may be treated as an ordinary application for advance of mortgage proceeds and may be approved in an amount which, when added to previous advances of mortgage proceeds, will equal 90% of the total advances to which the Borrower will be entitled at 100% completion.
   b. Following 100% completion of all off-site facilities, ORCF will require submission of a new Application for Insurance of Advance of Mortgage Proceeds for approval of the final advance and subsequent submission of an updated Request for Final Endorsement.

F. **Security and Start of Amortization.**

1. Non-Realty Items. All non-realty items must be covered by the mortgage lien or security agreement, or both, whether or not paid for with mortgage proceeds, so long as such items are reasonably necessary to operate the project for the Approved Use. Any items not secured at initial Closing must be secured at final closing.

2. Start of Amortization. Whether construction has been completed or not, amortization must start on the date specified in the Note, unless a deferment has been recommended by the Lender and approved in advance by ORCF. Any request for deferment of amortization will be reviewed by the Closer, ORCF Account Executive, and the HUD Attorney.

G. **Mortgage Amount.**

1. Decrease in Mortgage Amount.
    a. Modification Agreement. If there is a mortgage decrease based upon HUD's final mortgage determination, a draft Modification Agreement must be submitted prior to final closing. The Modification Agreement must amend the Security Instrument and set forth the new mortgage amount. HUD will endorse the HealthCare Facility Note for the decreased mortgage amount.
        i. The following provision must be included in the Modification Agreement: Nothing in this Agreement shall waive, compromise, impair or prejudice any right HUD may have to seek judicial recourse of any breach of that certain Regulatory Agreement executed by the parties hereto, recorded on even date with the Security Instrument, which breach may have occurred prior to or may occur subsequent to the date of this Agreement. In the event that HUD initiates an action for breach of said Regulatory Agreement and recovers funds, either on HUD's own behalf or on behalf of the Project or the Borrower, those funds may be applied, at the discretion of HUD, to payment of the delinquent amounts due under the HealthCare Facility Note or the Security Instrument or as a partial prepayment of the Healthcare Facility Note.
        ii. Prior to final endorsement, the Modification Agreement must be properly executed and recorded in the real property records of the county in which the project is located.
    b. The Healthcare Facility Note may be modified, with an allonge, to set forth the decreased mortgage amount and the new amortization schedule. Any such modifications are subject to HUD approval.
    c. HUD must approve appropriate title evidence related to the modification(s), as set forth above.

2. Increase in Mortgage Amount. If ORCF approves an increase in the mortgage

amount, the following documents must be submitted to HUD for approval prior to final endorsement:

a. Supplemental HealthCare Facility Note.
   i. The Lender must prepare a Supplemental HealthCare Facility Note acceptable to HUD, entitled "Supplemental HealthCare Facility Note."
   ii. This document must contain a cross-default provision with the original HealthCare Facility Note.
   iii. The principal amount of the Supplemental HealthCare Note must be for the amount of the increase to the mortgage, not for the new total mortgage amount.
   iv. The amount of the payments to principal must be sufficient to amortize the increase amount over the mortgage term.
b. Supplemental Security Instrument.
   i. The Lender must prepare a Security Instrument acceptable to HUD, entitled "Supplemental Security Instrument."
   ii. This document must contain a cross-default provision with the original Security Instrument.
   iii. The Supplemental Security Instrument must encumber the entire project and must secure repayment of the Supplemental HealthCare Facility Note.
c. Modification and Consolidation Agreement.
   The Lender must prepare a Modification and Consolidation Agreement, acceptable to HUD, to be recorded in the real property records in the property jurisdiction. Such documents must evidence the following:
   i. The original Healthcare Facility Note and the Supplemental Healthcare Facility Note will be deemed one indebtedness; and
   ii. The original Security Instrument and the Supplemental Security Instrument will be deemed one indebtedness.
   iii. The original Security Instrument shall be modified to provide for cross-default with the Supplemental Security Instrument.
   iv. The original Healthcare Facility Note shall be modified to provide for cross-default with the Supplemental Healthcare Facility Note.
d. Borrower's Attorney's Opinion. The Borrower's Attorney must give an opinion, in a format approved by HUD, with respect to the documents evidencing the increased mortgage amount.
e. Title evidence approved by HUD.

H. **Application for Insurance of Advance of Mortgage Proceeds.** For the contractor's remaining retainage and any outstanding costs to be paid at final closing, the Borrower and Lender must execute this form. The form must be accompanied by a completed Contractor's Requisition (Form HUD-92448), signed by the contractor and the architect.

1. If no items of on-site construction are incomplete, enter "None" in the space provided for the amount of the escrow deposit on the form.

2. If items of on-site construction are incomplete and an escrow deposit is required, attach an itemized list of incomplete items and enter the amount of the escrow deposit required.

3. The Closer will determine if:
    a. any items of on-site construction are incomplete;
    b. any off-site facilities are incomplete;
    c. any revisions are required in connection with hazard insurance; and if
    d. the necessary non-realty items have been submitted.

4. The Closer will obtain ORCF approval signatures on the Application for Insurance of Advance of Mortgage Proceeds and the Contractor's Requisition. Electronic copies will be forwarded to the HUD Attorney and the Lender.

I. **As Built Survey**. The final as-built survey must be dated within 120 days of closing. The term "dated" means the surveyor's certification must show that the survey was made "on the ground" within 120 days prior to closing. The survey accompanying this request must show the exact location of all buildings, water, sewer, gas and electric mains, and all easements for such existing utilities. The survey must be prepared, signed and sealed by a licensed surveyor and must include a certification in the format set out in the Survey Instructions and Owner's Certification.

J. **Permits, Licenses and Approvals.** All building and other permits, licenses, and governmental approvals required to own and operate the project must be provided for HUD review and approval including, but not limited to, the Certificate of Occupancy and the Certificate of Need.

K. **Lender Letter of Loan Status.** The Lender must submit a letter, dated the day of final closing, stating that the loan is current. This may be combined with the Current Payment Letter.

L. **Request for Final Endorsement.** An updated and fully executed Request for Final Endorsement must be submitted and reflect any material change made from the time of cost certification.

M. **Insurances.** Proof of acceptable insurances for professional liability, property, and fidelity must be provided.

N. **Request for Release of Escrows.** To release any escrow for a change order, minor moveables, or working capital, submit a Request for Approval Advance of Escrow Funds (Form HUD-92464-ORCF).

O. **License.** The facility license must be current with the correct number of beds/units approved in the underwriting.

P. **Current Payment Letter.** The Lender must provide evidence that all impound payments, such as for debt service, Reserve for Replacements, and taxes and insurances, are current.

Q. **Secondary Financing.** If any secondary financing sources are utilized, the source and amount will be verified against what was approved in the approved cost certification.

R. **Lease.** The operating lease must be executed and meet all ORCF lease requirements. The Lender must also demonstrate that the amount of the lease payment conforms to ORCF's requirements.

9.12 Insurance Upon Completion – New Construction, Substantial Rehabilitation and Section 241(a)

Section 232 New Construction, Substantial Rehabilitation and 241(a) projects that are Insurance Upon Completion only have a final closing, which is addressed in Section 9.11 above.

9.13 Closing Section 223(d) Operating Loss Loans and Section 232(i) Fire Safety Equipment Loan Insurance Programs

A loan insured under Section 223(d) is an Operating Loss Loan provided to a project owner with a current FHA-insured loan. To be eligible, a project must have experienced operating losses incurred during the first two years after project completion, or any other 2-year period within the first 10 years after completion. A credit subsidy is required for this type of loan. After the acceptance of the Firm Commitment, ORCF will request HUD obligate a credit subsidy. If HUD so obligates, the Firm Commitment will be extended 60 days after the date of obligation.

Section 232(i) sets forth the requirements for the Fire Safety Equipment Loan Insurance Program. This type of loan insurance is provided for nursing homes, skilled nursing facilities and intermediate care facilities to purchase and install fire safety equipment, primarily fire sprinkler systems. Qualified loans must be secured by a lien that may be superior or inferior to other liens.

For both these types of loans, see Production, Chapter 2, Eligible Section 232 Mortgage Insurance Programs, and Chapter 3, Loan Sizing, for more details. Consult with the Closer for closing document requirements.

Section II
Production

Appendix 9.1
Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care

Form Number	Form Name
HUD-2205A-ORCF	Borrower's Certificate of Actual Cost
HUD-2328	Contractor's and /or Owner's Cost Breakdown
HUD-91112-ORCF	Request Overpayment of Firm Application Exam Fee
HUD-91118-ORCF	Borrower's Certification – Completion of Critical Repairs
HUD-91710-ORCF	Residual Receipts Note
HUD-92023-ORCF	Request for Final Endorsement
HUD-92117-ORCF	Borrower's Certification – Full or Partial Completion of Non-Critical Repairs
HUD-92223-ORCF	Surplus Cash Note
HUD-92241-ORCF	Building Loan Agreement
HUD-92264a-ORCF	Maximum Insurable Loan Calculation
HUD-92403	Application for Insurance of Advance Mortgage Proceeds
HUD-92408-ORCF	HUD Amendment to B108
HUD-92412-ORCF	Escrow Agreement for Working Capital
HUD-92434-ORCF	Lender's Certificate
HUD-92442-ORCF	Construction Contract
HUD-92443	Incentive Payment Addendum
HUD-92448	Contractor's Requisition
HUD-92450-ORCF	Completion Assurance Agreement
HUD-92451	Financial Record of Mortgage Loan Transaction
HUD-92452-ORCF	Performance Bond-Dual Obligee
HUD-92452A-ORCF	Payment Bond
HUD-92456-ORCF	Escrow Agreement for Incomplete Construction
HUD-92466-ORCF	Healthcare Regulatory Agreement - Borrower
HUD-92476-ORCF	Escrow Agreement for Non-Critical Deferred Repairs
HUD-92476B-ORCF	Escrow Agreement for Operating Deficits
HUD-92479-ORCF	Offsite Bond- Dual Obligee
HUD-92554-ORCF	Supplementary Conditions of the Contract for Construction
HUD-93305-ORCF	Agreement and Certification
HUD-94001-ORCF	Healthcare Facility Note
HUD-9443-ORCF	Minor Moveable Equipment Escrow Agreement
N/A	HUD Closer 223(a)(7) Closing Checklist
N/A	HUD Attorney 223(a)(7) Closing Checklist
N/A	HUD Closer 223(f)

	Closing Checklist
N/A	HUD Attorney 223(f) Checklist Closing
N/A	HUD Attorney/Closer NC/SR/241(a) Closing Checklist
N/A	Special Condition Matrix

Section II
Production

Chapter 10
Construction Period

10.1 Start of Construction

A. General Contractor shall provide the Lender's Pre-construction Conference Coordinator (PCCC), U.S. Department of Housing and Urban Development (HUD) Office of Residential Care Facilities (ORCF) Construction Manager (CM), HUD Labor Relations Specialist, and HUD Contract Inspector, letters indicating the date (actual date, not anticipated) of Initial Construction Start (the beginning of initial site clearing and preparation) and the date of Permanent Construction Start (permanent on-site building elements put in place, such a footings and utility lines).

B. Letters can be transmitted in PDF format, via email to all recipients.

C. As there is no HUD form for these letters, the General Contractor shall use their letterhead.

D. For Substantial Rehabilitation projects, the construction start date shall be the actual date that work begins on the project. This date shall be verified by the project architect.

E. The HUD Contract Inspector must record the date of Initial Construction Start and the date of Permanent Construction on the HUD Representative's Trip Report (HUD-95379-ORCF).

10.2 Early Start of Construction

Early Start of Construction may be authorized only in 241(a) transactions, only after a firm commitment has been issued, and only in accordance with established procedures found in Appendix 10.1. Where it occurs:

A. A Pre-construction Conference is required before the start of initial construction in accordance with Section 10.3 below;

B. Construction inspections must be done in accordance with Section 10.4 below; and

C. Authorization of any insured advances cannot occur until the endorsed instrument is recorded at Initial Closing.

10.3 Lender Duties Related to the Pre-construction Conference

A. Prior to the Pre-construction Conference

1. The lender will identify a Pre-construction Conference Coordinator (PCCC). The Lender Narrative (or for Early Start, the Memo Requesting Early Start of Construction (HUD-9442-ORCF)) will include the contact information for this person (Note: If the Originating Lender will be assigning the loan at Initial Closing, the Servicing Lender shall designate a PCCC who will coordinate and conduct the Pre-construction Conference as described below).

2. The Firm Application package or Early Start Documents will include Division 00 73 00 (Master Format 2010) of the project specifications, which includes the Supplementary Conditions of the Contract for Construction (HUD-92554-ORCF) and the preliminary Davis-Bacon wage determination. The ORCF Underwriter (UW) will forward this document and the Lender Narrative (or for Early Start, the Memo Requesting Early Start of Construction) to the HUD Regional Labor Relations Officer (RLRO)/designee. This document will include the project location, number of stories, details on commercial areas, a statement as to whether all units have both a kitchen/kitchenette and bathroom, and the contact information for the PCCC.

3. The RLRO/designee shall notify the U/W via email either confirming that the wage determination is correct, or advising that the wage determination must be changed. If a change is required, the RLRO/designee shall attach an electronic copy of the correct wage determination. Upon receipt, the U/W will email a copy to the ORCF Construction Manager (CM) and to the PCCC.

4. The wage determination is subject to modification and must be current as of the date of Initial Closing/Early Start. The PCCC shall consult with the RLRO/designee to obtain any wage determination updates for inclusion in the project specifications to be signed at the Pre-construction Conference.

5. Prior to the Pre-construction Conference, the PCCC will email the CM to request the name and contact information of the HUD Inspector.

6. The PCCC will notify via email the following Pre-construction Conference attendees of the location, date, and time of the Pre-construction Conference:
    a. Borrower Representative
    b. Borrower's Supervisory Architect
    c. General Contractor
    d. Regional Labor Relations Officer / Designee
    e. ORCF Underwriter (UW) (optional attendee)
    f. ORCF Contract Inspector

g. ORCF Account Executive (AE) (optional attendee)
h. ORCF Closing Coordinator (Closer) (optional attendee)
i. ORCF CM

If the PCCC wishes to have the meeting at the HUD office (corresponding to the date/time of the Initial Closing), they shall contact the HUD Closing Attorney to make arrangements. The HUD staff listed above shall either attend the Pre-construction Conference in person or participate via conference call. Should the RLRO/designee determine that they need to make a *separate* presentation on Davis-Bacon requirements, the RLRO/designee shall advise the PCCC.

B. The Pre-construction Conference

1. The format shall follow the Lender's Pre-construction Conference Agenda (available on the Section 232 Program website).

2. The PCCC shall include the most recent Davis-Bacon wage determination in the project specifications signed at the Pre-construction Conference. Note, if a revised Davis-Bacon wage determination is required, the change will be made via addendum requiring subsequent changes to other documents such as the Firm Commitment (Exhibit B: Index to Drawings and Specifications) and the Construction Contract, which lists the Plans and Specifications.

3. At the Pre-construction Conference, the "Suggested Format for Signature Pages: Electronic HUD Set of Plans and Specifications" (Appendix 10.5), and two (2) hardcopy sets of the plans and specifications, shall be prepared and distributed as follows:

"HUD Inspection Set" of Plans and Specifications
- Legible, half-size set of Plans, and full-size Specifications manual, annotated, "HUD Inspection Set" on each
- Both shall be signed and dated on the front sheet of the plans and cover of the specifications by the Architect, General Contractor, General Contractor's Surety (if applicable), and the Borrower
- Sent to the HUD Contract Inspector

"HUD As-Built Set" of Plans and Specifications
- Full-size set of Plans, and full-size Specifications manual, annotated, "HUD As-Built Set" on each
- Both shall be signed and dated on the front sheet of the plans and cover of the specifications by the Architect, General Contractor, General Contractor's Surety (if applicable), and the Borrower
- Given to the General Contractor
- This set is not to be used for construction purposes, but rather is red lined as any changes are made to the original documents

"HUD Master Set" of Plans and Specifications

- "HUD Master Set – Plans," cover sheet (Appendix 10.5) shall be executed, and electronically "attached" to the front of a PDF version of the Plans (Plans identical to those used for the Inspection and As-Built Sets above)
- "HUD Master Set – Specifications," cover sheet (Appendix 10.5) shall be executed, and electronically "attached" to the front of a PDF version of the Specifications (Specifications identical to those used for the Inspection and As-Built Sets above)
- PDF's shall be sent on a flash drive, CD, or DVD, to the ORCF CM

4. Early Start: If plans and specifications are complete at the time of Early Start, they will be prepared as described above. If plans and specifications are not complete at the time of Early Start, they will be required to be signed prior to Initial Closing.

C. After the Pre-construction Conference

1. The General Contractor shall notify the PCCC, Supervisory Architect, HUD Inspector, and CM of the date that construction starts. See Section 10.1.A above.

2. Within one working day following the start of construction, the PCCC shall notify the RLRO/designee, and the CM of the applicable wage determination being used for the project (attach to an email). In the event that construction did not begin within 90 days after Initial Closing, the RLRO (or his/her designee) shall determine whether the wage determination had been modified and whether any updates must be incorporated into the Construction Contract.

10.4 HUD Construction Monitoring

A. Purpose of Inspection.

1. Inspection means the periodic observations made of construction at the site of a care facility project by a HUD representative (inspector) for the purpose of protecting HUD's interests. Inspections are made to evaluate the General Contractor's and Architect's performance, to obtain construction in accordance with the contract documents, and to report on conformance with prevailing wages and other contract requirements.

2. The instructions for inspection services, and the review of inspection deliverables, are described in the applicable Construction Inspection Services Contract, administered by HUD's Office of the Chief Procurement Officer (OCPO), and managed by the assigned Government Technical Representative (GTR) and/or Government Technical Monitor (GTM).

B. Access. At all times, HUD has the right of access to the property and the right to inspect all work performed and materials furnished to complete the project.

C. Upon HUD's issuance of the Early Start of Construction approval, or Initial Closing, the ORCF CM shall transmit the following executed documents, where applicable, to the assigned HUD Contract Inspector:

1. "HUD Inspection Set" of the Plans and Specifications
2. Firm Commitment, and Amendments
3. Construction Contract
4. Owner-Architect Agreement
5. Design Architect's Certification (HUD-91124-ORCF)
6. Offsite Escrow Agreement and/or Offsite Construction Contract
7. Demolition Escrow Agreement and/or Demolition Construction Contract
8. Early Start of Construction approval, if applicable.

D. Field Supervision. The CM shall keep informed of the general quality of inspections and the performance of inspectors by maintaining close contact with their work through job site visits. A regular routine for supervising field operations should be established and followed. Required and suggested methods of field supervision follow:

1. a minimum of two field review inspections should be made on each project to evaluate the performance of the HUD Contract Inspector. Field review inspections shall be recorded on a HUD Representative's Trip Report;
2. the HUD Contract Inspectors may be accompanied during their rounds. This method is particularly advantageous in training new inspectors;
3. construction should be field reviewed where the use of questionable methods of construction, materials, uncorrected non-compliance, or other problems are reported; and
4. Projects should be field reviewed at construction stages where problems have occurred in that jurisdiction.

10.5 Architect's Duties in Administering Construction Contract

The Architect's duties shall be in accordance with Item 6, of the Lender's Pre-construction Conference Agenda (available on the Section 232 Program website), including:

A. Provide services in accordance with the Owner-Architect Agreement.

B. Have no identity of interest with the Borrower or General Contractor. An identity of interest is defined in the Construction Contract (HUD-92442-ORCF).

C. Ensure construction is carried out in accordance with the contract documents.

   1. Restrict materials, products and equipment to those specified.

   2. Restrict all deviations to those substantially consistent with the original design concept including form, color, and texture.

   3. When arriving at the net amount due on every requisition, compare the cost of the work and materials with the cost to complete the project. Current and previous payment must relate to the total cost for completion.

   4. Restrict substitution of items of a different design or size from those specified to those that are equivalent in utility (i.e., durability, quality, and ease of maintenance).

   5. Restrict substitution of any material differing in composition or appearance from the one specified to one which is equivalent in its attributes (i.e., character, quality, durability and ease of maintenance).

   6. Keep a log on the site that is readily available to the Borrower and HUD Contract Inspector.

D. Architect's supplemental instructions. The architect administering the construction contract may issue field orders using American Institute of Architects' (AIA) Document G710, Architect's Supplemental Instructions, or a similar form.

   1. Supplemental instructions must not involve a change in contract sum or contract time.

   2. Uses of supplemental instructions
      a. Directive to General Contractor to bring construction into compliance with the contract documents
      b. Interpretation or clarification of the contract drawings and specifications.
      c. Order minor changes in the work, not involving cost
      d. Accept specified equivalent
      e. Record other "field orders" that are not construction changes

E. The Architect administering the construction contract is responsible for reporting in writing the results of periodic visits to the construction site. The Architect's Field Report should provide information regarding assessment of the progress of the work and a record of the actions taken to insure that the work is being accomplished in the best interests of all the parties.

1. The AIA Document G711, Architect's Field Report, may be used, or a similar other format.

2. A Field Report of each visit shall show as a minimum the following:
    a. Date of inspection
    b. HUD project identification and location
    c. Time, weather, and temperature range
    d. Estimated percent of completion
    e. Work in progress and conformance with the General Contractor's Progress Schedule
    f. Persons present at work
    g. Observations and items to verify
    h. Information or action required
    i. Firm name and signature

10.6 Architect's Adequacy

The provision for the Architect's administration of the construction contract is covered by the Owner-Architect Agreement and by the General Conditions of the Contract for Construction, AIA Document A201. It is the responsibility of the HUD Contract Inspector to determine the adequacy of the Architect's administration. The adequacy of the Architect's administration in this context is results-oriented, meaning the construction fully complies with the contract documents; the determination of adequacy will not be based on the number of visits or the length of time spent by the Architect on the job.

A. Deficient administration. If the Architect does not report all observed non-compliances with contract documents and unacceptable performances by the General Contractor and exploit all avenues to obtain compliance with the contract, then the Architect's administration of the construction contract will be considered deficient. The Architect is not responsible for actual construction, construction means, methods, techniques or other related responsibilities of the General Contractor. However, the Architect must keep the Lender, Borrower and HUD informed of the progress of the work and endeavor to guard the Borrower and HUD against defects and deficiencies in the construction.

B. Reasons for termination of services. Inadequate performance, undue delay, misrepresentation, failure to act on the part of the Architect or the Architect's associates and employees, and any other material breach of Owner-Architect Agreement shall be reason for

the termination of the Architect's services on the project and may adversely affect the firm's acceptability on future projects.

C. ORCF actions. The HUD Contract Inspector shall bring to the attention of the Architect specific areas in which services are considered deficient. Sufficient time and appropriate assistance shall be given to obtain necessary compliance.

1. When the Architect's performance is first observed as deficient, in addition to the HUD Representative's Trip Report, the inspector shall also prepare a written memorandum to the CM of the deficiency advising of any planned actions or assistance. The memorandum should recommend that future requests for Architectural inspection fees be disallowed until performance improves to an acceptable level.

2. An immediate follow-up by the CM is always required. Conferences with the HUD Contract Inspector, the Supervisory Architect, and the Lender should be arranged and a target date established for the Architect to obtain compliance. The CM shall inform ORCF Management of current problems and of established target dates for corrections. Deficiencies related to misrepresentation, undisclosed identity of interest and known illegal kick-backs should be immediately referred to HUD's Office of Counsel with a copy to ORCF. All actions shall be clearly documented.

D. Request for contract termination. When compliance with the Owner-Architect Agreement cannot be obtained within thirty (30) days, ORCF Management shall request termination of the Architect's contract in accordance with the provisions of the Owner-Architect Agreement. Upon termination, the Architect shall be entitled to no more than the prescribed portion of the fee determined by the percentage to which construction was completed on the date that the Architect was removed from the project. The Borrower may pursue other legal remedies for the Architect's failure to perform, including the recovery of any monetary damages.

E. Contract termination. The Borrower will hire an independent Architect who is acceptable to all parties to continue the administration of the project construction documents. In no event will HUD or the HUD Contract Inspector does not assume the Architect's responsibilities or assume any liability for the Architect's work.

10.7 Permission to Occupy, Final Trip Report, and Warranty Inspections

A. Permission to Occupy.

Permission to Occupy – Project Mortgages (HUD-92485) must be executed by the HUD ORCF CM before the Borrower permits occupancy of any dwelling unit, care facility unit, or other project service facility.

1. Physical completion – The work or portion thereof, for which Permission to Occupy is approved, must be sufficiently completed in accordance with the contract

documents so the Borrower can occupy or utilize the identified portion of the work for its intended use.

a. Support facilities (utilities, disability access, vehicular access and parking, fire & life safety equipment, etc.) must be in place.
b. Acceptability of each unit and facility for which a Permission to Occupy is requested must be established:
    i. Property must be inspected and Permission to Occupy – Project Mortgages must be signed by the Borrower, Supervisory Architect, General Contractor, and Contract Inspector (CI).
    ii. Minor items that do not preclude occupancy are permitted but must be listed as an attachment to the Permission to Occupy – Project Mortgages.
    iii. The General Contractor is fully responsible for any incomplete or improperly performed contract work whether or not listed.

2. Documents Submission – The Lender must sign the Permission to Occupy – Project Mortgages agreeing with the request and stating that insurance risks have been covered for the project. The Borrower must include the following documents with the completed Permission to Occupy – Project Mortgages:
    a. A Certificate of Occupancy or equivalent permit from the governing municipal or other local authority for all units and facilities on the Permission to Occupy, and any other required permits or authorizations;
    b. A valid and current Certificate of Property Insurance, Certificate of Fidelity Insurance, and Certificate of Professional Liability Insurance from the Borrower's insurance company;
    c. Satisfaction of any Firm Commitment Special Conditions related to the Permission to Occupy, if applicable.

3. Partial Occupancy Approval:
    a. Favorably consider partial occupancy of units as they become available; where vandalism could be minimized, needed project income is provided, an earlier rent-up date could be achieved, utility costs for occupied units can be metered separately from the General Contractor's utilities, etc.;
    b. Approve a series of Permission to Occupy as units or facilities become available, e.g. individual buildings on multi-building projects, or individual floors or wings on larger buildings;
    c. Approve a single Permission to Occupy for all units where dictated by management considerations, e.g. very small projects;
    d. Discussion shall be held during the Pre-construction Conference regarding the handling of all Permission to Occupy submittals.

4. Signatures, Approval, and Permission:
    a. Permission to Occupy – Project Mortgages is signed by the Borrower, Supervisory Architect, General Contractor, and Contract Inspector (CI);
    b. Approval – The ORCF CM checks either, "as reported above," or "as modified by me," and signs and dates above "Chief Architecture and

Engineering," and "Deputy," as the Federal Housing Administration's "Authorized Agent";

c. Distribution: Lender, General Contractor, Borrower, Supervisory Architect, HUD Contract Inspector, ORCF Closer, HUD Attorney, and ORCF AE.

B. Final Construction Completion / Final Trip Report.

The Architect and Contract Inspector make the final inspection upon written request of the General Contractor.

1. The Architect determines that all punch list items have been completed unless they are beyond the control of the General Contractor. (Items of delayed completion)

2. The inspector prepares the final inspection report on HUD Representative's Trip Report. The inspector:
   a. Reports onsite construction complete though there may be items of delayed completion;
   b. Lists and describes any items of delayed completion and estimate of cost of completion for each item. (Note: Escrow must not be less than 150 percent of the estimate to complete and must not exceed 2 percent of the mortgage. Work must be completed within 12 months of the date of the Final Trip Report);
   c. Lists any offsite work and reports percentage of completion for each;
   d. Includes the following endorsements:
      i. "Construction acceptably completed." (If there are items of delayed completion, add, "subject to escrow of funds to assure completion of listed items of delayed completion.")
      ii. "All offsite sewer, water, electrical and gas facilities are complete, connected and operable, and safe, adequate, all-weather ingress and egress provided." (If offsite item incomplete, adds, "except as stated at the time of inspection.")

3. The ORCF CM reviews the Final Trip Report, and if acceptable, signs and dates the Report, and distributes copies to: Lender, Borrower, General Contractor, Supervisory Architect, HUD Contract Inspector, ORCF Closer, HUD Attorney, ORCF AE, and HUD Labor Relations Specialist.

C. Warranty Inspections.
A minimum of two inspections are made of all work to discover and require correction of latent defects (defective or nonconforming work not observed during construction) within one year of the date of the Final Trip Report.

1. The HUD Contract Inspector schedules warranty inspections.
   a. First must be within nine months of final completion and shall provide for inspection of the entire project.

b. Other inspections may be necessary to assure inspection of seasonal items such as heating and landscaping.
c. The last inspection must be not later than the 10th day of the 12th month to check previously reported defects and correction, and discover any additional defects.

2. The inspector reports each warranty inspection on HUD Representative's Trip Report.
    a. If work is acceptable, state, "All observable work acceptable at the time of this inspection."
    b. If unacceptable, list latent defects.
        i. Describe each item.
        ii. Recommend method of correction.
        iii. Estimate current cost of correction.
    c. Check any item of delayed completion and list completed and uncompleted items under a separate heading.
    d. Note any improper maintenance or casualty damage under a separate heading.

3. The ORCF CM reviews each warranty inspection, and if acceptable, signs and dates the Report, and distributes copies.

10.8 Insurance of Advances and Related Matters

A. General.
Insurance of advances is the process of releasing HUD insured mortgage funds and other funds necessary for the construction, acquisition, and/or refinancing of the project. The following general criteria apply to advancing such funds.

1. All escrowed funds for on-site improvements (with the possible exception of grant/loan proceeds furnished by a government agency or instrumentality or tax credit proceeds) must be disbursed before mortgage proceeds. See Appendix 10.2 for instructions on grants/loans and tax credits.

2. The amount of construction funds approved and advanced for insurance must be consistent with construction progress approved by the HUD Contract Inspector.

3. Other mortgageable items must be supported with proper bills and/or receipts before funds can be approved and advanced for insurance.

4. The amount advanced for construction items must be adjusted for a 10 percent retainage.

5. The final amount approved for insurance must be supported by certified costs recognized in the cost certification review.

B. The Application for Insurance of Advance of Mortgage Proceeds (HUD-92403) is initiated by the Borrower. The initial and final advances are submitted by the Lender to HUD for review and approval. Interim advances are approved by the Lender (including those advances requesting a Partial Release of Retainage), based upon the HUD Contract Inspectors' approval of the construction amount using the Contractor's Requisition – Project Mortgages (HUD-92448). (Mortgagee signs the Application for Insurance of Advance of Mortgage Proceeds, and Contractor's Requisition – Project Mortgages as described in C. below.)

C. For the initial and final advances, the ORCF Closer and ORCF Workload Manager (WLM) sign the Application for Insurance of Advance of Mortgage Proceeds, and Contractor's Requisition – Project Mortgages, in the following spaces:

1. CC signs in Mortgage Credit Examiner box, and WLM signs as Authorized HUD Official, for the Application for Insurance of Advance of Mortgage Proceeds, and

2. CC signs as Chief Mortgage Credit, and WLM signs under Director, Housing Development, for the Contractor's Requisition – Project Mortgages.

3. Supporting materials to the Application for Insurance of Advance of Mortgage Proceeds include supporting bills/receipts and the Contractor's Requisition – Project Mortgages, if requesting construction funds.

D. The Lender's role in processing the Application for Insurance of Advance of Mortgage Proceeds is as follows.

1. Completes application indicating:
    a. Amount requested by Borrower;
    b. Approximate disbursement date;
    c. Amount to be advanced from mortgage proceeds;
    d. Amount disbursed from Borrower's front money escrow, if any; and
    e. Total loan proceeds disbursed including current request.

2. Submits initial and final application to ORCF Closer for review and approval.

3. Processes and approves interim advances.

4. Ensures clear title before advancing the approved disbursement.

5. Notifies HUD in writing if clear title does not exist.

E. Stages of Advances.

In cases involving insurance of advances, HUD and the Lender's processing of the advance is divided into the following stages:

1. Initial advance. Refers to the first application and coincides with the Initial Closing of the credit instrument. The initial advance will be reviewed by the ORCF Closer, and executed by the ORCF Closer and ORCF WLM. The Lender shall submit the Application for Insurance of Advance of Mortgage Proceeds, Application for Insurance of Advance of Mortgage Proceeds, with supporting documentation for HUD approval.

2. Interim advances. Interim advances are subsequent applications up to completion of the project. Interim advances will be processed and approved by the Lender.

3. Next to Final Advance. When HUD has consent from the Borrower, and surety, if any, all but 2 ½% of the construction retainage may be released.
   Note: This only applies to non-identity of interest General Contractors or where the General Contractor's identity of interest is a project ownership of less than 5 percent.

4. Final Advance. It is any remaining balance of mortgage proceeds at Final Closing. This advance takes into consideration funds necessary to set up the escrows for "Items of Delayed Completion" and "To Be Paid in Cash Items". The final advance, using the Application for Insurance of Advance of Mortgage Proceeds, is to be processed by HUD.

F. Instructions for Approval of Initial/Interim Advances. These instructions can be found in Appendix 10.2.

G. General Contractor's Monthly Requisition and Related Matters. See Appendix 10.3 for instructions on completing the Contractor's Requisition – Project Mortgages, and related matters.

H. Next to Final Advance. The final advance is requested when construction is acceptably complete, even though there may be items of delayed completion.

   1. It may provide for the release of the General Contractor's retainage provided the conditions in Section 10.15.D have been met.

   2. The balance of the off-site escrow may be released provided:
      a. The off-site sewer, water, electrical and gas facilities are completely installed and connected; and safe and adequate all weather facilities for ingress and egress are provided;
      b. All other required off-site construction, if any, is completed;
      c. Otherwise, completion is to be assured by a cash deposit in an amount equal to 150 percent of the HUD estimate of the cost of such off-site construction.

I. Final Advance. The Application for Insurance of the Final Advance requests any remaining balance of mortgage proceeds. It ensures that:

1. The Borrower's cost certification has been approved and the Maximum Insurable Mortgage Letter has been issued approving the final maximum mortgage amount. See Production, Chapter 11.

2. The Application for Insurance of Advance of Mortgage Proceeds is accompanied by a completed Contractor's Requisition – Project Mortgages, with required Contractor's Prevailing Wage Certificate, if the General Contractor's retainage has not been previously disbursed. Refer to Section 10.15.D for instructions on releasing the General Contractor's retainage.

3. The sum to be approved for advance is the balance of the mortgage proceeds, based on the final approved Mortgagor's Certificate of Actual Cost (HUD-92330).

4. Establishment of the escrow under the provisions of the Escrow Agreement for Incomplete Construction (HUD-92456-ORCF).

5. Request for Final Endorsement of Credit Instrument (HUD-92023-ORCF), or Commitment to Insure Upon Completion (HUD-92453-NH), have been submitted and reviewed.

J. For instructions on establishing the escrow for the Borrower's unpaid construction costs under the provisions of the Escrow Agreement for Non-Critical Deferred Repairs (HUD-92476-ORCF), see Production, Chapter 9.

K. Keeping the mortgage in balance.
Soft cost overruns such as interest, taxes, MIP, and insurance resulting from construction delays at the fault of the General Contractor (i.e., poor performance) are funded from the liquidated/actual damages clause in the construction contract. This clause is not a penalty. It instead provides a source of funds to cover the increased soft costs. When the interest allocation is near exhaustion, HUD should be notified immediately. The Lender should follow the following procedure:

1. When the interest allocation is near exhaustion, ask the Architect and the HUD Contract Inspector to estimate an expected completion date.
    a. Compute the minimum liquidated damages for the period between the completion date specified in the construction contract, as adjusted by approved change orders, and the assumed completion date.
    b. When the interest allocation has been exhausted, Developer's fee if applicable, or the working capital escrow should be used to keep interest current.
    c. Transfer the computed liquidated damages amount from column I, Construction, to Column G, Carrying Charges and Financing, on the Financial Record of Mortgage Loan Transaction (HUD-92451).
    d. Allocate full amount to interest, initially.
    e. Funds may be used for MIP, taxes, or insurance payments, if requested, after the funds for these line items and non-profit Developer's fee, if

applicable and working capital escrow are exhausted. However, funds transferred from the construction account may be used to cover only the cost of these items attributable to the period in Paragraph 1 above, specified in the construction contract and the assumed completion date.

2. Notify the Borrower, General Contractor, HUD and surety, if any, by certified mail of the amount and the reason for the transfer.

3. Require written acknowledgment from HUD and surety, if any, before transferring funds.

4. The amount of transferred funds must be reflected on subsequent Contractor's Requisition – Project Mortgages' as a decrease to item 7, Sum of Cost Breakdown Items Plus Inventories of Materials.

5. After review of the cost certification documents, if the full amount of transferred funds was not needed to cover the cost of interest, MIP, taxes, and insurance attributable to the period identified, the balance will be transferred back to the construction account.

6. In processing the Contractor's Requisition – Project Mortgages, before releasing the General Contractor's retainage, make adjustment for the lesser of actual or liquidated damages determined in the cost certification review.

7. This procedure should be invoked only if, after consulting with ORCF Management, it can be confirmed that the problems causing the delay will be remedied within a reasonable time.

10.9 Construction Change Orders – General

A. General Instructions. Construction contract changes (change orders) must be requested by the Borrower through the Lender. Request for Construction Changes on Project Mortgages (HUD-92437) is used for on-site changes during construction in all projects involving Insurance of Advances of Mortgage Proceeds, and Insurance Upon Completion, when the change involves a change in the scope of work, or a change in construction time. Multiple construction changes may be placed on a single form. However, both a construction change(s) and a time extension change may not be listed on the same form. Forms must be signed by the Borrower's Architect, the Borrower, the General Contractor, and the Lender (including the Lender's Architectural Reviewer, Cost Analyst, Appraiser, and Mortgage Credit Specialist, as necessary). The Contract Inspector shall review the change order for technical acceptability and for duplication within the drawings and approve or disallow prior to submission to the Lender for approval. Final change order approval is made by the ORCF CM.

1. The General Contractor shall maintain a Change Order Log, showing the status of potential Change Orders. An updated copy must be kept on site, in the construction office, and a copy provided to the HUD Contract Inspector whenever changes are made to the Log.
2. The project Architect shall draft and assemble attachments for each Change Order clearly describing each change, and the reason for the change. Required attachments for physical changes include:
    a. Appropriate modifications to the contract drawings and specifications**,**
    b. An Architect's narrative confirming that the change(s):
        i. Conforms to the original intent of the contract drawings and specifications; or
        ii. is necessary to overcome an impediment to construction; or is a betterment, an equivalent, or an addition desired by the Borrower,
        iii. is permissible under the applicable zoning, building, housing, and other codes, ordinances and/or regulations, as modified by any and all waivers obtained from appropriate officials,
        iv. incorporates foundation designs that reflect site soils limitations and design recommendations included in the foundation soils report and any other geotechnical reports (if applicable),
        v. complies with the HUD Minimum Property Standards; all applicable accessibility laws for persons with disabilities, including the Fair Housing Accessibility Guidelines, and the Uniform Federal Accessibility Standards (Direct link: http://portal.hud.gov/hudportal/documents/huddoc?id=AccessMatrixSec232.docx); as well as any state or local law that requires higher accessibility requirements; and all other applicable HUD Standards, guidelines and criteria,
        vi. complies with the applicable State Energy Efficiency Design Code,
        vii. for Substantial Rehabilitation, structures in seismic zones 3 and 4 meet three fourths (3/4) of the seismic force level resistance contained in ASCE 31-02: Seismic Evaluation of Existing Buildings, American Society of Civil Engineers, as determined by a registered engineer familiar with lateral force design (if applicable), and
        viii. incorporates noise attenuation measures which are sufficient to mitigate interior noise levels to an "Acceptable" level and complies with the recommendations of the Noise Engineer (if applicable).
    c. Backup documentation for amount(s) requested consisting of itemized quantities and costs (including itemized Builder's Fees).

3. After the General Contractor or Supervisory Architect has drafted the Change Order, and included all necessary attachments, the Contract Inspector will review the change order in the field for technical acceptability and for duplication within the drawings. If necessary, the Lender's Architectural Reviewer and Cost Analyst (per the instructions below), and Lender's Appraiser and Mortgage Credit Specialist (as required by the instructions below), will then review and process the Change Order. The Change Order is then reviewed and signed by the Lender, who then sends the

complete Change Order package to the ORCF CM for final review and approval. Copies of the fully executed Change Order will then be distributed as listed below.

4. Approve change orders only when they are necessary, a betterment, or an equivalent. The following information shall appear in the Change Order submission:
    a. Classification (necessity, betterment, etc.);
    b. Qualification for payment from the contingency reserve, or Borrower cash escrow;
    c. Whether change order results from error, omission, or negligence on the part of the Architect, General Contractor, or Borrower.

5. Do not approve any change orders submitted after the final HUD Contract Inspector's Trip Report, except where:
    a. The change order pertains to "Items of Delayed Completion," or
    b. Prior written approval is given by the ORCF CM.

6. Surety approval must be secured in writing before approving any change or aggregate of changes that increase the contract price 10 percent or more. There is no consent requirement where the project's assurance of completion is by a cash escrow or letter of credit.

7. Change Orders must be submitted in a timely manner. HUD regulations prohibit processing of change orders after the Final Trip Report.

8. The form selected must be signed by:
    a. Borrower,
    b. General Contractor,
    c. Architect, and
    d. Lender

9. All offsite changes must be:
    a. Requested in a letter or other format acceptable to ORCF. The Request for Construction Changes on Project Mortgages shall not be utilized for this purpose.
    b. The request will be otherwise documented and processed in the same manner as on-site changes.

10. HUD will endeavor to promptly review all requests submitted. All construction change requests must be reviewed, signed, and dated by the ORCF CM.

11. Voiding Changes. If an approved change is not made, it must be nullified by a Request for Construction Changes on Project Mortgages restoring the drawings and specifications to the status prior to the change request or to a status acceptable to HUD.

12. Unapproved Changes. When there are unapproved changes in construction, the HUD Contract Inspector is required to modify the amount of the General Contractor's requisition to cover any additional costs related to the unapproved construction including, without limitation, those required to remove work that does not conform to the plans and specifications as approved by HUD originally or in accordance with approved Change Orders.

B. General Change Order Policies.

1. Changes must be accurately reported and accounted for pursuant to U.S. Criminal Code, Section 1010, Title 18, U.S.C.

2. The Change Order process is not to be implemented as a means for making fundamental alterations to a project as approved and underwritten, particularly with respect to retaining its full operational functions, amenities, and value.

3. HUD does not initiate any changes but may require them as a condition of approval in connection with a change proposed by the Architect, Borrower, or General Contractor.

4. All changes must be approved in writing by the Lender and HUD before related work begins.

5. Any change that is made without formal approval, even though tentatively agreed to as technically acceptable, must be recorded by the Contract Inspector as a noncompliance. This stands until, and unless, the Request for Construction Changes on Project Mortgages, is approved, and also affects payment of advances.

C. Change Order Classification.

1. Necessary changes are those that arise from:
    a. Latent conditions that differ from conditions contemplated by the construction documents;
    b. Changes in the applicable codes, ordinances, etc. after:
        i. Initial closing for insured advances;
        ii. Firm Commitment for insurance upon completion;
    c. Errors or omissions by the Architect;
    d. Physical damages to completed construction.

2. Betterment changes are those that are economically justified. They must either:
    a. Increase net income;
    b. Reduce long-term project maintenance and/or operating expenses;
    c. Otherwise enhance the value of the mortgaged property.

3. Equivalent changes are those proposed because:

a. Specified item is not readily available and the substitution provides equivalent or better utility, or
b. Proposed substitution reduces the contract price but provides equivalent or better utility and performance.

D. Additive Change Orders. An Additive Change Order does not give any explicit or implied assurance that an increase in the insured mortgage amount will be granted.

1. Require the Borrower, except for "necessary" change orders on substantial rehabilitation projects, to escrow funding with the Lender for any additive change order where HUD first estimates that the aggregated change orders equal or exceed a $5,000 increase in the construction contract price, and for all subsequent additive change orders.
    a. Excess mortgage proceeds, if available, may be used to fund the escrow for "necessary" and "betterment" change orders. However, any excess mortgage proceeds used to fund the escrow for General Contractor estimated costs in excess of HUD estimated costs, or HUD estimated costs in excess of General Contractor estimated costs, may not be disbursed until final closing.
    b. Permit Lender to accept a third party letter of credit instead of a cash deposit, subject to the Lender agreeing to provide the cash equivalent, where the letter of credit is not immediately met.
    c. Recognize the cost of third party paid change orders at cost certification, where there are available mortgage savings.

2. On substantial rehabilitation projects, approve payment from the established contingency reserve in an amount not to exceed the HUD cost estimate for "necessary" additive change orders. "Betterment" change orders are not eligible for payment from the contingency reserve.
    a. Require an escrow for any amount that the General Contractor's cost estimate exceeds the HUD estimate.
    b. Authorize use of excess mortgage proceeds, if available, to satisfy the escrow requirement Excess mortgage proceeds, if available, may be used to fund the escrow for "necessary" and "betterment" change orders. However, any excess mortgage proceeds used to fund the escrow for General Contractor estimated costs in excess of HUD estimated costs, or HUD estimated costs in excess of General Contractor estimated costs, may not be disbursed until final closing.

3. Approve the following forms for Borrower's application of funds for completed additive change orders:
    a. Request for Approval of Advance of Escrow Funds (HUD-92464), where an escrow is used. Note: This form must be submitted to HUD for approval.
    b. The Application for Insurance of Advance of Mortgage Proceeds, where a rehabilitation project's contingency funds or non-profit's Developer's fee or excess mortgage proceeds are used.

E. Deductive Change Orders. Where the HUD estimated decrease in contract price for any aggregation of change orders:

1. Remains less than 2-1/2 percent of the contract price reduce the "final" Contractor's Requisition – Project Mortgages, by the appropriate amount.

2. Equals or exceeds 2-1/2 percent of the contract price and for all subsequent deductive change orders regardless of the amount:
    a. Reflect the decrease in the Contractor's Requisition – Project Mortgages, Item (8).
    b. Reduce the original mortgage amount at cost certification, where required.

F. Changes that adversely affect income are a basis for change order rejection, except where it is a necessary change order and the situation is unavoidable.

G. Extension of Contract Time.

1. Approve an extension only where:
    a. The delay was beyond the General Contractor's control (e.g. strikes, differing site conditions, bad weather exceeding the average for the season, etc.) and is documented or associated with an approved change order,
    b. The extension request was submitted within the limit provided by the contract and the general conditions for delays beyond the General Contractor's control, and submitted concurrently with any requested changes in the work, and
    c. The request is accompanied by a surety's written consent. There is no consent requirement where the project's assurance of completion is by a cash escrow or letter of credit.

2. Require funding for the increased cost for overhead, interest, taxes, insurance, MIP, and General Contractor's general requirements by use of a cash escrow, or excess mortgage proceeds, or non-profit's Developer's fee, if applicable, or from contingency reserve.

3. HUD enforces liquidated damages in accordance with the contract.

4. Required documentation. Within 21 days of the date a construction delay occurs, the General Contractor must document it with the Architect and include:
    a. Date of occurrence and number of calendar days it covered.
    b. Effect on construction progress.
    c. Cause of the delay. If the cause is of a continuing nature, submit the extension request when the cause ceases, but still record the initial date of occurrence and its effects on construction.
    d. Extension request must also include written consent of the surety and conform to AIA Document A201.

H. Changes to Items of Delayed Completion. These are the only construction contract changes that ORCF can approve after project completion. All others require ORCF consent.

I. Emergency changes.

1. The only time a change can be made without prior written approval of the Lender and HUD is in emergencies that:
    a. Endanger life or property; or
    b. Halt construction.

2. In these instances, the Architect must notify the Lender and HUD and, as soon as possible, submit a Request for Construction Changes on Project Mortgages.

J. Insurance Upon Completion. The Request for Construction Changes on Project Mortgages, are processed in the same way as Insurance of Advance cases, except as modified:

1. An escrow is not required for additive change orders. The Borrower:
    a. Must be able to provide the additional funds required; and
    b. Must not have any outstanding obligation in connection with construction other than the insured mortgage at the time the mortgage is presented to HUD for insurance upon completion.

2. Surety approval is not required for the approval of additive change orders regardless of the percentage of contract increase.

K. Changes to offsite construction must be requested by letter or other acceptable format. The Request for Construction Changes on Project Mortgages may be used as a general guide, but the form itself may not be utilized for this purpose.

L. Other Changes. These changes necessitated by error, omission, or negligence of Architect, Borrower, or General Contractor must be so recorded by HUD architectural staff or Contract inspector, the Request for Construction Changes on Project Mortgages.
    1. Record the reason for the determination.
    2. Indicate that the cost effect must not be included in the mortgage amount.

M. Distribution of fully executed Change Orders: Lender, Borrower, Supervisory Architect, General Contractor, and HUD Contract Inspector.

10.10 Change Orders – HUD Contract Inspector Instructions

A. For specific situations, see the appropriate subject heading.

NOTE: For projects involving insurance upon completion, references here to "contract requirements" or "contract documents" include the conditions and provisions of the

commitment if there is no construction contract.

B. Contemplated changes are first discussed among the Architect, General Contractor, Borrower, and HUD Contract Inspector.

C. The HUD Contract Inspector will make a preliminary determination of technical acceptability before a change order is submitted for approval of the Lender and the HUD Office. (This preliminary determination neither commits HUD to the change, nor relieves the Architect or the General Contractor from completing the process described below.)

10.11 Change Orders – Lender's Architectural Reviewer and Cost Analyst's Instructions

A. Architectural Reviewer. Review all requested changes for technical acceptability.

B. Cost Analyst.

1. Construction changes:
    a. The Lender's Cost Analyst will produce a cost estimate for each construction change request submitted by the Borrower. Apply current data to accepted or amended change order quantities. Include amounts for general requirements and builder's overhead and profit using the percentage of each from the "Replacement Cost" tab of the Maximum Insurable Loan Calculation (HUD-92264A-ORCF) at Firm commitment.
    b. Compare estimate with Borrower's estimate. If reasonable, use Borrower's figure, otherwise use HUD estimate.
    c. Complete cost entries on the Request for Construction Changes on Project Mortgages and forward completed form to the Lender's Appraiser and Mortgage Credit Specialist, if applicable (see "Lender's Appraisal and Mortgage Credit Instructions," below)

2. Approved time extensions:
    a. Calculate additional general requirements cost due to extension of time.
        i. Divide cost of general requirements from the approved Contractor's and/or Mortgagor's Cost Breakdown (HUD-2328) by the number of months estimated for construction from the "Replacement Cost" tab of the Maximum Insurable Loan Calculation at Firm commitment. Sixty-five percent of this amount is the estimate per month of additional general requirements.
        ii. Use one quarter of the monthly estimate per week.
        iii. There is no cost effect for extensions of time for less than one week (seven calendar days).
    b. Complete cost entries on the Request for Construction Changes on Project Mortgages and forward completed form to the Lender's Mortgage Credit Specialist (see "Lender's Appraisal and Mortgage Credit Instructions," below)

10.12 Change Orders – Lender's Appraisal and Mortgage Credit Instructions

A. Appraisal.

1. The Lender's Appraiser must review all requested changes that may affect marketability, value, income, or maintenance or operating cost. The Lender's Appraiser must identify and explain any estimated increase or decrease in net project income on the reverse of the Request for Construction Changes on Project Mortgages.

2. If applicable, per A.1 above, the Lender's Appraiser must forward a Maximum Insurable Loan Calculation reflecting the new data for the Lender's Mortgage Credit Specialist's re-determination of the maximum insurable mortgage.

B. Mortgage Credit.

1. Processing.
    a. If the Borrower's or General Contractor's estimate for the change order exceeds HUD's estimate, the difference must be escrowed with the Lender. Excess mortgage proceeds, if available, may be used to satisfy this requirement. Conversely, that portion of HUD's estimate which exceeds the Borrower's or General Contractor's estimate must be restricted and held until Final Closing to ensure funds to complete the project.
    b. Process the cost and appraisal findings and show the cumulative effect on cost of all approved change items.
    c. Additive Change Orders. Do not give any explicit or implied assurance that an increase in the insured mortgage amount will be granted when approving construction changes.
        i. Require the Borrower, except for "necessary" change orders on substantial rehabilitation projects, to escrow funding with the Lender for any additive change order where HUD first estimates that the aggregated change orders equal or exceed a $5,000 increase in the construction contract price, and for all subsequent additive change orders.
            1. Excess mortgage proceeds, if available, may be used to fund the escrow for "necessary" and "betterment" change orders. However, any excess mortgage proceeds used to fund the escrow for General Contractor estimated costs in excess of HUD estimated costs, or HUD estimated costs in excess of General Contractor estimated costs, may not be disbursed until final closing.
            2. Permit Lender to accept a third party letter of credit instead of a cash deposit, subject to the Lender agreeing to provide the cash equivalent, where the letter of credit is not immediately met.

3. Recognize the cost of third party paid change orders at cost certification, where there are available mortgage savings.

ii. On substantial rehabilitation projects, approve payment from the established contingency reserve in an amount not to exceed the HUD cost estimate for "necessary" additive change orders. "Betterment" change orders are not eligible for payment from the contingency reserve.
    1. Require an escrow for any amount that the General Contractor's cost estimate exceeds the HUD estimate.
    2. Authorize use of excess mortgage proceeds, if available, to satisfy the escrow requirement, subject to the disbursement limitations in 1 a. above.

iii. Approve the following forms for Borrower's application of funds for completed additive change orders:
    1. Request for Approval of Advance of Escrow Funds, where an escrow is used. Note: This form must be submitted for approval.
    2. The Application for Insurance of Advance of Mortgage Proceeds, where a rehabilitation project's contingency funds excess mortgage proceeds are used.

d. Deductive Change Orders. Where HUD estimated decrease in contract price for any aggregation of change orders:
    i. Remains less than 2 ½ percent of the contract price, reduce the "final" Contractor's Requisition – Project Mortgages, by the appropriate amount.
    ii. Equals or exceeds 2 ½ percent of the contract price and for all subsequent deductive change orders regardless of the amount:
        1. Reflect the decrease in the Contractor's Requisition – Project Mortgages, Item (8)
        2. Reduce the original mortgage amount at cost certification, where required.

e. Recalculate the maximum insurable mortgage when any approved construction change or changes adversely affect net income, e.g., a change that causes an increase in operating costs.
    i. Lender's Appraiser completes a Maximum Insurable Loan Calculation with an updated income and expense analysis.
    ii. Re-determine the maximum insurable mortgage.
    iii. If the re-determined mortgage is lower than the original mortgage amount, as a condition of approval of the change order, indicate in item 3b of the Request for Construction Changes on Project Mortgages that subsequent Contractor's Requisition – Project Mortgages, must be reduced by the greater of:
        1. The difference in mortgage amounts;
        2. The net increase in costs resulting from acceptable construction changes.

f. Extensions of time.
    i. Lender's Architectural Reviewer, and Cost Analyst are responsible for determining whether the delay was beyond the General Contractor's control and, if so, the length of the approved time extension.
    ii. Calculate the cost increase due to the extension:
        1. Compute daily rate for interest, taxes and insurance by using estimates in the "Replacement Cost" tab of the Maximum Insurable Loan Calculation and multiply these rates by the approved time extension.
        2. An additional year of MIP will be required if the approved time extension, when added to the estimated construction term plus the 2 months included in the "Replacement Cost" tab of the Maximum Insurable Loan Calculation plus previously approved time extensions, will require an additional MIP payment during the construction period.
        3. Add the additional general requirements, if any, noted by the Lender's Cost Analyst on the change order request.

NOTE: Only Item 3 above amends the construction contract price on the Request for Construction Changes on Project Mortgages.

    iii. Determine the source of funds for any increase due to the extension, i.e., cash, excess mortgage proceeds or non-profit's Developer's fee, or contingency reserve funds.
    iv. Requests for release of excess mortgage proceeds or contingency reserve funds set aside to fund time extensions are submitted on the Application for Insurance of Advance of Mortgage Proceeds.
    v. Releases from a cash deposit are made using the Request for Approval of Advance of Escrow Funds.
    vi. These funds may be released only after the account for the soft cost item(s) being requested has been exhausted on the Financial Record of Mortgage Loan Transaction.

2. Requests for disbursement of contingency reserve funds and non-profit's Developer's fee for completed change order items are made on the Application for Insurance of Advance of Mortgage Proceeds. All requests:
    a. Must be accompanied by a certification by the Borrower's supervisory Architect and the Contract Inspector that all the work covered by the change order has been acceptably completed in accordance with contract documents;
    b. Must include the Borrower's certification relative to payment to the General Contractor contained on the Request for Approval of Advance of Escrow Funds;
    c. Must include the criminal certification contained on the Request for Approval of Advance of Escrow Funds for certifications made in paragraphs a and b above;
    d. Are subject to a 10 percent retainage.

3. Change orders funded from excess mortgage proceeds. Excess mortgage proceeds may be used to fund either "necessary" or "betterment" change orders.
    a. These funds may be used to fund HUD's estimate of increased costs as well as any portion of the General Contractor's estimate which exceeds the HUD estimate. The portion which exceeds HUD's estimate must be restricted until Final Closing.
    b. Funds are released in the same manner as contingency reserve funds.

4. Releasing Cash Deposit. The Borrower submits through the Lender the Request for Approval of Advance of Escrow Funds when construction covered by a cash deposit is complete and acceptable to HUD.
    a. The Borrower's supervisory Architect and the HUD Contract Inspector must certify on the Request for Approval of Advance of Escrow Funds that all work and materials covered by the change order are satisfactory and consistent with contract drawings.
    b. If construction costs were paid in full with other than the cash escrow or excess mortgage proceeds before submitting the disbursement request to HUD for approval, the Borrower must submit a receipt of payment signed by the General Contractor.
    c. If construction costs will be paid after HUD's approval for the release of the funds deposited for the construction change, before the next Application for Insurance of Advance of Mortgage Proceeds is submitted, the Borrower must submit a receipt of payment signed by the General Contractor.

5. Change Order Summary Sheet showing cumulative cost of all executed change orders should contain, at least:
    a. The date the change order was signed by the Borrower;
    b. The date HUD received the change order;
    c. The date the Lender's Mortgage Credit Specialist processed the change order;
    d. The Borrower's or General Contractor's estimate of cost for the change order;
    e. HUD's estimate of cost for the change order;
    f. The amount of change orders to be funded from contingency reserve, non-profit's Developer's fee, or excess mortgage proceeds;
    g. The required cash escrow deposit, if any;
    h. The HUD percentage of cost increase or decrease.

10.13 Labor and Fair Housing and Equal Opportunity (FHEO)

A. Wages

1. Payrolls. General Contractor payrolls are submitted directly to the designated HUD Labor Relations Specialist weekly for each week in which contract work is performed.

2. On-site interviews. The ORCF CM forwards PDF copies of the Record of Employee Interview (HUD-11), which are submitted by the HUD Contract Inspector, to the HUD Labor Relations Staff.

B. Labor violations. The CM shall advise the Labor Relations Staff of continuing minor infractions that cannot be resolved or of any identified or suspected major violations.

C. FHEO violations. The CM shall advise the applicable HUD Director of FHEO of continuing minor violations that cannot be resolved or of any identified or suspected major violations.

10.14 Surveys

Surveys must be performed by a licensed surveyor and show the exact location of on-site improvements, including utility lines and easements, as described in the Survey Instructions and Borrower's Certification, and as outlined below:

A. The General Contractor must give the Borrower and HUD surveys:

1. At any time the Borrower or HUD requires, and

2. When construction is complete ("as-built" survey).

B. The HUD Contract Inspector, when uncertain of the location of construction or stored materials in relation to property lines or easements, may ask the Architect to require a survey with the next General Contractor's requisition.

C. If encroachments are found, the HUD Contract Inspector must notify the ORCF CM by memorandum explaining the conditions. (Encroachments may jeopardize the entire property as security for an insured mortgage.)

10.15 Escrowed Funds, Letters of Credit, Deposits, Retainage and Related Matters

A. Borrower's Application for Escrowed Funds.

1. Request for Approval of Advance of Escrow Funds, must be used where the escrow is to ensure completion of offsite improvements, demolition, additive change orders, minor movable equipment, non-critical repairs (under the Section 223(f) program), or Borrower's unpaid construction items at Final Closing.

2. The Borrower initiates and forwards the Request for Approval of Advance of Escrow Funds to the Lender for its review before submitting the disbursement request to HUD for approval.

3. Require the HUD inspector to reflect the percentage of acceptably completed escrow work on the HUD Representative's Trip Report, and forward a copy after review to the Lender for use in reviewing the Request for Approval of Advance of Escrow Funds.

4. Do not authorize advances in excess of the documented percentage completed, less previous payments and a 10 percent retainage.

B. Release of letters of credit. In the event of a claim:

1. Assignment. HUD will not accept an assignment of the letter of credit to HUD from the Lender.

2. Un-drawn Balance. HUD will treat any un-drawn balance from a letter of credit or escrow agreement as cash held by the Lender.

3. Cash equivalent. The Lender is required to provide cash equal to the un-drawn balance, if demand on a letter of credit is not met.

C. Working Capital Deposit is established with the Lender at initial closing. It may be funded by cash, letter of credit or excess mortgage proceeds, if any.

1. Purpose. The deposit is used to:
    a. Defray cost of pre-operations marketing and initial rent-up. This includes: sales and advertising, model furnishing, and equipment and supplies essential to initial rent-up, etc.;
    b. Escrow funds for items due during the first operating year that project income is not expected to cover, including real estate taxes, permanent property insurance premiums, ground rents and assessments;
    c. Cover shortfalls in interest, taxes, property insurance premiums, ground rents and assessments during construction after funds available under the Building Loan Agreement are exhausted;
    d. Potentially allocate funds to the Reserve for Replacement (R4R) account for a project with low income housing tax credits, where acceptable to the Borrower and HUD;
    e. The new construction contingency portion of the escrow will be used for change orders and cost overruns.

2. Control and Release of Escrow. The Lender controls disbursements from the escrow, subject to HUD approval where appropriate (where required by escrow agreement), except where the Borrower certifies at firm commitment that any balance of the escrow will be applied to the reserve for replacements or additional betterments on a

LIHTC, Historic Tax Credit, or New Markets Tax Credit project. In reviewing a Borrower's request for release of part of the escrow, consider the following:

a. Borrower's request for the release of such escrow funds must be by letter to the Lender, rather than on the Application for Insurance of Advance of Mortgage Proceeds;
b. None of the escrow can be used to defray any of the hard costs of construction applicable to the "Total for All Improvements." in the "Replacement Cost" tab of the Maximum Insurable Loan Calculation;
c. Avoid premature disbursements and unnecessary expenditures;
d. As portions of a project are ready for occupancy, a partial disbursement may be permitted for reasonable opening expenses: however, it must be determined that the escrow is not exhausted before the entire project is complete;
e. ORCF may require that the deposit be used to cover any shortfall in interest, taxes, property insurance, ground rent and assessments;
f. Fully document all expenditures from the escrow.

3. Final Release of Escrow.
    a. The Lender may release any balance in the working capital escrow to the Borrower 12 months after Final Closing where the project is not in default and when the project has demonstrated to ORCF's satisfaction that the project has achieved break-even occupancy for each of six consecutive months. Break-even occupancy is defined as 1.0 debt service coverage, based on all sources of Project income including ancillary income.
    b. The Lender must hold this escrow until any project financial problems are resolved (e.g., has not reached sustaining occupancy, has poor liquidity or high payables, is operating at a deficit or is near default).
    c. If the project mortgage is in default, the Lender should use any balance of the working capital escrow to cure a default, where a default occurs before the Escrow's release.
    d. The working capital new construction contingency will be refunded to the Borrower at Final Closing, if not used.

D. Amount of General Contractor's 10 percent retainage and release. The retainage provides an incentive for the General Contractor and Borrower to: promptly complete the project, submit cost certification and reach final closing.

1. Amount of retainage. The Building Loan Agreement requires the Lender to retain at least 10 percent of the construction proceeds from each advance. The construction contract also provides for 10 percent retainage from the General Contractor's monthly payments for acceptably completed work, acceptably stored materials, and where applicable, components acceptably stored offsite. The requirement for contingency release is as follows:
    a. The General Contractor has no identity-of-interest with the Borrower greater than a 5 percent equity interest;
    b. If applicable, prior written consent from the surety company must be attached to the request for release; and

c. There are no questions regarding the General Contractor's performance concerning the quality of work, compliance with the contract and any change orders or work in progress;
d. Assuming these conditions are met, the existing standard of 10% retainage will be required only until 90% completion. After 90% completion, the requirement will be 5% retainage until 100% completion and 2.5% retainage until the loan reaches Final Closing.

2. Release of retainage for identity of interest General Contractor. Except as provided in paragraphs 4 and 5 below, do not release any part of the retainage until final closing for a General Contractor with an identity of interest.

3. Release of retainage for non-identity of interest General Contractor. Release the General Contractor's retainage or remaining balance at the next to last advance, where requisitioned on the Application for Insurance of Advance of Mortgage Proceeds, and subject to compliance with the following:
    a. General Contractor's cost certification, where required, has been reviewed and approved;
    b. General Contractor has disclosed its final obligations on the Request for Final Endorsement of the Credit Instrument;
    c. All work under the construction contract has been inspected and approved by the controlling jurisdictions and/or authorities;
    d. Certificates of occupancy or other required approvals for the dwelling units, and non-dwelling facilities, where applicable, have been issued by governmental authorities having jurisdiction. Separate buildings for community rooms, rental offices, laundry rooms, etc., commonly require certificates of occupancy;
    e. Permission To Occupy – Project Mortgages has been issued by HUD for all units;
    f. All Davis Bacon payroll requirements have been satisfied;
    g. As-Built Survey, has been submitted to HUD, per the Survey Instructions and Borrower's Certification (HUD-91111-ORCF), and
    h. Retain, where applicable, an adequate amount for the following:
        i. Items of delayed completion in an amount equal to 150 percent of the HUD Inspector's cost estimate for completion,
        ii. Any owed or contested amounts indicated by mechanics, subcontractor, supplier, or equipment lessor liens, etc.
        iii. Lessor of the liquidated damages or actual damages computed at cost certification, and
        iv. Net effect of negative change orders.

4. Early partial release of retainage.
After 90 percent construction completion, the ORCF CM may approve the partial release of the General Contractor's retainage, and suspend further withholding of retainage from payments due, where:

a. The General Contractor has no identity of interest or the General Contractor's only identity of interest is a project ownership of less than 5 percent;
b. The General Contractor, Borrower and mortgagee request the early release of the retainage in accordance with Appendix 10.4, and attach the request to the Application for Insurance of Advance of Mortgage Proceeds; and
c. The surety, if any, has provided written consent to the release

d. The ORCF CM determines that:
    i. The General Contractor's general performance warrants partial release of the retainage without conditions, and
    ii. There are no significant outstanding Labor Standards / Davis-Bacon issues (if applicable), or
    iii. Partial release of the retainage with conditions, e.g., measures to assure immediate distributions to subcontractors or others would be in the mutual interest of all participants.
e. The un-disbursed retainage must equal or exceed 5 percent of the contract amount.

5. Projects in difficulty. Release of part of the General Contractor's retainage before 90 percent contract completion may be granted only to prevent a default of the construction loan and only if it would solve the project's problems and enable it to reach construction completion.
    a. Review the General Contractor's performance including:
        i. The completed work must be satisfactory;
        ii. The percentage of completed contract work must be sufficient to ensure project completion within the specified contract time; and
        iii. Do not release any retainage if there are serious, unresolved questions concerning:
            1. Quality of work,
            2. Compliance with the contract, including outstanding change orders, or
            3. Work is progressing behind the General Contractor's construction schedule, as amended by approved change orders.
    b. Require a written consent for the early release of retainage from the surety, if any, the Borrower and mortgagee.

E. Release of the Initial Operating Deficit. ORCF's AE will consider Lender requests for initial operating deficit draws during lease-up. The Lender's request must be accompanied by:

1. A review and analysis of the monthly accounting reports detailing progress on lease up as compared to the lease up projections used in underwriting, and

2. An updated calculation of the sufficiency of the escrow. This analysis and calculation is particularly important if the project is experiencing substantial variations from its lease up projections.

3. Unused portions will be returned to the Borrower twelve months after final closing and when the project has demonstrated to ORCF's satisfaction that the Project has achieved a debt service coverage ratio (including the Mortgage Insurance Premium) of at least 1.45 for each month of three consecutive months. The Lender is responsible for insuring that escrow funds are released solely for project operating needs.

10.16 Completion of Repairs Pursuant to Section 223(f) and 223(a)(7)

A. Required Repairs are documented by the Lender's Needs Assessor. A list is prepared which categorizes repairs into critical repairs and non-critical repairs.

1. Critical repairs must be completed before closing. Critical repairs are any individual or combination of repairs required to correct conditions that:
    a. Endanger the safety or well-being of residents, visitors or passers-by;
    b. Endanger the physical security of the property;
    c. Adversely affect project or unit(s) ingress or egress;
    d. Prevent the project from reaching sustaining occupancy;
    e. Require correction of accessibility deficiencies (See Accessibility Matrix available on the Section 232 Program website. Direct link: http://portal.hud.gov/hudportal/documents/huddoc?id=AccessMatrixSec232.docx).

2. Non-critical Repairs consist of all repairs other than Critical Repairs. Non-critical Repairs may, at the request of the Borrower, be completed after closing.

3. Completion of repairs.
    a. Completion of repairs before closing. Lender shall submit a completed Owner's Certification - Completion of Critical Repairs (HUD-91118), to HUD for review and approval.
    b. Completion of repairs after closing. See Asset Management, Chapter 3.2.4 for details regarding Non-Critical Repair Escrows.

4. Payment for Repairs.
    a. Repairs completed before closing: No mortgage proceeds may be advanced.
    b. Repairs completed after closing: Shall be funded from the Non-Critical Repair Escrow established at Initial Closing.

B. Repair completion. All work must be acceptably completed before the loan closing, except for the following:
    1. Exterior Repairs, that cannot be completed because of weather conditions, may be completed after closing, with prior ORCF approval. Include amount(s) to be escrowed.

2. Non-critical repairs may be completed after closing when the commitment provides for it and a completion escrow is established at closing, except that:
    a. All critical repairs must be completed before closing, and
    b. An additional deposit must be made to the operating deficit account for delayed repairs which will delay or interrupt occupancy or income for any period.

10.17 Major Movable Equipment – Requisitions, Inspections, and Changes to Equipment Schedule During Construction

A. Requisitions.

1. The Borrower prepares the Application for Insurance of Advance of Mortgage Proceeds, indicating the total amount of Major Movable Equipment delivered to the site and installed or stored onsite.

2. Related attachments will include:
    a. A summary sheet, and detailed lists all Major Movable Equipment purchased and installed/stored on site within the past month;
    b. All invoices for equipment purchased.

NOTE: *Deposits* for Major Movable Equipment are not eligible for funding from mortgage proceeds.

B. Inspection of Major Movable Equipment.

The HUD Contract Inspector:

1. Confirms delivery and installation (or acceptably stored on site) of Major Movable Equipment and the invoice amounts;

2. Will only approve payment for equipment actually delivered and installed/stored on site, and may change the listed equipment and requested amount on the Application for Insurance of Advance of Mortgage Proceeds accordingly, to agree with actual delivery and installation / storing;

3. Initials the summary sheet, and documents their observations and conclusions in the HUD Representative's Trip Report.

C. Changes to the Major Movable Equipment (MME) Schedule during construction.

1. Lender requires the Borrower to submit a revision of the itemized MME list. The revised MME list should itemize which specific MME items are being replaced, and

contain a complete description and cost of the MME items that have been chosen as replacements.

2. The Borrower presents the revised MME list to the Lender for review. The Lender reviews the revised MME list and certifies that the replacement MME items are of equal quality and will perform the intended function of the MME items being replaced. Lender forwards a copy of the revised MME list and certification to the ORCF CM.

3. The ORCF CM forwards a copy of the revise MME List to the HUD Contract Inspector.

Note: If a revised MME item costs more than the item being replaced, the price differential *may* be paid from the Working Capital Escrow.

Section II
Production

Appendix 10.1

Procedures for Requesting Approval for Start of Construction Prior to Initial Closing for Section 241(a)

The following is applicable to requesting approval for start of construction prior to Initial Closing for mortgages insured by the Housing and Urban Development pursuant to Section 232 of the National Housing Act using Section 232 processing. Early Start, prior to Initial Closing, is not permitted for New Construction, Substantial Rehabilitation or Blended Rate projects.

1. Certain Defined Terms. As used in this document, the following words and terms shall have the meanings set forth below:

    a. "HUD" means the Department of Housing and Urban Development.

    b. "ORCF" means the Office of Residential Care Facilities.

    c. "Good Cause" means the existence of circumstances likely to increase costs, create additional risk, or otherwise impair HUD's interests and which may be partially or fully resolved by permitting the early start of construction. These circumstances may include, for example (i) compliance with a deadline imposed by state or local law or any applicable governmental approval or permit (e.g., certificate of need, special zoning permit or building permit); (ii) adverse weather conditions/time of year; or (iii) atypical spikes in the pricing of labor and materials.

    d. "Site and Foundation Work" means, with respect to an Early Start Project, any and all work that is customarily performed in the construction of health care facilities up to and including the completion of foundations, including, but not limited to, clearing, grading, underground utilities, roads, parking areas, building pads, footers and foundations.

    e. "Underwriter" means the underwriter for a project designated by HUD to underwrite a mortgage loan for such project on behalf of HUD. The ORCF staff or contractor designated by HUD to evaluate the anticipated Section 232 loan and determine its conformity with the applicable program underwriting requirements.

2. Request for Permission to Commence Construction. At any time prior to Initial Closing of a mortgage for insurance, the Borrower, with the concurrence of the Lender, may submit a Request for Permission to Commence Construction Prior to Initial Closing for Mortgage Insurance (HUD-92415-ORCF) by completing and delivering to the Underwriter an executed Request form, together with the supporting documentation set forth therein. The Early

Commencement of Construction Checklist, located on the Section 232 Program website, contains the documents required to be submitted with such a request. If the Borrower is a non-profit entity, the Request must be accompanied by a resolution of the governing body of the entity authorizing the Request and confirming the certifications made by the Borrower therein.

3. Approval of Requests. The Underwriter shall consider such Request and shall approve such Request if (a) the Borrower shall have complied with applicable HUD requirements as set forth in the Request Form and this Appendix 10.1, and (b) if the approval is to be granted prior to issuance of a HUD firm commitment, (i) the environmental review (HEROS – Form HUD-4128) shall have been signed by HUD, and (ii) the Borrower shall have shown Good Cause for commencing construction prior to Initial Closing.

4. Certification of Borrower. Approval of the Request will be subject to the Borrower certifying that:

    a. there is Good Cause for requesting permission to commence construction prior to Initial Closing (Such Good Cause shall have been described in detail and documented to the Underwriter's satisfaction);
    b. the work to be performed pursuant to the Request shall be limited as set forth in this document;
    c. the Borrower has arranged for independent financing of the work to be performed pursuant to the Request;
    d. the Borrower acknowledges and agrees that approval of the Request by HUD (i) does not constitute a commitment by HUD to insure a mortgage on the project, nor create any obligation on HUD to issue such a commitment, nor create any obligation to approve a mortgage insurance application and (ii) does not in any way obligate HUD to insure a mortgage with respect to the project;
    e. the Borrower acknowledges and agrees that concurrence in the Request by the Lender (i) does not constitute a commitment by the Lender to make a mortgage loan with respect to the project and (ii) does not constitute any representation, warranty or other assurance by the Lender that HUD will insure a mortgage with respect to the project; and
    f. the Borrower waives and releases any and all claims that borrower may have against HUD and/or the Lender with respect to any losses, damages, costs and/or expenses incurred in connection with any construction undertaken prior to Initial Closing.

5. Certain Requirements; Limitations on Performance of Work.

    a. The work may not begin until HUD approves the Request. The work must (i) meet all requirements and guidelines as if it were approved for mortgage insurance and (ii) comply with all state and local requirements.
    b. The work may be eligible to be financed with insured mortgage proceeds if the mortgage insurance application is approved, a HUD firm commitment is issued and the mortgage is initially endorsed for mortgage insurance by HUD.

c. For Early Start Projects only, the work performed prior to issuance of a HUD firm commitment shall be limited to Site and Foundation Work. ORCF may approve the performance of additional work prior to issuance of a HUD firm commitment upon a showing of urgent and compelling circumstances, subject to such conditions as ORCF may specify.

6. Inspection Fee Payments. The Borrower shall make non-refundable inspection fee payments to HUD in accordance with the Request Form.

7. No express or implied intent. Approval of any Request shall in no way be construed as indicating any intent, express or implied, on the part of HUD to approve, disapprove, or make any undertaking or promise whatsoever with respect to the application for mortgage insurance or with respect to any commitment for mortgage insurance. Any work performed prior to Initial Closing shall be undertaken at the sole risk and responsibility of the Borrower.

8. The Lender shall obtain an FHA Project number prior to requesting Early Start of Construction.

9. One paper copy of the Early Start documents (as detailed in the Early Start of Construction Checklist), an electronic version of the documents, and the inspection fee check will be submitted to ORCF.

10. The Construction Contract may need to be revised via a rider to address the fact that construction is beginning prior to Initial Closing (particularly the portion related to liquidated damages). Moreover, the Contract may need to be revised prior to Initial Closing, if necessary.

11. The Lender will be responsible for conducting a Pre-construction Conference prior to start of construction. See Production, Chapter 10 and sample available on the Section 232 Program website.

12. HUD will require only one Pre-construction Conference. If plans and specifications are complete at the time of Early Start, they will be signed in accordance with Production, Chapter 10.3. If plans and specifications are not complete at the time of Early Start, they will be required to be signed prior to Initial Closing. In the latter situation, HUD will notify the Lender regarding the need for plans and specifications prior to Initial Closing.

13. At Initial Closing, a release of liens must be provided by the Contractor and each subcontractor who performs work on the project, prior to recording the insured mortgage. No additional exceptions are permitted in the mortgage title policy due to the early start.

Section II
Production

Appendix 10.2

Instructions for Approval of Initial/Interim Advances

A. Approving Initial/Interim Advances

1. Before advancing any insured mortgage proceeds, disburse other available funding sources in the following order:
    a. All funds from the cash escrow established by the Borrower for onsite construction, fees, carrying charges, and financing (front money escrow).
    b. Grant/loan proceeds furnished by a national, regional, or local community service organization or a private source.
    c. Grant/loan proceeds furnished by a government agency or instrumentality unless a pro-rata disbursement arrangement has been previously approved by the Office of Residential Care Facilities (ORCF).

2. The amount approved for a requested item cannot exceed the amount claimed by the Borrower.

3. The Lender states on the Application for Insurance of Advance of Mortgage Proceeds the cumulative total of all advances made to the Borrower, including the advance under consideration. Reconcile any discrepancies before recommending approval of the advance.

4. Lender-approved disbursement amounts shall not exceed the sum of the amounts approved:
    a. For mortgage insurance;
    b. For funding from the Borrower's cash escrow; and
    c. For funding from available grant/loan proceeds.

5. HUD recognizes that, in order to deliver documents to the investor for satisfactory receipt and delivery of the initial GNMA Construction Loan Certificate, a de minimis first draw of the loan proceeds may need to be approved for disbursement at initial closing. The disbursements must be supported by justification and found acceptable to ORCF.

B. Architect's Fees

1. The Architect's cash fee is in the Standard Form of Agreement between Owner and Architect for a Federally Funded or Federally Insured Project,

AIA Document B108.

2. If there is one agreement for both design and supervisory services, a specific dollar amount must be indicated for each service.

3. There may be separate agreements for design and for supervisory services.

4. The Architect's design cash fee may be released with the initial advance.

5. Design services provided by others as detailed in the B108 must be supported by contracts approved by HUD during commitment processing before any funds may be advanced.

6. The Mortgagor's and Architect's Certificate (HUD-92403.1), must accompany any request or partial request for advance of the design fee.

7. The Architect's supervisory cash fee is advanced based on a percentage of completion method. The maximum amount that may be approved is computed by multiplying the Architect's supervisory cash fee by the percentage of work completed and approved on the Contractor's Requisition – Project Mortgages, then deducting the total of installments previously paid.

8. There is no "holdback" applied to the disbursements approved from the Architect's Cash Fee.

C. For Insurance of Advances, the Carrying Charges, Financing, Legal, and Audit Expense must not exceed their allocations in the Building Loan Agreement. Approve items due or already paid by the Borrower which are supported by bills or paid receipts. Do not approve costs for interest, taxes and insurance incurred during early commencement/start period.

Note: At cost certification, certify to the actual cost without regard to release limitations imposed by the Building Loan Agreement during the Construction period.

1. Interest is to be advanced only when and as earned. The Lender must specify on Application for Insurance of Advance of Mortgage Proceeds, the period(s) for which interest is requested and the amount for each period.
    a. At initial closing, verify as to whether a 360 or 365-day (or 366, if leap year) factor is to be used in calculating interest. Check each interest request for accuracy based on the factor indicated, and the annual interest rate approved at Initial Closing.
    b. The Lender is prohibited from drawing down interest and refunding a portion of the money to the Borrower. Such practice constitutes a kickback and is not acceptable to HUD and will be treated as a direct mortgage reduction.

2. Taxes. In approving amounts for this line item:
    a. Do not allow amounts which accrued before Initial Closing.

b. Approve invoices which are payable during construction, even if a portion of the billing period will be after an allowable cutoff date. Necessary adjustments will be made at the time of cost certification.

3. Insurance. Allow amounts for fire, windstorm, extended coverage, liability, and other risk insurance customarily insured against in the community.
   a. Do not allow amounts which accrued before Initial Closing.
   b. Do not approve invoices/receipts for workers' compensation and/or public liability insurance which are included in the cost estimate.

4. Mortgage Insurance Premium may not exceed the amount due for 1 year.

5. Initial service charge and permanent lender fees are limited to:
   a. The actual amount paid or the amount stipulated in the Mortgagee's Certificate (HUD-2434), whichever is less.
   b. The initial service fee cannot exceed 2 percent.
   c. The combined amount may not exceed 3.5 percent of the mortgage.
   d. Note: If the 3.5 percent included in processing exceeds the financing fee charges by the mortgagee, identify the excess as restricted funds.

6. Legal fees may be allowed for:
   a. Counsel to create the Borrower entity; however, legal services for the creation of tax shelters, trusts, estate planning maneuvers, and similar efforts intended to benefit the project's principals should be excluded.
   b. Costs associated with counsel's review of initial and final closing documents.
   c. Normal interim activities in creating a project.
   d. Documented costs for items in paragraphs 6.a, b, and c above which are due and payable before or at final closing may be approved in the initial advance, provided the limitation in paragraph 6.e below is not exceeded.
   e. Seventy-five percent may be disbursed at initial closing or during construction. The remaining 25 percent may not be released before Final Closing.

   NOTE: Do not allow legal expenses connected with land acquisition, title and recording charges and/or obtaining zoning as they are reflected in the land value. Amounts included in the Maximum Insurable Loan Calculation for legal and audit expenses are not blanket allowances, but ordinarily set an upper limit on allowable amounts. Atypical fees must be borne by the Borrower, unless in an exceptionally complex case, a higher fee is proven by the Borrower to be necessary and reasonable. Detailed invoices and/or other documentation are/is required as to the reasonableness, purpose, necessity, and proper classification of all items in the category.

7. Organizational Fees:

a. The amount included in the replacement cost estimate for organizational fees is an allowance to reimburse the Borrower for costs incurred to:
    i. Initiate a project;
    ii. Organize the Borrower entity;
    iii. Organize its planning, financing and construction, and
    iv. Control and manage construction through Closing
    v. Third Party costs (Appraiser etc.)
b. Release based upon the following:
    i. Disburse 65 percent at initial closing.
    ii. Disburse 15 percent during construction based upon a percentage of completion.
    iii. Disburse the remaining 20 percent at Final Closing.

    Note: Lender's Third Party Costs, reflected in Organization Costs are exempted from the 65% rule. The rule only applies to the Borrower's organizational costs.
c. This allowance may not be used to subordinate the cash requirements for closing.
d. At cost certification allow only the amount included in the Maximum Insurable Loan Calculation for organizational fees, unless fully supporting documentation is submitted by the Borrower which justifies the need for and reasonableness of the additional expenditure. Any costs incurred in excess of this allowance are not eligible for recognition in processing a mortgage increase or the equity computation on the Maximum Insurable Loan Calculation.

8. Audit fees associated with obtaining an accountant's opinion of the Borrower's cost certification cannot be advanced until Final Closing.

9. Title and Recording. Approve amounts typically incurred for:
    a. Title search and policy at the time of Initial Closing;
    b. Recording fees at Initial Closing;
    c. Mortgage and stamp taxes;
    d. Survey recording fees;
    e. Updating title policy during construction;
    f. Final title policy and recording charges; and
    g. Legal fees actually incurred and clearly for these purposes.

** Do not fully disburse these funds at Initial Closing. Ensure that sufficient funds are maintained in the account to cover title and recording costs required at Final Closing. This may require the approval of an amount less than that requested in the initial draw.

** Do not disburse funds for title and recording cost associated with acquisition of the land or property.

** Legal, organizational, title, recording costs and taxes incurred in connection with the site purchase may be added to the cost of the land in establishing the latest arms' length purchase price.

10. Developer's fee is provided in the estimated replacement cost involving non-profit Borrowers. Part or the entire fee may be used to pay for transactional costs associated with developing the project including but not limited to:
    a. Reduction of the estimated closing costs of the project;
    b. Staff salaries;
    c. Non-profit working capital deposit;
    d. Relocation expenses;
    e. Operating deficit escrow;
    f. Financing fees over and above the 3.5 percent included in the estimated replacement cost of the project;
    g. Environment studies; and
    h. Housing Consultant services provided by either in-house staff or contractor.

11. Tap fees, soil testing and other fees. Approved disbursement must be fully supported and is not to exceed the amount estimated in the general contractor's or Borrower's list of other fees for requested items. Approve disbursement only for items actually due.

12. The contingency reserve is included in the replacement cost of substantial rehabilitation projects.
    a. Use the contingency reserve for:
        i. Unforeseen costs of necessary changes approved by ORCF.
        ii. Unanticipated soft costs associated with extension of time change orders approved by ORCF.
    b. Changes classified as betterments are ineligible for funding.

13. Third-Party Lender Expenses: Fees to be paid for third-party review costs of the Lender including but not limited to Architectural reviews, Cost reviews, appraisals, and market studies.

14. At Initial Closing, HUD fees for examination and inspection.

15. Sums allocated to acquisition cost of land or existing building.

D. Allocation of Cash Available to the Borrower:

1. Allocation of cash available to the Borrower is limited to the following items and, when applicable, should be identified in an unused column on Financial Record of Mortgage Loan Transaction:
    a. New Construction.
        i. HUD's estimate of the "as-is" value of land or the actual latest arms' length purchase price, whichever is less. The latest arms' length purchase price may include the following costs incurred in connection with the site purchase:
            1. Legal fees associated with negotiations for acquisition of land,

zoning, and examination of title on the purchase or defense of title after purchase.

2. Prepaid special assessments.
3. Interest on bridge loans to purchase property after the date of submission of the initial application for mortgage insurance.
4. Taxes.
5. Cost of improvements made to the project site by the sponsor/Borrower.

b. Cash escrow to cover offsite construction cost.
c. Cost of any demolition reflected in the Fair Market Value of Land. Payment is approved as demolition progresses.
d. Construction and/or permanent loan discounts required to be paid at initial closing.
e. Escrow to cover interest shortfall escrow, working capital deposit, initial operating deposit, nonrealty items and any permanent loan discounts not required to be paid at initial closing.
f. Remaining balance may be used to fund any approved change orders or held until Final Closing.

2. Rehabilitation of Existing Construction.
   a. HUD's estimate of the "as-is" value by market comparison or the Borrower's acquisition cost/existing indebtedness, whichever is less.
   b. Items 1a through 1f above.

E. Restricted Excess Mortgage Proceeds:

Restricted excess mortgage proceeds are those excess mortgage proceeds determined not to be available to the Borrower during construction, i.e., difference by which the HUD estimate exceeds contract amounts.

1. These funds cannot be used to satisfy any escrow requirements and must be held until Final Closing.

2. Identify these funds in an unused column of the Financial Record of Mortgage Loan Transaction as restricted funds.

F. Lender Duties for Processing the Application for Insurance of Advance of Mortgage Proceeds. The Lender must review and approve the Application for Insurance of Advance of Mortgage Proceeds conducting the following major responsibilities:

1. Reconcile any discrepancies between the cumulative total for all advances, including the advance under consideration, and conclusions reached in the processing before recommending the advance for approval.
   a. Enter any required adjustments in Column B and note, "No Adjustment Necessary, Except As Indicated," or "No Adjustment Necessary," as appropriate.

b. Enter the approved amount in the "Certificate of Mortgage Insurance" on the face of the form, and where the request is reduced; explain the disallowance on the form's reverse side.

2. Determine monthly that advances are proportionate to construction progress.
   a. Require the Lender's underwriter to advise you where advances for "soft costs", i.e., financing and carrying charges, are in excess of work progress as shown by the most current Progress Schedule accepted by the HUD and the percentage of project completion reflected on the Contractor's Requisition – Project Mortgages.
   b. Take action where the mortgage is not in balance due to the fault of the contractor.
3. Secure approval from HUD for any advance requesting release of any portion of the contractor's 10 percent holdback.

4. Maintain a record of approved disbursements on the Financial Record of Mortgage Loan Transaction.

G. Certificate of Mortgage Insurance: (Prepare when the advance is eligible for approval.)

1. The approved sum is the total for the Contractor's Requisition and other eligible line items.

2. The total approved for any item must not exceed the amount allocated to the item unless the Lender submits a written request to HUD for permission to reallocate funds between line items.

3. The sum approved for mortgage insurance is the amount approved for advance less any funds remaining in the front money escrow and any grant/loan proceeds.

4. For interim advances, the Lender is to prepare this Certificate and sign for HUD, to increase the amount of mortgage insurance.

5. After signing the Application for Insurance of Advance of Mortgage Proceeds in the space for the Authorized HUD Official, and signing the Contractor's Requisition – Project Mortgages (HUD-92448) for the Director of Housing Development, the Lender sends a PDF copy of the Application for Insurance of Advance of Mortgage Proceeds, Contractor's Requisition – Project Mortgages, Financial Record of Mortgage Loan Transaction, and supporting documentation to the HUD ORCF Construction Manager.

H. HUD Monitoring of Interim Draws. The HUD ORCF Construction Manager will monitor interim draws. If a problem is encountered during an interim draw, they will bring the problem to the Lender, and, if necessary, ORCF Management in order to:

1. Modify the next draw, or

2. Withdraw the Lender's authority to approve advances.

I. Disbursement of Grant/Loan Proceeds. Grant/loan proceeds may come either from a governmental source, i.e., Federal, State, or local government agency or instrumentality, or a nongovernmental source, e.g., a foundation.

1. General for Governmental/Nongovernmental Source Funds. The proceeds are used to fund a front money cash escrow (Maximum Insurable Loan Calculation) at initial closing, whether the funding source is a governmental or nongovernmental entity. See paragraph 2 below for additional options to a cash escrow available to governmental source entities only.
    a. Disbursement priority of grant/loan proceeds in relation to mortgage proceeds and other escrows is discussed in paragraph A.
    b. Disbursement procedures from the cash escrow are discussed in paragraph D.
    c. Release of grant/loan proceeds may not be targeted to the completion of specific onsite improvements.

2. Additional Options for Governmental Source Funds. Where the grant/loan proceeds come from a governmental source, the Borrower may use instead of a cash escrow:

    a. An unconditional irrevocable letter of credit issued by a banking institution, or
    b. An agreement entered into by HUD, the Lender, the Borrower and the governmental entity for a pro rata disbursement of the loan/grant proceeds.

Section II
Production

Appendix 10.3

General Contractor's Monthly Requisition Procedures

A. Contractor's Monthly Requisition must be made on the Contractor's Requisition – Project Mortgages. The Contractor's Prevailing Wage Certificate on the form's reverse side must be signed. The Contractor's Requisition – Project Mortgages shall be a 2-sided form executed by the Contractor, and Supervisory Architect. The Contract Inspector must then review for acceptability and any modifications and execute the document. If acceptable, the document is forwarded to the Lender's mortgage credit analyst for further processing, and inclusion in the Application for Insurance of Advance of Mortgage Proceeds.

1. Eligible items for inclusion on the Contractor's Requisition – Project Mortgages.
   a. Acceptably completed onsite work, i.e. in full compliance with contract documents;
   b. Materials acceptably stored onsite itemized by quantity and cost with supporting invoices;
   c. Components acceptably stored offsite, where provisions are made at initial closing (including an acceptable Assurance of Completion for Offsite Improvements), and requirements of Paragraph B below are met.
   d. The Architect determines amounts due by job site observation of acceptable work. (The Contract Inspector makes the determination if there is no Architect.)
   e. The Contract Inspector:
      (1) Checks the Architect's determination using the Contractor's and/or Mortgagor's Cost Breakdown, and trade item cost breakdowns (guides) to assure that amounts are reasonable for acceptable work and those funds remain for unacceptable and incomplete work;
      (2) Spot checks the count of stored onsite items, determines that storage is acceptable, and assures that amounts are reasonable for approval;
      (3) Checks the invoice and certificate for stored off-site items, and approves payment after assuring that funds remain for transportation to the site and erection.

2. Ineligible items for inclusion on the Contractor's Requisition – Project Mortgages.
   a. Noncompliant work and work supported or dependent upon noncompliant work. Work changes completed in anticipation of future change order approvals are noncompliant work.
   b. Additive change orders. See Production, Chapter 10.9.
   c. Off-site work. See Paragraph C below for the contractor's requisition of payment, and release of funds to the Borrower for acceptably completed offsite work.

3. Modification of Contractor's Requested Amount.
   Where there is disagreement with the requisition, the Contract Inspector may modify the contractor's requested amount by:
   a. Entering trade item modification(s) on the Contractor's Requisition – Project Mortgages;
   b. Explaining the modification(s) in the HUD Representative's Trip Report.
   c. Completion of the Contractor's Requisition – Project Mortgages, Items (1) through (13) are made by the Lender.

4. Supporting Documentation.
   a. In order to help the Contract Inspector reconcile differences with contractor claims, the contractor will submit receipts, bills of lading for onsite deliveries, billings for onsite work, evidence of onsite payrolls, etc.
   b. Surveys may be submitted with each contractor's requisition for improvements not previously shown on a survey, especially regarding:
      (1) Where the structures site or setting of finished floor elevations are questioned;
      (2) Location of materials stored onsite.
   c. A survey is required for the next to last advance.

B. Components Stored Off-site.

1. Eligible Building Components. Only "building components" qualify for insurance of advances when stored offsite.
   a. An "eligible building component" is a manufactured or pre-assembled building element which, by reason of bulk, size or weight, vulnerability to weather conditions or lack of space at the site, is impractical to store at the site.
   b. Eligible building components comprise, but are not limited to:
      (1) Precast concrete floor, wall, and roof panels;
      (2) Assembled bath and/or kitchen core units;
      (3) Fully fabricated structural steel beams and columns.
   c. Items that are not eligible "building components" are (but not limited to): kitchen appliances, carpeting, wood roof trusses, etc.

2. Basic Requirements for insured advances.
   a. The Lender must have agreed to the necessary provisions at initial closing, including an acceptable Assurance of Completion for Offsite Improvements.
   b. The Construction Contract must include the rider "Amendment to the Construction Contract for Payment for Components Stored Offsite."
   c. Payments are limited to the invoice value of the components.
   d. The contractor and its surety bear full responsibility for fraudulent claims for payment and fraudulent disposition of such payments. Safeguards are to protect against premature payments, against materials that do not meet contract requirements and against losses not covered by insurance.
   e. The construction contract must be secured by a 100 percent performance and payment bond.
   f. Components must be stored at a location approved by the Lender and HUD.

3. Lender's Responsibilities.
   a. File Uniform Commercial Code (UCC)-1, financing statements with the proper office in the proper jurisdiction.
   b. Make whatever additional filings are necessary to maintain a first lien on the components until they are incorporated into the building(s).
   c. Release the financing statement filings as appropriate.
   d. Unconditionally certify by letter to HUD that the security instrument(s) is (are) a "first lien" on the components covered by the instrument(s). The Lender's certification must be supported by an opinion from the Lender's counsel.
   e. In the event of default under the mortgage, either assigns its security interest to HUD or acquires title through foreclosure to the components intended for use or incorporation into the building(s) and conveys title to HUD.

4. General Contractors' Responsibilities.
   a. All direct and indirect costs associated with the storage and transportation of components stored offsite;
   b. Obtaining a risk of loss insurance policy which covers the components. Evidence of this policy must be submitted to the Lender prior to approval of any advance for components stored offsite;
   c. Assurance that there is a valid security agreement that is a first lien on the components.

5. Contractor's Requisition. All requests for payment for components stored offsite must be submitted on the Contractor's Requisition – Project Mortgages, accompanied by the following:
   a. A statement from the Borrower's Architect certifying that:
      (1) He/she has visited the storage site and inspected the components for which payment has been requested;
      (2) The components are in good condition and they comply with the contract requirements;
      (3) The components are properly stored and protected;
      (4) The components are segregated, in an easily identified manner from other materials stored at the same site and are marked for identification;
   b. A bill of sale accompanied by an itemized invoice transferring title of the components to the Borrower;
   c. A copy of the security agreement provided to the mortgagee by the Borrower;
   d. A copy of the financing statement or statements filed by the Lender in accordance with the Uniform Commercial Code;
   e. A warrantee from the Lender that the security instruments represent a first lien on the building components;
   f. An opinion from the Lender's attorney that he/she has reviewed the security agreement and associated documents relative to the building components and that the security agreement creates a valid security interest in the collateral and that when the financing statement or statements is (are) duly filed, the secured party will have a first lien.

6. Review of Contractor's Requisition.
   a. The Contract Inspector must request an inventory of the "stored components" and a breakdown of the line item of which the stored components are a part before approving payment for the components stored offsite. The breakdown must state:
      (1) Cost of Components (invoice value).
      (2) Cost of transportation from the offsite storage location to the construction site.
      (3) Cost of Installation.
      (4) Costs of any other items included in the line item.
   b. The breakdown is to insure a remaining undisbursed balance sufficient to cover the costs of transportation and installation, and any other items included in the line item.
   c. Do not approve payment for components stored offsite where a contractor's performance is marked by serious deviations from the contract documents, or if payment will cause excessive additional interest costs.
   d. Do not approve any insured advances for components stored offsite where the contractor does not have a 100 percent performance and payment bond.
   e. Do not approve insured advances for components stored offsite in an amount exceeding 50 percent of the contract amount.
   f. The minimum advance is $10,000.
   g. Limit advances for components stored offsite to the cost of components (invoice value) less the usual 10 percent holdback.

C. Offsite Construction. Separate from work done under the Construction Contract for the project. Where offsite work is completed by the Borrower, rather than by a municipality or utility company, a separate construction contract is required, even if completed by the project contractor. Offsite work must also be funded from sources outside the mortgage, except that an escrow for its completion may be funded from available excess mortgage proceeds.

   1. Completion Monitoring is performed by the Contract Inspector and reported on the HUD Representative's Trip Report.

   2. Contractor's Requisition is by letter to the Borrower. Do not use the Contractor's Requisition – Project Mortgages to reflect the value of acceptably completed offsite work, even if completed by the project contractor. Request for Approval of Advance of Escrowed Funds is used.

   3. Construction Changes for offsite work must be requested by letter. Request for Construction Changes on Project Mortgages, may be used as a guide, but the form itself must not be used for offsite change orders. Any additive change order for off-site construction will result in a corresponding increase to the required escrow.

Appendix 10.4

Specimen Letter – Request for Early Partial Release of Contractor's Holdback

____(HUD ORCF Construction Manager)_____
_____
_____
_____

RE: _____(Project Name)_____
_____(Project Location)_____
Project No. _____

Dear:

We request that you authorize release of $_____, of the contractor's retainage at this time. Current holdback through Requisition No._____, is $ _____, minus the requested release, leaves $_____ as undisbursed holdback, which equals _____ percent of the contract amount. We also request that no further holdback be retained from future amounts due the contractor. The following certifications are provided as a basis for your favorable determination.

The undersigned hereby certify in regard to subject project, that to the best of our knowledge the following are true statements:

1. The contractor, _____, has no identity of interest as defined by the Construction Contract, except that the contractor has a _____ percent ownership interest in the project.

2. *Actual* project completion is _____ percent, and *scheduled* completion is _____ percent.

3. There is no noncompliant work or other exceptions, including: stop orders, other sanctions, or warning to impose sanctions against the contract work, or the contractor in regard to the contract work, by any controlling authority.

4. There is no violation of the Davis-Bacon and Related Acts, no claim for nonpayment by any mechanic, subcontractor, supplier and/or Borrower, no dispute regarding under or nonpayment, nor payment more than 30 days past due, except:

_____.

5. There is no claim for damage arising from the performance of the contract.

6. The contractor's performance has been timely and responsive throughout the construction period.

7. The surety, _____ (where applicable, Surety Name, otherwise omit item) _____, has given its consent for the early release of the contractor's retainage, as requested herein. The surety's consent and power of attorney for the authorizing agent are attached hereto.

_____ (Contractor) _____

By _____

_____ (Title) _____

_____
Date

_____ (Borrower) _____

By _____

_____ (Title) _____

_____
Date

_____ (Mortgagee) _____

By_____

_____ (Title) _____

_____
Date

WARNING: Title 18 U.S.C. 1001, provides in part that whoever knowingly and willfully makes or uses a document containing any false, fictitious, or fraudulent statement or entry, in any matter in the jurisdiction of any department or agency of the United States, shall be fined not more than $10,000 or imprisoned for not more than five years or both.

Appendix 10.5

Suggested Signature Page Format for the Electronic HUD Master Set of Plans and Specifications

"HUD Master Set – Plans"

_____
Project Name

_____
HUD Project Number

Signatures

Borrower Print Name Signature Date	**General Contractor** Print Name Signature Date
Bonding Company Print Name Signature Date	**Architect** Print Name Signature Date

This executed cover page shall be electronically attached to the front of a PDF version of Plans (Plans identical to those used for the Inspection and As-Built Sets).

“HUD Master Set – Specifications”

Project Name

HUD Project Number

Signatures

Borrower Print Name Signature Date	**General Contractor** Print Name Signature Date
Bonding Company Print Name Signature Date	**Architect** Print Name Signature Date

This executed cover page shall be electronically attached to the front of a PDF version of Specifications (Specifications identical to those used for the Inspection and As-Built Sets).

Section II
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Appendix 10.6
Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care

Form Number	Form Name
HUD-11	Record of Employee Interview
HUD-2328	Contractor's and/or Mortgagor's Cost Breakdown
HUD-5372	Construction Progress Schedule
HUD-91111-ORCF	Survey Instructions and Borrower's Certification
HUD-91118-ORCF	Borrower's Certification - Completion of Critical Repairs
HUD-91124-ORCF	Design Architect's Certification
HUD-92023-ORCF	Request for Final Endorsement of Credit Instrument
HUD-92117-ORCF	Borrower's Certification – Full or Partial Completion of Non-Critical Repairs
HUD-92205A-ORCF Borrower's	Mortgagor's Certificate of Actual Cost
HUD-92264A-ORCF	Maximum Insurable Loan Calculation
HUD-92330-A	Contractor's Certificate of Actual Cost
HUD-92403	Application for Insurance of Advance of Mortgage Proceeds
HUD-92403.1	Mortgagor's and Architect's Certificate
HUD-92415-ORCF	Request for Permission to Commence Construction Prior to Initial Endorsement for Mortgage Insurance
HUD-92434-ORCF	Lender's Certificate
HUD-92437	Request for Construction Changes on Project Mortgages
HUD-92442-ORCF	Construction Contract
HUD-92448	Contractor's Requisition – Project Mortgages
HUD-92451	Financial Record of Mortgage Loan Transaction
HUD-92453-NH	Commitment to Insure Upon Completion
HUD-92456-ORCF	Escrow Agreement for Incomplete Construction
HUD-92464-ORCF	Request for Approval of Advance of Escrow Funds
HUD-92476-ORCF	Escrow Agreement for Non-Critical Deferred Repairs
HUD-92485	Permission to Occupy—Project Mortgages
HUD-92554-ORCF	Supplementary Conditions of the Contract for Construction
HUD-9442-ORCF	Memo Requesting Early Commencement of Construction
HUD-95379-ORCF	HUD Representative's Trip Report
HEROS	HUD Environmental Review Online System
N/A	Early Commencement of Construction Checklist

Section II
Production

Chapter 11
Cost Certification

11.1 Introduction

Prior to final closing, the final eligible mortgage costs must be certified by both the Lender and the Borrower. This chapter contains the guidance and program requirements for the Section 232 Office of Residential Care Facilities cost (ORCF) certification process.

11.2 Projects That Must Certify

A cost certification is required by Section 232 of the National Housing Act and its implementing regulations for all mortgage insurance applications processed by FHA Lenders.

11.3 Purpose For Certification

The purpose of a cost certification is to establish the Borrower's actual costs, including the contractor's cost, to establish the "maximum insurable mortgage" for Final Closing of the insured mortgage.

11.4 Certifiable Costs

Certifiable costs are those costs that have been paid in cash or will be paid in cash within forty-five (45) days of final closing.

The Lender's appraiser will establish land value which shall be reviewed by ORCF. Eligible land cost will be determined in compliance with program guidance in Production, Chapter 3 of this Handbook.

The following costs must always be certified, whether or not paid in cash:

A. General overhead; and

B. Non-profit developer's fee, which is cost-certifiable whether or not it is paid in cash, less amounts certified to and allowed on other line items.

11.5 Types of Cost Certification

A. In general, a standard or "long form" cost certification shall be required except for projects permitted to use the "simplified" cost certification described in Section 11.5.B.

B. A simplified cost certification is permitted for projects with forty (40) or fewer units of proposed construction or substantial rehabilitation. A simplified cost certification is also permitted for projects refinanced under Section 232 pursuant to Section 223(f) of the National Housing Act.

11.6 Entities That Must Cost Certify

A. The Borrower shall cost certify for all projects, except for certain projects assisted with LIHTC, Historic Tax Credits or New Market Tax Credits as outlined in 13.4.

B. Tax Credits Exemption from Cost Certification Requirements: The Housing Economic Recovery Act (HERA) of 2008 affected the borrower's obligation to certify "actual cost" (as defined in the National Housing Act) under the insured mortgage programs. If it is determined at the time of issuance of the Firm Commitment for insurance that the ratio of loan proceeds to the actual cost of the project is less than or equal to 80 percent, the borrower and general contractor are not required to certify actual cost to HUD. The exemption affects construction, rehabilitation (including property acquisition), purchase or refinance of a project for which equity is provided through tax credits. However, the borrower (or operator as applicable) will be required to provide an audited Income Statement covering the project operations from Initial Closing to the Construction Cut-Off date for new construction and rehabilitation projects. Any Windfall (See Appendix 11.1 and 11.2) should be treated as a reduction in actual cost on an updated HUD-92264A-ORCF submitted with final closing documents.

   Note that the borrower and the general contractor have the option to cost certify according to the guidance in this chapter.

C. The general contractor shall cost certify where:

1. The general contractor has an identity of interest with the Borrower, regardless of whether such identity of interest existed prior to initial closing (for insured advances projects) or issuance of the firm commitment (for insurance upon completion projects), or such identity of interest developed after such dates; and/or

2. The general contractor used the "cost plus" principles of the Construction Contract (Form HUD-92442-ORCF), regardless of any identity of interest with the Borrower.

   The general contractor and subcontractors will not be required to cost certify when the Borrower is exempt from certifying actual costs.

D. Subcontractors at any tier, equipment lessors, materials suppliers, and manufacturers of industrialized housing shall cost certify where:

   1. The total of all subcontracts, purchases, and leases exceed one-half percent (0.5%) of the FHA-insured mortgage amount; and

   2. An identity of interest exists or comes into being between such subcontractor, equipment lessor, materials supplier, or manufacturer of industrialized housing, and either:
      a. The Borrower; or
      b. The general contractor, if the general contractor is required to cost certify.

11.7 Final Completion Date and Cut-Off Date

The final completion date for determining actual costs is the date the HUD inspector signs the final HUD Representative's Trip Report (Form HUD-95379-ORCF), provided that such trip report is subsequently endorsed by the construction manager. Construction must be completed by the final completion date, except for acceptable items of delayed completion approved in writing by HUD. HUD will notify in writing each of the Borrower, general contractor and Lender of the approved final completion date.

A. The final completion date is the effective date for the cost certification. However, the Borrower has the option to include in the cost certification all soft costs incurred up to sixty (60) days beyond such date. The date selected by the Borrower is the "cut-off date" for all soft costs.

B. The Borrower's balance sheet and the Borrower or the Operator's operating statement date must conform to the selected cut-off date.

11.8 Administrative Completion Date

The ORCF construction manager (the "CM") may advance the completion date to prevent unnecessary accumulation of soft costs. Such advancement may be deemed warranted by HUD for nearly-completed projects that face unnecessary delays.

A. The CM may set an administrative completion date for any project when the monthly inspection reports show ninety-five percent (95%) completion of work, and thereafter less than a two percent (2%) increase in percentage of completion in any subsequent month.

B. The CM shall notify in writing each of the Borrower, general contractor and Lender of such administrative completion date, and the following:

    1. That the administrative completion date shall be the effective date for cost certification, except that all soft costs up to sixty (60) days beyond such date may be included at the option of the Borrower.

    2. That the date of the balance sheet and operating statement must be the same as the cut-off date selected by the Borrower.

    3. That all liquidated and/or actual damages for cost certification purposes shall be computed using the administrative completion date. However, the general contractor shall be liable for any liquidated and/or actual damages that arise after the administrative completion date and before the date of substantial completion.

11.9 Submission Date

The submission date for cost certification shall be within sixty (60) days after the cut-off date.

11.10 Required Forms and Documentation

The following items shall be submitted for purposes of cost certification, as applicable:

A. A Mortgagor's Certificate of Actual Cost (Form HUD-92330-OHF) shall be required for the cost certification of all Borrowers. Excel spreadsheets and instructions are provided in the Lender Narrative Cost Certification Supplement (Form HUD-9444-ORCF).

B. A Contractor's Certificate of Actual Cost (Form HUD-92330-A) shall be required for the cost certification of all general contractors. Excel spreadsheets and instructions are provided in the Lender Narrative Cost Certification Supplement.

All subcontractors, materials suppliers and equipment lessors shall also use this form to certify cost.

Note: When a project includes both rehabilitation and new construction, a separate form of cost certification shall be required for each, as well as a master form of cost certification that summarizes total project costs, including fees.

C. Borrower's Certificate of Actual Cost (Form HUD-2205A-ORCF) shall be required for all projects refinanced under Section 232 pursuant to Section 223(f).

D. The Lender Narrative Cost Certification Supplement shall be submitted for all substantial rehabilitation projects and any new construction projects for which a mortgage increase is requested at Final Closing. The Excel spreadsheets contained in the Lender Narrative Cost Certification Supplement shall be used as a guideline for auditors and Lenders to better assure consistency and accuracy of cost certification submissions.

E. A Lender Certification (Form HUD-91129-ORCF) shall be required with short form cost certifications for new construction, substantial rehabilitation, supplemental loans and all long-form cost certifications.

F. Audited Borrower and Operator financial statements (*see* Section 11.11).

G. A Request for Final Endorsement of Credit Instrument (Form HUD-92023-ORCF). Such Request for Final Closing shall be updated if there are material changes prior to Final Closing.

H. A draft Maximum Insurable Mortgage Letter (*sample available on Section 232 Program website*).

I. All invoices that have not previously been provided to ORCF (for initial closing or insured advances).

> Note: Cover sheets for invoices or other documentation shall be required for each line item of the cost certification. Such cover sheets shall identify the number and name of each line item by sub-category. Additional cover sheets shall be provided for each sub-category and shall specifically identify the purpose of each invoice (*e.g.*, third-party appraiser, PCNA, Phase I, survey, etc.). If an invoice is not available for a particular sub-category, a cancelled check may be submitted in order to satisfy such requirement.

J. An updated third-party appraisal and Lender Narrative appraisal section (in the case of a request for mortgage increase that includes a proposed revision to value).

K. A Financial Record of Mortgage Loan Transaction (Form HUD-92451) or similar advances register at the option of the Lender.

11.11 Required Cost Certifications

Borrowers shall comply with either subsection A or B below, depending on the criteria described in subsection A.1.

A. Simplified form of cost certification. For projects that qualify for a simplified cost certification, the Borrower's Certificate of Actual Cost and Contractor's Certificate of Actual Cost shall be required. Eligible projects include those that use a cost plus construction contract and those for which an identity of interest exists between the Borrower and the general contractor. For all such projects, an accountant's opinion shall not be required.

    1. A simplified cost certification, in lieu of a long form cost certification, shall be permitted for new construction or substantial rehabilitation projects involving forty (40) or fewer units and for the refinance or acquisition of existing projects under Section 232 pursuant to Section 223(f) of the National Housing Act.

    2. If an identity of interest exists between a subcontractor, materials supplier and/or equipment lessor, and the Borrower and/or the general contractor (if such general contractor must cost certify), and the total of all identity of interest subcontracts, purchases and leases is more than one-half of one percent (0.5%) of the FHA-insured mortgage amount, the applicable party shall use the Contractor's Certificate of Actual Cost. This requirement, as further described in the Agreement and Certification (Form HUD-93305-ORCF), shall apply for all projects.

    3. An unaudited balance sheet of the Borrower, as of the cut-off date, shall be required for all projects. The format and content of such balance sheet shall comply with Section 11.11.B.4.

    4. An unaudited operating statement (from the Borrower and/or the Operator, as applicable) shall be required if occupancy commenced during the construction period. The format and content of such operating statement shall comply with Section 11.11.B.5.

B. Long form cost certification. For all projects that do not qualify for a simplified cost certification under the criteria of subsection A.1 above the following items shall be required:

    1. A Borrower's Certificate of Actual Cost, supported by an accountant's opinion, shall be required for all projects.

    2. A Contractor's Certificate of Actual Cost, supported by an accountant's opinion, shall be required for the general contractor if such general contractor shares an identity of interest with the Borrower and/or if the "cost plus" principles of the Construction Contract were used.

3. All subcontractors, materials suppliers, and/or equipment lessors with an identity of interest with either the Borrower or the general contractor shall submit a Contractor's Certificate of Actual Cost, supported by an accountant's opinion.
    a. As required, all materials suppliers shall attach to the Contractor's Certificate of Actual Cost a sheet describing in sufficient detail:
        i. Quantities of such materials furnished;
        ii. Sources from which such materials were obtained; and
        iii. Unit prices paid to the sources of such materials, as well as the brand names, model numbers, sizes, and lumber grades of such materials, etc., as applicable.

    Note: No amount shall be included for general requirements (*e.g.*, job overhead).

    b. Equipment lessors shall attach to the Contractor's Certificate of Actual Cost a sheet describing in sufficient detail:
        i. Dates such equipment was acquired;
        ii. Ages of such equipment at acquisition date;
        iii. Brand names and model numbers of such equipment;
        iv. Sizes of such equipment;
        v. Dates and length of time such equipment was used; and
        vi. Rates charged for such equipment.
    c. In addition, such equipment lessors shall certify that:
        i. The rates charged were not more than the local market rate for such equipment, including the maintenance and/or repair of such equipment;
        ii. The time charged for such equipment was not more than essential for the project; and
        iii. The charges did not exceed the purchase price of such equipment.
    d. Lump Sum Basis. In lieu of providing an attachment describing the above-required items, such equipment lessors may elect to certify that its rates are less than or equal to eighty-five percent (85%) of the local market rate for identical equipment under arms' length (lump sum) leases. When making this election, the equipment lessor shall agree:
        i. That the Closer shall be the sole judge of the reasonableness for the time and rates charged; and
        ii. That all equipment maintenance and repair expenses shall be the responsibility of such equipment lessor and shall not be included as an additional cost.
    e. Subcontractor's equipment. All costs for the equipment of subcontractors, whether owned or rented, shall be considered in the markup for overhead and profit. Such costs shall be reflected in the total subcontract and in the prior approval for identity of interest entities. A separate certification of such equipment shall not be required.

4. An audited balance sheet of the Borrower, as of the cut-off date, shall be required. Such balance sheet shall:

a. Incorporate the following certification:

"I hereby certify that the foregoing figures and statements contained herein, and as submitted by me as an authorized agent of [Name of Borrower] for the purpose of obtaining mortgage insurance under the National Housing Act, are true and provide a full and accurate description of the current financial position of (Name of Borrower) as of (date of financial statement).

Signed this __day of ___, 20__.

_____

(Signature of authorized agent with name printed or typed below signature)

WARNING: **Any person who knowingly presents a false, fictitious or fraudulent statement or claim in a matter within the jurisdiction of the U.S. Department of Housing and Urban Development is subject to criminal penalties, civil liability, and administrative sanctions.**"

b. Furnish reconciling information if short-term liabilities on the balance sheet do not agree with Column B of the Borrower's Certificate of Actual Cost.
c. Explain the purpose of all liabilities in the notes to the financial statement and include repayment requirements for such liabilities. Special care shall be taken to disclose any liabilities in the balance sheet that were not disclosed prior to Initial Closing. If such liabilities are disclosed, the Lender shall promptly inform the Borrower that such liabilities cannot be an obligation of the project and that repayment shall solely be the responsibility of the Borrower. Such liabilities shall not be considered (i.e. they shall not be allowed nor disallowed) in the review of the cost certification. When previously non-disclosed items are disclosed in the audited balance sheet, a detailed review of the Borrower's Certificate of Actual Cost and the Contractor's Certificate of Actual Cost shall be required and may result in delays in HUD's review of the cost certification.
d. If any proceeds and/or obligations from a syndication of the project are passed through the books and records of the Borrower, receivables shall be described as an asset of the Borrower.
e. The notes to the balance sheet shall identify the original amount of the working capital deposit and shall summarize any expenditures thereof.

5. An audited operating statement covering the period from the beginning of marketing and rent-up activities (or the date of Initial Closing in rehabilitation projects involving insurance of advances, or the date of the start of construction for rehabilitation projects involving insurance upon completion) to the cost certification cut-off date, shall be submitted for:
   a. The Borrower, for all projects;
   b. The Operator, when an identity-of-interest exists between the Borrower and the Operator and the Operator has executed a Regulatory Agreement

c. The Borrower only, where no identity-of-interest exists between the Borrower and the Operator and the Operator has executed a Regulatory Agreement in favor of HUD. The Borrower's income statement shall reflect a market comparable lease payment as income; and
d. The Borrower, where the Borrower and the Operator are the same entity and a Regulatory Agreement has not been executed.

6. All operating statements shall include the certification described in Section 11.11.B.4, and shall comply with the following additional requirements:
    a. The operating statement shall be prepared on an accrual basis;
    b. The operating statement shall cover the beginning of marketing and rent-up activities (or the date of Initial Closing in rehabilitation projects where occupancy is continuous) to the cost certification cut-off date;
    c. Marketing and rent-up activities shall start no earlier than six (6) months prior to the issuance of the first Permission to Occupy-Project Mortgages (Form HUD-92485);
    d. The operating statement shall sufficiently describe the dates covered by such statement;
    e. The operating statement shall sufficiently describe income from all sources, and shall not consider security deposits as income;
    f. The operating statement shall not contain any expense items that were paid or that should have been paid from the working capital deposit or otherwise included in the cost certification.
    g. Operating expenses may include the following:
        i. Expenses directly relating to renting the project, such as:
            1. Rental commissions customary for the type of project, if any; and
            2. Marketing and advertising expenses.
        ii. Expenses for the purchase of furnishings, equipment not paid from the working capital deposit, and other supplies essential to project operation.
        iii. Reasonable fees for preparing any federal, state, or local tax return required for the project.
        <u>Note</u>: If the Borrower is a partnership, reasonable fees for preparing both the tax return of the partnership, shall be permitted, but the cost of preparing a partner's personal tax returns shall not be permitted.
        <u>Note</u>: If the Borrower is an individual, reasonable fees for preparing a tax return for project operations shall be permitted, but not for non-project related items on such tax return.
        iv. Electricity, gas, water, waste water and operating salaries (maintenance, cleaners, gardeners, elevator operators, etc.) to the extent they are not included in construction cost of Borrower's Certificate of Actual Cost, or Contractor's Certificate of Actual Cost.
        v. Management fee stated in the contract.

7. Operating expenses may not include:

a. Depreciation;
b. Interest, taxes, property insurance premiums, and mortgage insurance premiums that are reflected in the Mortgagors Certificate of Actual Cost;
c. Salaries paid to principals of the sponsor or Borrower for managing the Borrower entity.

8. Treatment of net operating income generated during construction (by the entity which operates the facility):
    a. The windfall is the amount that will be entered as net income on the Mortgagor's Certification of Actual Cost.
    b. The windfall calculation and explanation are provided in Appendix 11.1 and 11.2. The windfall calculation is not applicable:
        i. When the Borrower and Operator are unrelated entities.
        ii. For Section 241(a) Supplemental Loans.
    c. If the windfall is less than or equal to zero:
        i. No entry is made on the Mortgagor's Certification of Actual Cost.
        ii. Operating deficit may be carried over as a reduction to net income on the supplemental operating statement.

9. A certification by an independent Certified Public Accountant or an Independent Public Accountant must accompany the, Borrower's Certificate of Actual Cost, including the audited balance sheet of the Borrower and operating statement of the Borrower or Operator, and the Contractor's Certificate of Actual Cost.
    a. The accountant must meet the auditor qualifications of the Government Auditing Standards (GAO Yellow Book), including the qualifications relating to independence and continuing professional education. The audit organization also must meet the quality control standards of the GAO Yellow Book.
    b. Part 24 of Title 24 of the Code of Federal Regulations prohibits accountants from contracting for services when their name is shown on the HUD and General Services Administration Government-wide Consolidated List of Debarred, Suspended and Ineligible Contractors and Grantees.
    c. The accountant must also comply with the requirements in Chapters 1, 2, and 6 of HUD Handbook IG 2000.4, (Consolidated Audit Guide for Audits of HUD Programs.)

10. The Borrower must submit a supplemental operating income statement (of the Borrower or Operator) if more than 3 months exist between the cut-off date and the start of amortization. If a deferment of amortization was granted, use the new date for the start of amortization in determining the need for a supplemental operating statement.
    a. This requirement does not apply to non-profit Borrowers or any project where the mortgage is $200,000 or less.
    b. The statement covers the period from the cost certification cut-off date to the date, which is 3 months before the start of amortization. The Borrower shall submit the statement within 30 days after the expiration of this period.

c. If the required original cost certification was audited, a CPA or IPA must prepare and certify the supplemental statement.
d. The Borrower may advance the date of amortization to avoid submitting a supplemental income statement.
e. In preparing the statement, if the operating statement submitted at cost certification shows expenses in excess of income, such expenses may be carried forward as "un-recovered expense–prior period."

C. **Section 232/223(f) Projects:** The Borrower certifies to the total costs incurred in the acquisition or refinancing of the property using the Borrower's Certificate of Actual Cost. The certification must be dated and signed by an authorized agent of the Borrower. An accountant's opinion is not needed.

1. The certification must be submitted after all critical repairs have been completed.

2. The general contractor will be required to cost certify using the Contractor's Certificate of Actual Cost if a cost plus construction contract is used.

3. A balance sheet and income statement are not required.

11.12 ORCF Closer Review of Borrower's and Contractor's Cost Certifications

When the cost certification package is received for processing, the Closer shall:

A. Complete the cost certification review checklist and determine deficiencies associated with the Borrower's and contractor's cost certifications.

B. Send an email to the Lender stating the deficiencies and requesting further information.

C. The Lender shall be required to provide a full response in writing within ten (10) working days.

D. Send a HUD-approved maximum insurable mortgage letter to the Lender when the cost certification review is complete.

11.13 Allowable Costs in Borrower's Certificate of Actual Cost

A. Construction Contract:

1. A lump sum construction contract is permitted when no identity of interest exists between the Borrower and the general contractor. The amount allowed in cost certification shall be the lesser of:

a. The actual cash paid or to be paid by the Borrower under the construction contract; or
b. The construction contract price, as adjusted by ORCF's estimated cumulative effect of approved change orders paid, or to be paid, by the Borrower, and, if applicable, the liquidated or actual damages provision to the contract.

2. A cost-plus construction contract shall be required when an identity of interest exists between the Borrower and the general contractor.

3. 50/75 Percent Rule:
   a. Whether or not there is an identity of interest, no general contractor's fee (general overhead and profit) shall be allowed when:
      i. More than fifty percent (50%) of the contract sum in the Construction Contract is subcontracted to one subcontractor, materials supplier or equipment lessor; or
      ii. More than seventy-five percent (75%) of the contract sum in the Construction Contract is subcontracted with three (3) or fewer subcontractors, materials suppliers or equipment lessors.

   If two (2) or more subcontractors have common ownership, they shall be treated as one subcontractor for purposes of this Section.
   b. Exceptions: The 50/75 percent rule shall not apply to:
      i. Trade items performed by persons on the general contractor's payroll.
      ii. The supplemental loan program.
      iii. Rehabilitation programs other than gut rehabilitation.
   c. The Closer shall make all final determinations on the applicability of the 50/75 percent rule.
   d. Where the 50/75 percent rule is violated, the general contractor shall forfeit its anticipated profits.

4. The amount permitted in cost certification when a cost-plus contract is used is the lesser of:
   a. The actual cash paid, or to be paid, by the Borrower under the construction contract.
   b. The amounts the Closer approved for construction.
   c. The construction contract price, as adjusted by the ORCF's estimated cumulative effect of approved change orders paid, or to be paid, by the Borrower, and, if applicable, either the incentive provision or the liquidated or actual damages provision of the contract.
   d. Borrowers shall be expected to adhere to the following additional guidelines:
      i. Recognizing approved change orders necessitated by errors or omissions of the architect only to the extent that such change orders result in savings for the mortgage. Borrowers shall not recognize such change orders when processing a mortgage increase.
      ii. Not recognizing approved betterment change orders in calculating the adjusted upset price.

iii. Recognizing the increase in general requirements, if any, noted on approved time extension change orders. Borrowers shall not recognize any increases in soft costs associated with such change order. Soft costs will instead be recognized under applicable line items.

iv. For profit-motivated projects involving an identity of interest between the Borrower and the general contractor, the amount of builder's profit as shown on the Agreement and Certification shall be an eligible expense whether or not it was paid in cash.

v. For non-profit Borrowers, the allowable builder's profit is the lesser of the amount actually paid or to be paid in cash to the general contractor or the amount of builder's profit shown in the Maximum Insurable Loan Calculation replacement cost tab, plus or minus any applicable amount due under ORCF-approved change orders.

5. An identity of interest shall be deemed to exist under any of the following circumstances:
   a. The Borrower has any financial interest in the general contractor, or conversely, the general contractor has any financial interest in the Borrower.
   b. Any officer, director, stockholder, member, manager, trustee or partner of the Borrower is also an officer, director, stockholder, member, manager, trustee or partner of the general contractor.
   c. Any officer, director, stockholder, member, manager, trustee or partner of the Borrower has any financial interest in the general contractor; or any officer, director, stockholder, member, manager, trustee or partner of the general contractor has any financial interest in the Borrower.
   d. The general contractor advances any funds to the Borrower.
   e. The general contractor supplies and pays, on behalf of the Borrower, the cost of any architectural services or engineering services other than those of a surveyor, general superintendent, or engineer employed by a general contractor in connection with its obligations under the construction contract.
   f. The general contractor takes stock or any interest in the Borrower or its controlling stockholders, members or partners as consideration of payment.
   g. There exists or comes into being any side deals, agreements, contracts, or undertakings entered into by either the Borrower and/or the general contractor which modifies, amends, subordinates and/or terminates any provisions and/or mortgage insurance documents required by Program Obligations, except as approved by ORCF.

   Any relationship (e.g., familial) exists which would give the Borrower or the general contractor undue control or influence over the terms and price of the contract or the price paid to any subcontractors, materials suppliers and/or lessors of equipment.

6. Incentive fee payments to contractors:
   The Borrower may request that the construction contract be modified before Initial Closing to provide for an incentive fee for the general contractor for completing the specified construction work in its entirety and delivering a completed project before

the date specified in the construction contract (or as amended by any ORCF-approved time extensions). Incentive fees shall be described in sufficient detail in a rider to the construction contract and shall be approved by ORCF prior to Initial Closing, or, for insurance upon completion and insurance of advance projects, prior to execution of the construction contract. An incentive fee rider may not be added to the construction contract after Initial Closing.

<u>In calculating an incentive fee, Borrowers shall be expected to adhere to the following additional guidelines:</u>

a. Identity-of-interest Borrowers.
    i. The general contractor may benefit from savings in construction interest, taxes, property insurance, and mortgage insurance premiums to the extent there are construction cost overruns.
    ii. The incentive payment shall be reflected in the adjusted upset price of the construction contract.

    If there is an identity-of-interest between the Borrower and the general contractor, an incentive fee shall only be paid if there are certified cost overruns that were not included in an ORCF-approved change order, and the amount of such incentive fee shall not exceed the amount of certified cost overruns that were actually incurred.

b. Non-identity of interest Borrowers.
    i. The incentive payment shall be reflected in the Construction Contract Incentive Payment (Form HUD-92443).
    ii. Incentive fees shall be calculated in accordance with instructions of the Construction Contract Incentive Payment.
    iii. The incentive fee computed for lump sum construction contracts shall not exceed fifty percent (50%) of the amount by which the estimated mortgage interest, taxes, property insurance and mortgage insurance premium exceeds the certified costs for those same items through the actual date of completion.
    iv. The incentive fee computed for cost plus construction contracts shall be paid in an amount calculated in accordance with the incentive payment computation on Page 2 of the Construction Contract Incentive Payment. Additionally, when a cost plus construction contract is used, the general contractor shall not receive any incentive payments that exceed:
        1. the actual costs of construction,
        2. the cash fee provided in the construction contract, or
        3. the incentive fee as determined by the incentive payment computation.

        In addition, the general contractor shall not be paid an incentive fee that is greater than the amount of cost overruns; any excess of this amount shall be refunded to the Borrower.

7. Damages clause. The Borrower shall exercise the damages clause of the construction contract when the general contractor does not complete the project on time. Such clause holds the general contractor financially responsible for the added soft costs resulting from the delays in completion of the project.

   In applying the damages clause, Borrowers shall be expected to adhere to the following additional guidelines:

   a. Borrowers shall calculate the amount of actual and liquidated damages, as further defined by the construction contract, using the lesser to determine the adjusted upset price.
   b. To determine actual damages, Borrowers shall compute the actual cost of mortgage interest, taxes, insurance and mortgage insurance premiums for the period from the scheduled completion date (as amended by any ORCF-approved change orders) through the substantial completion date.
   c. To determine liquidated damages, Borrowers shall multiply the daily liquidated damages rate from the construction contract by the number of days between the scheduled completion date specified in the construction contract, as amended by any ORCF-approved time extensions, through the substantial completion date.
   d. Borrowers shall reduce the calculated damages by the portion of the net operating income earned during the respective periods for calculating the liquidated or actual damages.
   e. For those cases where an administrative completion date has been established, Borrowers shall use the administrative completion date for computing damages for cost certification purposes. However, the general contractor shall remain liable for damages through the date of substantial completion.

8. If the Borrower acts as its own general contractor:
   a. A construction contract shall not be required. Instead, the Building Loan Agreement Supplemental (Form HUD-92441a-ORCF) shall be incorporated into the Building Loan Agreement (Form HUD-92441-ORCF).
   b. The upset price for construction shall be described in Line 51 of the ORCF-approved Contractor's and/or Borrower's Cost Breakdown (Schedule of Values (Form HUD-2328) as adjusted by the cumulative effect of any ORCF-approved change orders and/or incentive provisions, as applicable.
   c. All incentive payment clauses shall be incorporated by an addendum to the Construction Contract Incentive Payment (Form).
   d. There shall be no liquidated and/or actual damages clause.

   NOTE: The Borrower may serve as its own general contractor only when the Borrower is an individual or a general partnership.

9. Incomplete minor items. The Borrower's certification of the amount due under the terms of the construction contract may include the cost of minor items of on-site work that remain incomplete under the terms of the construction contract.

B. Owner-Architect Agreement**.** Architect's fees shall be limited to amounts paid in cash. Borrowers shall be expected to adhere to the following additional guidelines:

1. Borrowers shall recognize the cost of additional services set forth in Article 10 of the Standard Form of Agreement between Owner and Architect for Housing Services (AIA Document B108).

2. Borrowers shall not recognize the following costs:
    a. Any portion of the architect's fee paid in stock.
    b. Any costs associated with a clerk of the works.

Note: Clerk of the works are individuals (in addition to the supervisory architect) who represent the Borrower on the job site during construction of large and/or complex construction projects. Their cost may be allowable when included in underwriting as a Mortgagor Other Fee.

3. If any identity of interest exists or comes into being between the architect and either the Borrower or the general contractor, or both, during project construction:
    a. The design architect's fee shall be limited for cost certification purposes as set forth in the Agreement and Certification; and
    b. Borrowers shall not be permitted to allow a fee for supervisory services.

4. Borrowers shall apply any unused balance of the total architect's fee as a direct reduction of the allowable cost.

C. Interest shall be allowable on the amount accrued on the HUD-insured mortgage between Initial Closing (or the start of construction, for insurance upon completion projects) and the cut-off date. Borrowers shall be expected to adhere to the following additional guidelines:

1. Borrowers may recognize interest costs associated with an approved early start, provided that:
    a. The Borrower entered into a binding agreement with the general contractor which:
        i. Was previously approved in writing by ORCF;
        ii. Agrees to reimburse the general contractor for interest on money borrowed for construction prior to Initial Closing; and
        iii. States that reimbursement will be made only to the extent that the Borrower has funds available in the amount estimated for interest during construction.
    b. The certified amount of such interest, when added to the interest costs incurred directly by the Borrower, does not exceed the total amount of interest estimated in the Maximum Insurable Loan Calculation replacement cost tab.

c. A Request for Permission to Commence Construction Prior to Initial Endorsement for Mortgage Insurance (Form FHA-2415) was executed and previously approved in writing by ORCF.
d. The interest costs reflect the general contractor's actual cost of money borrowed to cover the cost of construction between the early start date and Initial Closing as adjusted by subsection (e) below.
e. The rate of interest does not exceed the rate of interest approved for the FHA-insured loan.

2. The interest rate paid on the construction loan shall not exceed the rate stated in HUD's firm commitment.

3. Borrowers shall deduct accrued interest forgiven by the Lender or otherwise not paid in cash.

4. Borrowers shall treat any refunds from the Lender and/or bond underwriters of any portion of the construction loan interest as a reduction to the allowable cost.

5. If the construction interest rate changed prior to Initial Closing, and it was not feasible to reprocess the project, or if a state housing agency sold bonds to finance the construction loan and the true interest rate was not known until cost certification:
   a. Interest savings may be created from the difference between the processed interest rate and the actual final interest rate approved by ORCF.
   b. Borrowers may treat such savings as a reduction to the allowable cost if the following condition is included in HUD's firm commitment:

      "Any interest savings resulting purely from a differential between the HUD-processed interest rate and the actual construction interest rate may not be construed as excess funds that may be used to offset costs in other categories at the time of cost certification. Any such saving must be applied as an allowable cost reduction."

6. Neither the interest on subordinated liens nor other obligations of the Borrower shall be allowed as certifiable costs.

D. Costs for taxes and insurance shall be allowable in the amount accrued on the first mortgage between Initial Closing (or the start of construction, for insurance upon completion projects) and the cut-off date as defined in Section 11.7 of this Chapter. Borrowers shall not recognize costs accrued during the early start period.

E. The exact amount of mortgage insurance premium due during the construction period will not be finally computed until the project has been completed. Such premium shall be calculated as follows:

1. The mortgage insurance premium shall be based on the applicable regulatory annual percentage of the mortgage amount on the basis of accrual for the number of days in

the period described in Section 11.13.C of this Chapter, for projects involving insurance upon advances.

2. No mortgage insurance premium shall be paid during construction for projects involving insurance upon completion.

F. HUD application, commitment and inspection fees shall be allowable as amounts paid. Fees paid to re-open an expired or terminated commitment shall not be allowable costs.

G. Financing expenses shall include any initial service charges, discount fees, Federal National Mortgage Association (FNMA), Government National Mortgage Association (GNMA) or other permanent Lender commitment and marketing fees, and other similar fees. B<u>orrowers shall be expected to adhere to the following additional guidelines:</u>

1. Permitted expenses shall include the lesser of:
    a. All expenses paid, or to be paid, in cash.
    b. All expenses described in the Lender's Certificate (Form HUD-92434-ORCF), or the Request for Endorsement of Credit Instrument & Certificate of Lender, Borrower & General Contractor (Form HUD-92455-ORCF) and approved by ORCF prior to Initial Closing (or issuance of the firm commitment, for insurance upon completion projects).

2. The construction Lender's initial service charge:
    a. May cover:
        i. Processing fees;
        ii. All expenses of counsel for the Lender paid directly from the initial service charge; however, any such expenses shall not be permitted if they cause the initial service charge to exceed two percent (2%) the mortgage amount. Lenders shall be responsible for reconciling separate invoices or bills with such itemized costs; and/or
        iii. All other charges of the construction Lender.
    b. Shall exclude:
        i. Any construction loan discounts.
        ii. Any construction loan extension fees.

3. The permanent Lender's placement fee:
    a. Shall cover all permanent placement expenses, except discounts and certain fees associated with a bond financed transaction, if applicable.
    b. Shall not incorporate any additional charges for a GNMA mortgage backed security application fee or other custodial or delivery fees.
    <u>NOTE</u>: Construction and permanent Lenders' initial service charges and placement fees in the aggregate shall not exceed three and one-half percent (3.5%) (or 5.5 percent for bond-financed projects), and the parties involved may divide such fees as negotiated.

4. The following costs shall additionally be permitted for cost certification:

a. Any reasonable discounts based on current interest rates at the time of HUD's issuance of the firm commitment, for projects involving insurance of advances and insurance upon completion charged by the construction and/or permanent Lenders. Extension fees charged by the construction Lender shall also be permitted, if funded at Initial Closing and disclosed in the Lender's Certificate.
b. Any permanent Lender extension fees, as disclosed in the Lender's Certificate, and if funded before the substantial completion date.
c. Any construction and/or permanent loan extension fees for insurance upon completion projects, as disclosed in the Request for Endorsement, and if funded before the cost certification cut-off date.
d. Any financing fees (including extension fees and discounts) paid on behalf of the Borrower by a third party and as disclosed by the Lender's Certificate or the Request for Endorsement, if shown as a current liability on the Borrower's balance sheet, and to the extent that such fees result in savings for the mortgage. At final closing, a promissory note in a format approved by HUD shall be used for any unpaid balance of such obligations recognized in cost certification.
e. Any costs of issuance, discounts, and financing fees in excess of five and one-half percent (5.5%) for bond-financed projects; provided that the cost certification evidences that the sponsor and Borrower shall not benefit monetarily from any excess investment income derived from the proceeds of any invested obligations.

5. The following costs shall not be permitted for cost certification:
    a. Any "side deals" (except for discounts previously approved by ORCF) by which the Borrower agrees to pay for the "added cost of money."
    b. The four percent (4%) construction loan and 1.75 percent permanent loan indemnification escrows required by GNMA.
    c. Any discounts required to buy down the construction and/or permanent rate to a below market rate.
    d. Any amount of the bond premium distributed to the Borrower, Operator and/or any of their principals.

6. The following items shall be treated as reductions for cost certification:
    a. Premiums paid by the Lender to the Borrower or sponsor for acquiring the construction or permanent loan.
    b. Partial refunds of the processing commitment fee, which are returned to the Borrower or sponsor.
    c. Discounts or other fees paid for by a contribution of a portion of the initial service charge by the Lender and/or bond underwriter.
    d. Rebates paid to the Borrower or sponsor by the Lender and/or bond underwriter for bond-financed mortgages.

H. Title and recording expenses shall be limited to cash paid for:

1. Title searches and/or title insurance policies required by HUD for Initial Closing;

2. Recording fees for mortgage insurance documents at HUD Initial Closing;

3. Mortgage and stamp taxes;

4. Survey fees;

5. Updates required by HUD for the title insurance policy during construction;

6. Title searches, title insurance policies and recording charges required by HUD at Final Closing; and

7. Legal fees incurred for the preparation of any of the above.

I. Legal, organization and audit expenses shall be limited to expenses incurred in organizing the Borrower and/or updating its governing documents in order to comply with Program Obligations, developing the financing proposal for HUD and other necessary governmental agencies, and for providing additional services during closing and construction.

1. Organizational expenses shall be further limited as follows:
    a. Borrowers shall be limited to the amount described in the Maximum Insurable Loan Calculation Replacement Cost Tab for the organizational fee, unless sufficient justification is submitted for the need for, and reasonableness of, any additional expenses, including fully supporting documentation such as receipts or cancelled checks.
    b. Additional information on organizational fees is provided in the LNCCS.

2. Legal expenses shall be further limited to those legal expenses incurred for representation of the Borrower during its organization and at initial and final closing, tax advice provided to the Borrower solely during its organization, and preparation of legal documents required for initial and/or final closing of the FHA-insured loan.
    a. Borrowers are permitted to include customary expenditures expected to be incurred before and during initial closing, over the construction period, and at final closing. This may include legal expenditures for any identity of interest Operator or Management Agent if they are directly related to the specific HUD- insured transaction.
    b. Borrowers shall not include:
        i. Customary expenses for land acquisition which are already incorporated in, or contributing to:
            1. Title and recording expenses;
            2. The estimated market price of the acquisition site; and/or
            3. Expenses related to changes, variances and/or special use permits for zoning.
        ii. The costs of legal services to create tax shelters and trusts.

3. Borrowers are permitted to include the cost of a “package deal” for organization and legal services, provided:
    a. The supplier of such services is qualified to furnish the respective services; and
    b. The costs do not duplicate expenses for the same services.

4. Audit fees shall be further limited to those expenses related to a qualified accountant’s audit and opinion of the Borrower’s certificate of costs.

5. Amounts included in the Maximum Insurable Loan Calculation Replacement Cost Tab for legal and audit expenses are not blanket allowances, but ordinarily set an upper limit on allowable amounts.
    a. Non-typical fees (i.e. those that exceed the above-described upper limits) shall be borne by the Borrower, unless in an exceptionally complex case, a higher fee is sufficiently demonstrated by the Borrower to be necessary and reasonable. Detailed invoices and/or other documentation shall be required to evidence the reasonableness, purpose, necessity, and proper classification of all non-typical fees.
    b. The restrictions of this Section are not flexible where Borrowers are permitted to include the cost of a “package deal” for organization and legal services, and where a substantial amount of such organization and legal services are performed by the same firm.

J. Offsite costs: Where the Borrower enters into a supplemental contract for constructing offsite improvements, the costs of such improvements shall be calculated using the lesser of the following:

1. The offsite construction contract price as adjusted by ORCF’s estimated cumulative effect of approved offsite change orders;

2. The actual cash paid or to be paid for such offsite work; or

3. The amount approved by ORCF for offsite construction.
   Offsite costs shall be further limited as follows:
    a. HUD shall adjust the as-is land value of the project, if the permitted amount for offsite and demolition differs from HUD’s estimate on the Maximum Insurable Loan Calculation land tab issued with HUD’s firm commitment.
    b. Offsite costs shall not be permitted for leasehold estates when the ground lease rent is based on a land value that reflects all required offsite improvements, since the Borrower has not or will not pay for such improvements.
    c. If the Borrower certifies to off-site costs, the land value utilized to determine the maximum insurable mortgage shall be reduced by the amount of such off-site costs.

K. Other permitted costs include all costs and/or recovery of costs which are not provided for elsewhere and which are clearly attributable to the actual cost of the project, including, but not limited to, the following items:

1. Any costs attributable to acquiring a leasehold interest in the project, provided that any such acquisition costs, ground rents and/or offsite costs are paid by the Borrower, do not exceed HUD's calculation of the fair market value of the land fully improved (from the land tab of the Maximum Insurable Loan Calculation. Any excess costs shall be reflected as a disallowed cost of acquiring the leasehold.

2. Any ground rents paid from Initial Closing of the FHA-insured loan (or the start of construction, for insurance upon completion projects) to the cut-off date.

3. Any allowable incentive payments paid to a non-identity of interest contractor for completing construction before the scheduled completion date, as amended by any ORCF-approved change orders.

4. Any bond premium for the general contractor, if paid by the Borrower. If the construction contract includes any expenses for the bond premium, this amount shall be subtracted from the construction contract amount when calculating the adjusted upset price.

5. Any other fees, including fees required for an engineering and/or topographical survey. The Lender shall be responsible for determining whether such costs are reasonable and not duplicated in those costs attributed to the general contractor.

6. Any grants, loans or tax credit equity of the Borrower and/or principals of the Borrower used to pay for allowed items of cost, but limited as follows:
    a. The deduction of such grants, loans or tax credit equity shall be treated as a recovery of such costs by the Borrower and/or its principals; and
    b. The Borrower shall not deduct grant, loan or tax credit equity funds from the total recognized costs when such funds were used to pay for certain non-replacement cost items (e.g., they were used for acquisition costs of the land in excess of the HUD allowance, operating deficits, working capital, and/or other items disclosed in the Applicant/Recipient Disclosure (Form HUD-2880).

7. Any residential relocation costs. Further instructions are provided in the LNCCS.

Note: Cost certification footnotes may use vendor names to identify third party costs. However, such footnotes shall describe in sufficient detail the services provided by such vendor. This requirement is critical to further assure that there are no duplication of costs between contractors, subcontractors, architects and subcontract engineers, etc. For rehabilitation projects, any costs that may be construed as maintenance costs attributable to ongoing operations shall also be described in sufficient detail in the audit footnotes.

L. Non-Profit Developer and Housing Consultant Fees: Non-profit Developer and Housing Consultant Fees are not permitted as mortgageable expenses on Section 232 projects.

M. Major Movable Equipment: Instructions are provided in the LNCCS.

11.14 Cost review of the General Contractor's Cost Certification

A. Actual costs shall be defined as all costs paid by the general contractor pursuant to the terms of the construction contract for completion of the project, and to which the general contractor certifies, using the Contractor's Certification of Actual Cost. Such costs shall include:

1. Actual costs paid in cash, or to be paid in cash (for items of delayed completion) within forty-five (45) days after the date of substantial completion, for all labor, materials, equipment, subcontract work, general requirements (including job overhead), fees, general overhead, and estimated costs for any items requiring an escrow.
    a. Actual costs are further limited as follows:
        i. The salaries of clerical staff for time actually spent at the project shall be permitted; however, the prorating of annual salaries on a percentage basis shall not be permitted.
        ii. Salaries of executives shall not be included in the calculation of general requirements, but shall instead be included in calculation of general overhead.
        iii. Any kickbacks, rebates, adjustments, discounts, or other similar devices which the general contractor has received or is entitled to receive from the Borrower or any subcontractors, materials suppliers or equipment lessors, shall be deducted from actual costs.
    b. General overhead expenses are further limited as follows:
        i. Such expenses shall include only the amount of the accepted Schedule of Values, adjusted by any ORCF-approved change orders.
        ii. Itemization shall not be required for general overhead expenses.

B. An ORCF cost review of the general contractor's cost certification shall be conducted in accordance with the following guidelines:

1. ORCF shall conduct a detailed review if the Borrower applies for a mortgage increase.

2. Such review shall include a sufficiency and consistency review of all certifications required from the contractor and/or any subcontractors, materials suppliers and equipment lessors.

3. The following documents, as applicable, shall be audited in the context of such review:
    a. Borrower's Certificate of Actual Cost;
    b. Contractor's Certificate of Actual Cost;
    c. Agreement and Certification;
    d. Request for Construction Changes–Project Mortgages--all approved for the project (Forms HUD-92437);
    e. Project Cost Estimate (Lender's Third Party Estimate) (Form HUD-92326);
    f. Contractor's and/or Borrower's Cost Breakdown.
    g. Trip Report (all for projects).

4. Such review shall determine the following:
    a. Whether the 50/75 percent rule applies. Such determination shall be based in part on the disclosures described in the "total" and "name of subcontractor or payee" columns of the general contractor's cost certification, and if such rule does apply, the general contractor's general overhead and profit shall not be permitted as expenditures.
    b. Whether any identity of interest exists among the Borrower, the general contractor and/or any subcontractors, materials suppliers and equipment lessors.
        i. Such determination shall be based in part on the disclosures described in the Agreement and Certification.
        ii. HUD shall review each cost certification for identity of interest subcontractors for compliance; however, if such cost certification is not submitted, such subcontractor's overhead, profit and other questionable costs shall not be permitted as expenditures. Permitted expenditures shall be further limited as follows:
            1. If such subcontractor was not previously approved as an identity of interest subcontractor, such subcontractor's overhead and profit shall not be permitted as expenditures.
            2. If such subcontractor was previously approved as an identity of interest subcontractor, all **subcontract overhead and profit previously approved by ORCF, plus or minus the effect of any approved change orders, shall be permitted as expenditures. Previously-approved subcontract overhead and profit shall not be reduced in the event that the certified cost for such work is less than the prior approved maximum subcontract price.** (c) Permitted expenditures may include up to the previously-approved maximum subcontract amount for work, plus or minus the effect of any ORCF-approved change orders.

5. HUD shall additionally review trade line item costs in accordance with the following guidelines:

a. HUD shall utilize the general contractor and subcontractor cost certification sections of the LNCCS as a template for calculations under this Section and pursuant to the following formula:
    i. Enter all trade line costs from HUD's estimate or the applicable contractor's schedule of values after adjusting for any ORCF-approved change orders.
    ii. Enter all trade line costs from the general contractor's cost certification.
    iii. Using dollar and percentage variance columns, compare each trade's actual cost with the estimate and determine permitted expenditures.
b. Permitted expenditures shall not be limited by the estimates described in Section 11.14.B.5(a) above; rather, HUD reserves the discretion to base any such determination on distinctions in the contracted work, in part based on the following criteria:
    i. Actual costs paid to complete the work in accordance with the construction contract shall be permitted; and
    ii. Actual costs incurred due to unusual circumstances shall be permitted (e.g., bankruptcy of the subcontractor, code changes, required replacement of completed work and/or replacements due to natural occurrences, such as storms, floods, earthquakes, etc.).
c. HUD shall only review expenditures under this Section if such expenditure is substantially in excess of the above-described estimates (i.e., those greater than ten percent (10%) of the estimated trade line cost). If expenditure requires such review, HUD shall:
    i. Contact the Lender to request an explanation of such expenses, including supporting documentation, as applicable.
    ii. Make disallowances if the requested explanation and/or documentation is not submitted in a reasonable amount of time.
    iii. Request that the Lender submit an amended Contractor's Certification of Actual Cost.
d. HUD shall not permit any amount not justified or supported as being part of the construction contract work.
e. HUD shall not permit costs for duplication of work due to a contractor's error or negligence (e.g., improper placement of construction, failure to protect the construction and/or noncompliance with the terms of the contract, etc.).

C. Lump sum construction contract cost certification

HUD shall review the cost certification of any subcontractor that has an identity of interest with the Borrower.

11.15 Section 232/223(f) and 232/223(a)(7) Modified Form of Cost Certification

A. Borrowers shall complete and submit for review a modified form of cost certification prior to the Initial/Final Closing of a loan for insurance for all projects insured under Section 232 pursuant to Sections 223(f) or 223(a)(7) that include repairs without a PCNA (Project Capital Needs Assessment). Such cost certification shall comply with the following requirements:

1. Borrowers shall be required to certify to the total actual costs incurred in the acquisition or refinancing of the project. Such certification shall be submitted with the Borrower's Certificate of Actual Cost and shall be dated and signed by an authorized agent of the Borrower.

   Invoices shall be submitted to describe in sufficient detail all third-party costs, including cover sheets for each invoice and/or document submitted for each line item of the cost certification. Such cover sheet shall identify the number and name of the applicable line item and any subcategories. Additional cover sheets shall be submitted for each subcategory and shall identify the purpose of each invoice. If no invoice is available for a particular line item, a cancelled check may be submitted in lieu of such requirement.

   The following categories of line items shall be further documented as follows:

   a. Purchase Price or Existing Indebtedness
      Purchase prices shall be evidenced by the relevant portion of the applicable purchase agreement and shall be supplemented by any necessary explanation and/or clarification.

      Existing indebtedness shall be evidenced by pay-off letters from all existing-debt holders dated the month of closing. Per-diem amounts (including all calculations for taxes and insurance) shall be evidenced as follows:
      i. Prepayment fees shall be evidenced with documentation of the relation of such fees to the project and the basis for their calculation.
      ii. Any existing indebtedness of a Real Estate Investment Trust shall be calculated using the same methodology as utilized for determining existing indebtedness in the Maximum Insurable Loan calculation attached to HUD's firm commitment.
      iii. Any portion of a bond premium being distributed to the Borrower, the Operator or any of their principals shall not be included.
   b. Repairs shall reflect the actual amount paid for repairs, and shall be evidenced by photographs, invoices and the Borrower's certification for critical repairs. If the Borrower performs such repairs, itemization of the labor, material, equipment rent and overhead, shall be identified by trade in Schedule A of the Borrower's certification for critical repairs. Permitted expenditures for such

repairs shall not exceed the estimated cost of repairs from HUD's firm commitment.

c. All HUD-required fees (including the Application Fee, Inspection Fee and Mortgage Insurance Premium) shall be itemized on the bottom of Page 2 of the Borrower's Certificate of Actual Cost.
d. The Lender's fees shall not exceed three and one-half percent (3.5%) of the mortgage amount; however, higher fees (up to five and one-half percent (5.5%)) may be permissible for bond transactions.
    i. The Lender's fee shall include the Lender's legal expenses, which shall be identified on Schedule B and additionally included in this line item.
    ii. Any broker's fee shall be identified (with the name and address of the broker) on Schedule B and additionally included in this line item.
    iii. Any placement fee (GNMA, etc.) shall be identified on Schedule B and additionally included in this line item.
    iv. Security extension fees are not an allowable mortgageable cost.
e. Recording expenses shall include any recording taxes.
f. Legal and organizational expenses shall be itemized on the bottom of Page 2 of the Borrower's Certificate of Actual Cost and shall be further supported by invoices of third-parties. Other expenses shall be described in sufficient detail in Schedule C and supported by invoices and/or other relevant documentation. All third party reports (appraiser, PCNA, environmental, survey, etc.) and the initial deposit to the R4R account shall additionally be included in this line item. All previously FHA-insured projects shall describe in sufficient detail the proposed disposition of the current R4R fund in Schedule C.

2. The Lender shall be responsible for submitting its certification to ORCF for computation of the maximum insurable mortgage and completion of Section II of the Borrower's Certificate of Actual Cost.

B. In circumstances where the actual costs are less than estimated, the Borrower shall deposit any remaining funds in the R4R account.

11.16 Mortgage Reduction After Cost Certification

A mortgage reduction is not required under Section 232.

A. The Lender must recalculate the replacement cost based on allowable cost.

B. The Lender must recalculate the mortgage determinants.

C. If the new mortgage amount is less than the firm commitment mortgage amount the Lender may request either:
    1. The difference may be added to the R4R account, or

2. The mortgage will be reduced.

The Lender request and explanation will be included as a part of the Lender's draft Maximum Insurable Mortgage Letter.

11.17 Increase in Mortgage Amount

A. Any requests for an increase in the mortgage amount shall be presented by the Lender and described in sufficient detail as part of the Lender's draft Maximum Insurable Mortgage Letter.

B. All mortgage increase requests shall require a detailed Lender review of the cost certification documents. Documentation of this review shall be evidenced by the LNCCS.

11.18 Inspector General Audit

ORCF reserves the discretion to request that the District Inspector General for Audit perform an audit the Borrower's and/or contractor's books where discrepancies appear to arise from other than inadvertent error or creditable misinterpretation of applicable criteria. ORCF additionally reserves the discretion to delay final closing if an audit will also be requested for any suspected fraud or material misrepresentation that arises prior to final closing.

11.19 Cost Certification Incontestability

After ORCF approves the respective cost certifications and signs the Maximum Insurable Mortgage Letter, such cost certifications shall be deemed final and incontestable unless there is determined to be fraud or material misrepresentation by the Borrower, the general Contractor or any subcontractors.

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Appendix 11.1
Windfall Calculation Example

Windfall Calculation Example	
Number of Days in Construction Period	252
Trailing Twelve Months Net Operating Income (TTM NOI)	$856,000
Annual Debt Service (Principal and Interest)	$450,000
Annual Mortgage Insurance Premium	+ $35,000
Total Underwritten Debt Service (Principal + Interest + MIP)	$485,000
Construction Period Net Operating Income	$683,000
Annual Historic Profit (TTM NOI – Total UW Debt Service)	$371,000
Equivalent Period Underwritten Debt Service ((Number of Days in Construction Period /365 days)*Total UW Debt Service)	$334,849
Construction Period Profit (Construction Period NOI – Equivalent Period UW Debt Service)	$348,151
Equivalent Period Historic Profit ((Number of Days in Construction Period /365 days)*Annual Historic Profit)	$256,142
Windfall (If Construction Period Profit is greater than the Equivalent Period Historic Profit, then the difference equals the Windfall)	**$92,009**

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Appendix 11.2
Windfall Calculation Explanation

Windfall = Construction Period Profit – Equivalent Period Historic Profit

Construction Period Profit = Construction Period Net Operating Income – Equivalent Period Underwritten Debt Service

Equivalent Period Underwritten Debt Service = Number of days in construction period/365 x Underwritten Debt Service (including MIP)

Equivalent Period Historic Profit = Number of days in construction period/365 x Annual Historic Profit

Annual Historic Profit = Trailing Twelve Months Net Operating Income – Underwritten Debt Service (including MIP)

Notes:

(1) The Trailing Twelve Months Net Operating Income and Construction Period Net Operating Income should not include any bond premium returned to the Borrower, depreciation and salaries to principals in expenses. It should include a 5% management fee and underwritten ongoing deposit to the reserve for replacement account as expenses. In addition, The Construction Period Net Operating Income should not include interest, taxes, insurance and any other items certified to as capital cost items in the cost certification.

(2) The Construction Period is defined as the period from initial endorsement to cutoff date.

(3) The windfall calculation is not applicable when the Borrower and Operator are unrelated entities.

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Appendix 11.3
Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/section_232/lean_processing_page

Form Number	Form Name
HUD-2328	Schedule of Values
HUD-2880	Applicant/Recipient Disclosure
HUD-2205A-ORCF	Borrower's Certificate of Actual Cost
HUD-91129-ORCF	Lender Certification
HUD-92023-ORCF	Request for Final Endorsement of Credit Instrument
HUD-92326	Project Cost Estimate
HUD-92330-OHF	Mortgagor's Certificate of Actual Cost
HUD-92330-A	Contractor's Certificate of Actual Cost
HUD-92264A-ORCF	Maximum Insurable Loan Calculation
HUD-92437	Request for Construction Changes
HUD-92441-ORCF	Building Loan Agreement
HUD-92441A-ORCF	Building Loan Agreement Supplemental
HUD-92442-ORCF	Construction Contract
HUD-92443	Construction Contract Incentive Payment
HUD-92434-ORCF	Lender's Certificate
HUD-92451	Financial Record of Mortgage Loan Transaction
HUD-92455-ORCF	Request for Endorsement
HUD-92485	Permission to Occupy—Project Mortgages
HUD-93305-ORCF	Agreement and Certification
HUD-9444-ORCF	Lender Narrative Cost Certification Supplement
HUD-95379-ORCF	HUD Representative's Trip Report
N/A	Cost Certification Review Checklist
N/A	Maximum Insurable Mortgage Letter

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Chapter 12
LIHTC and other Tax Credit Program Guidance

12.1 Introduction

The Low Income Housing Tax Credit (LIHTC) program was enacted as part of the Tax Reform Act of 1986 and is administered by the Treasury Department and State Housing Finance Agencies (HFAs). In July 2008, the Housing and Economic Recovery Act (HERA) was enacted which made changes to FHA programs to facilitate the use of FHA-insured mortgages with LIHTC developments.

This chapter outlines the policies and procedures to follow when underwriting and reviewing FHA mortgage insurance applications referenced under Title II of the National Housing Act with tax credits. Standard processing of applications apply except as modified below as well as within Production, Chapters 5, 9 and 11 of this Handbook.

All provisions of this Handbook applicable to LIHTC are also applicable to Historic and New Markets tax credit equity projects, to the extent consistent with the Section 232 program.

12.2 Program Guidance

A. **Use of Tax Credits with the FHA-Insured Mortgage:**

1. The Firm Application for any LIHTC project should generally include evidence of the LIHTC award, allocation or application. However, LIHTC allocation timing varies by state and in some cases FHA applications must be submitted before final allocations of tax credits can be secured. Accordingly, other evidence is allowable, for example state agency bond cap allocators' assurances and written procedures stating that bond cap remains available for the period in question, that an application has been submitted for the project in question, that allocations are obtainable in the time available, etc., in the case of 4% LIHTC allocations.

2. Government tax credits, combined with any secondary financing and grants, may be used to cover up to 100% of the equity requirement. Regarding secondary financing,

see requirements and limitations in Production, Chapter 3, at 3.15.

3. Secondary financing, grants, and government tax credits may also be used to finance non-mortgageable costs. Such funds covering non-mortgageable costs, when added to the FHA-insured mortgage and required equity contribution, may exceed 100% of the project's Fair Market Value (FMV) or Replacement Cost.

4. Non-mortgageable costs or replacement cost items required to complete the project may be included in the transaction with supporting documentation, subject to ORCF approval.

5. Publicly Funded Loans or Public Debt. Loans funded with HOME Funds or other federal, state or local public sources, as well as those funded by quasi-public agency programs, may be granted or lent directly to HUD's borrower, or to the GP or sponsor of the borrower, who will then loan it to HUD's borrower. All such sources will be treated as public secondary financing sources, and as such need not be included in the calculation of the total project cost limit applied to private secondary debt. However, none of these sources may be substituted for tax credit equity required by the pay-in schedule.

6. Tax Exempt Bonds/Take out by FHA Insured Permanent Debt. Tax credit projects are often financed with the "4%" tax credits allocated in conjunction with private activity bond volume cap. Taxable Ginnie Mae securities' yields and the resulting rates on FHA loans at times can be lower than tax exempt bonds and municipal bond-backed loan rates. Consequently, investment banks have developed an approach that combines taxable Ginnie Mae securities with short term, tax exempt bonds and **4%** LIHTC. This structure establishes several different accounts, along with a series of cash flow events between the various accounts upon a draw request. The tax exempt bonds are secured by cash collateral initially provided by the FHA lender's warehouse funds (or other funding sources, but not FHA-insured loan proceeds), which in turn are reimbursed with proceeds from the sale of Ginnie Mae-guaranteed securities. The tax exempt bonds are retired with the proceeds of the bond collateral account when the project is placed into service.

   This structure allows the borrower to avoid higher loan rates that exist when the loan funding source consists exclusively of tax exempt bonds, and still take advantage of the 4% LIHTC equity. This bond financing structure is generally acceptable to HUD, but each transaction must be reviewed by HUD for programmatic and legal sufficiency, including the review of specific transaction documents.
   NOTE: FHA-insured loan proceeds shall not be used to serve as collateral for the bonds, and they may not be paid to the bond trustee or sent to other accounts to facilitate issuance of the bonds. This is a statutory prohibition that may not be waived, as FHA-insured loan proceeds are only permitted to directly finance the relevant activity authorized under the applicable section of the National Housing Act. To ensure statutory compliance regarding the use of FHA-insured loan proceeds, HUD

requires lenders to sign and submit the "Lender Certification for Tax Exempt Bond and 4% Low Income Housing Tax Credit Transactions" for financings structured in this manner.

7. Borrowers using LIHTC or other government tax credit programs must demonstrate successful experience in developing and owning comparable regulated properties.

8. If a tax credit syndicator is identified, the Lender's Underwriter will also need to provide a brief overview and analyses of the entity. Typically, a tax credit syndicator is an investor intermediary with only a limited ongoing obligation to LIHTC rental properties. Nevertheless, the syndicator's liquidity, track record, asset management and monitoring capability and ability to perform on its commitment to provide equity to the Borrower after Initial Closing is a material issue for the experience and creditworthiness analysis of the tax credit investor/LP.

9. For LIHTC projects with a funded working capital reserve held by the partnership (even though controlled by the syndicator or investor and not by HUD or the Lender), the funded reserve will be credited towards the increased construction reserve requirement, although the Lender controlled account must still meet the 2% working capital escrow requirement.

10. For LIHTC projects with a funded operating deficit reserve held by the partnership (even if controlled by the investor and not by HUD or the Lender), the funded reserve will be credited towards the reserve requirements of the mortgage, although the Lender controlled account must still meet what the appraisal and underwriting analysis determines to be an appropriate operating deficit amount.

B. **Tax Credit Equity Bridge Loans:**

Tax credit equity syndicators or investors (which may, subject to the restrictions in Section 12.2(D) of this Chapter, have an identity of interest with Lender) may make equity bridge loans to tax credit projects during the construction or substantial rehabilitation period before the property's placed-in-service date, as defined by the applicable tax credit program. Bridge loans may be used by tax credit investors to defer the pay-in of equity during a project's development and stabilization phases, thereby increasing the return on equity. However, at final closing, all funds needed to meet the borrower's cash contribution must be in the transaction so the sources and uses will balance and the investors will pay in the equity to retire the equity bridge loan.

The bridge loan may be the obligation of one or more of the investors or other upper tier partners to the ownership entity (e.g. the limited or general partners), or an obligation of the project ownership entity/single-asset mortgagor itself. In addition the following conditions must be met:

1. The equity bridge loan may not be secured by a lien on the real estate or on any other real or personal property that is collateral for the FHA insured loan, as defined in the

Security Instrument, although the equity bridge loan may be secured with a pledge of tax credits and/or of limited partners' or investor members' interests in the project's ownership entity;

2. The equity bridge loan must be non-recourse to the Borrower, and the bridge lender shall have no claim even in an event of default against the Borrower, the Project, FHA mortgage loan proceeds, or any reserve or deposit made with the FHA Lender, or otherwise required by HUD;

3. In the event HUD acquires title to the Project by foreclosure or deed in lieu of foreclosure, the bridge loan documents shall automatically terminate and the Borrower shall be released of all of its obligations with respect to the equity bridge loan;
4. The obligation must be evidenced by a promissory note;

5. The term of the note may last through the construction or rehabilitation period but must be paid in full at or prior to final endorsement of the Note.

6. At application, or as soon as the need for a bridge loan is known, the lender must submit a term sheet describing the key terms of the bridge loan, as well as a certification that a) the loan will be secured only by a pledge of partnership interests or tax credit benefits and not by the project, and b) that the bridge lender will have no claim against the mortgaged property, mortgage proceeds, any reserves or deposits, or against the rents or other income from the property for repayment of the bridge loan.

7. Bridge loans for other purposes, (i.e. that are not used to advance equity in tax credit projects) are described in Chapter 3.

C. **Tax Credit Equity Contribution:**

1. ORCF requires that an appropriate amount of the tax credit equity be invested in the project and be applied to ORCF-approved items at the time of initial closing. The amount deemed by ORCF to be sufficient for such purposes will depend on the circumstances of each transaction, but must be an amount that assures an ongoing relationship between the Borrower and the tax credit syndicator or investor.

2. The initial installment of equity must be an amount that is equal to or exceeds twenty percent (20%) of the total equity that will be available for the project. If less than 20% is proposed, the Lender must submit a request for ORCF review and approval. ORCF will review the justification submitted to determine if the lesser amount is appropriate as an initial investment of equity.

3. The Commitment for Mortgage Insurance will contain, among other special conditions, a requirement for evidence satisfactory to ORCF of an agreement

that binds the investor to timely and periodically pay the Borrower tax credit equity to contribute to the completion costs, in the aggregate amounts shown on the Applicant/ Recipient Disclosure/Update Report (Form HUD-2880). An equity pay-in schedule, with actual total equity and net-equity amounts, must be included as a special condition and attachment to the Firm Commitment for all tax credit Projects. This schedule will be used as a method of checking proposed disbursement schedules.

4. The actual amount of the initial equity investment must be reflected in the Firm Commitment as a special condition with the requirement that the initial installment must be expended on the initial requisition at Initial Closing.

5. After the first installment of tax credit equity is distributed at initial closing, the subsequent contributions shall be made at a time and in a manner during construction to ensure that the underwriting requirements in the Firm Commitment are maintained and met for actual costs. To maintain the appropriate balance of tax credit equity and mortgage loan proceeds, at each infusion of tax credit equity those funds may need to be utilized before the next disbursement of mortgage loan proceeds.

D. **Sponsor's Continuing Commitment:**

1. To the extent consistent with the Section 232 program, the application must include a *Letter of Commitment* to fund the required equity from a tax credit equity syndicator or investor. This *Letter of Commitment* must specify the equity amount, pay-in schedule and other relevant details such as conditional benchmarks so that HUD and the Lender can ensure sufficient equity in a manner that meets HUD's requirements. The Lender may also make the determination to require additional documentation (e.g. financial statements, etc.) of a syndicator or investor.

2. The Lender must focus on and evaluate the tax credit syndicator's or the direct investor's financial strength, experience, reputation and asset management capabilities, if they have the majority ownership interest in the Borrower entity. Evaluating the syndicator is important because investors expect syndicators to support transactions that have cash flow problems or replace nonperforming general partners. In addition, the syndicator must typically assess the appropriate amounts of reserves at both the property and fund levels and must perform certain asset management functions.

E. **Identity-of-Interest:** An affiliate of the Lender can own up to a 25% percent interest in the investor limited partnership interests (or investor LLC membership interests) entity of the Borrower, under the following conditions:

1. In all instances where there is an identity of interest or affiliation between the Lender and the tax credit equity syndicator or investor, the loan must be processed, underwritten and approved by the Lender staff without involvement by the affiliated

equity staff.

2. The affiliated tax credit equity syndicator or investor can hold no more than a 25% interest in the limited partnership entity (or an equivalent percentage if owned as an LLC) of the Borrower after the project's placed-in-service date. During the construction or rehabilitation period before the property's placed-in-service date, the tax credit equity syndicator or investor may make an equity bridge loan that complies with Section 12.2.B. After the placed-in-service date, the affiliated tax credit equity syndicator or investor may not hold an equity bridge loan note and may not own more than a 25% interest in the limited partnership entity of the Borrower.

3. ORCF must ensure that the affiliated tax credit equity syndicator or investor does not improperly influence the Lender on a LIHTC project. Therefore, the Lender and the affiliated tax credit equity syndicator or investor must provide ORCF with a specific Representations and Warranties on applications submitted for each LIHTC project.

    a. **The Lender's Representation and Warranty must state:**
        i. No officer or employee of _____ (insert the name of affiliated tax credit syndicator or investor) or any director or parent thereof will have any loan-specific or decision making control or influence in _____'s (insert the name of Section 232 Lender) underwriting of the FHA-insured mortgage except by providing factual information to _____ (insert the name of Lender) in the same manner as would be provided by an unaffiliated syndicator).
        ii. _____ (insert the name of Lender) will not condition its agreement to provide such financing on _____ (insert the name of affiliated tax credit equity syndicator or investor) being selected as the tax credit equity syndicator or investor for the project to be financed by the FHA-insured mortgage.
        iii. _____ (insert the name of the Lender) will notify HUD promptly, in writing, during application processing of any change or event which causes the foregoing Representation or Warranty to be materially untrue or inaccurate.

    b. **The Lender's affiliated tax credit syndicator or investor's Representation and Warranty must state:**
        i. In the regular course of its business it syndicates or invests in tax credit equity investments in assisted living affordable housing projects.
        ii. With respect to any project loan that is to be underwritten by _____(insert name of Lender) and in which _____(insert name of affiliated tax credit equity syndicator or investor) intends to make an equity investment or sell equity to other investors:
            1. No officer or employee _____(insert name of Lender) will have any loan-specific control or influence in

_____'s (insert name of affiliated tax credit equity syndicator or investor) processing of the sponsor's application for tax credit equity syndication or investment except by providing factual information to _____ (insert the name of affiliated tax credit equity syndicator or investor) in the same manner as would be provided to an unaffiliated Lender.

2. _____ (insert the name of affiliated tax credit equity syndicator or investor) will not condition its commitment to syndicate or invest in the project equity on debt financing for such project being provided by _____ (insert the name of Lender).
3. Except during the interim period prior to the placed in service date during which _____ (insert name of affiliated tax credit equity syndicator or investor) may make an equity bridge loan to the project, neither _____ (insert the name of affiliated tax credit equity syndicator or investor) nor any affiliate or subsidiary thereof will hold greater than a 25% interest in the 99% investor limited partnership entity (or an equivalent percentage if owned as an LLC) of the Borrower.

4. The Representations and Warranties must include the following criminal warning language: **WARNING**: *"HUD will prosecute false claims and statements. Convictions may result and/or civil penalties. (18 U.S.C. 1001, 1010, 1012; 31 U.S.C. 3729, 3802)"*

F. **Subsidy Layering Review:** Tax credit equity solely in combination with FHA-insured debt is exempt (by the Housing and Economic Recovery Act of 2008 (HERA)) from a subsidy layering review. Beyond the FHA-insured debt, a subsidy layering review is required when other public funds are combined. In every case, regardless of the sources of supplemental public grant, loan, or equity funds, the Lender must review the Sources and Uses statements for both mortgageable and non-mortgageable funds to ensure costs are not being funded twice, and that costs funded directly or indirectly from mortgage proceeds are appropriate and necessary to complete the transaction.

G. Tax Credit Regulatory Agreements. In tax credit projects, certain IRS Section 42 obligations must be allowed to continue post-default. Generally, however, for the Tax Credit Land Use Restriction Agreement (LURA), and/or when public secondary financing with regulatory agreements or restrictive covenants are required, HUD requires the use of its standardized rider, indicating that in case of conflicts between a LURA or another restrictive covenant and FHA "program obligations," FHA requirements take precedence. Alterations of the rider that are once approved for certain jurisdictions may then be used as the template for that jurisdiction, with prior ORCF approval. **It is the lender's responsibility to draw attention to potential conflicts between FHA requirements and the LURAs or other restrictive covenants in the Firm application submission.** If they are not addressed in the Firm Commitment, the lender should assume the closing will be delayed.

12.3 Firm Commitment and Initial Closing

A. The Firm Commitment will include special Firm Commitment conditions to confirm and assure the Tax Credit Equity requirements stated in Section 12.2:

1. That the Commitment is subject to, and has been issued upon the reliance of, the receipt of Low Income Housing Tax Credit (Historic Tax Credits or New Market Tax Credits) syndication funds in the amount of $ of which a $ cash investment is required for mortgageable items including land and $ for HUD required escrows. The initial installment of funds allocated to mortgageable items must be provided prior to initial closing, with a disbursement agreement that evidences the timely infusion of funds required to pay for all project costs. All documents relating to the tax credit funds, including the Land Use Restriction Agreements, the final statement of sources and uses, and the final Applicant/ Recipient Disclosure/Update Report, must be reviewed and approved by ORCF prior to initial closing.

2. HUD's review and determination of acceptability and sufficient financial capacity is required for the tax credit investor(s). This investor entity and all principals are subject to Previous Participation clearance requirements, except to the extent limited liability corporate investors may submit an Identification and Certification of Limited Liability Investor Entities, found in Housing Notice H 2016-15 (or successors thereto), in lieu of other previous participation requirements. HUD approval of the final investor(s) must be accomplished prior to initial closing.

3. The Borrower's organizational documents must include a provision that prohibits any changes to the organization documents that affect the investor commitment without the written consent of the Lender and HUD.

B. **Initial Closing:** Prior to initial closing, HUD will review and approve all proposed closing documents to ensure compliance with all firm commitment obligations and Special Conditions. Specific to loans involving tax credits, the initial closing documents must include:

1. A final detailed Sources and Uses statement of total development costs, reflecting any revisions to hard and soft costs as reflected on the firm commitment, HUD-92264a-ORCF. If any funding sources have changed, a revised Applicant/ Recipient Disclosure/Update Report is also required.

2. Tax credit syndicator and investor documents. The Partnership Agreement or other investor documents of the syndicator, including:
    a. Consolidated Certifications,
    b. Previous Participation certifications,

c. Modified credit package to include current financial report or Annual Report, as applicable.

3. Evidence that the FHA-Insured Mortgage will be in first lien position with respect to all project collateral.

4. All documents shall include conflict language giving the HUD documents supremacy over other documents. Documents may not include indemnification provisions, except as otherwise permitted by outstanding HUD guidance.

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Appendix 12.1
Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care

IRS webpage:
http://www.irs.gov/

Form Number	Form Name
IRS-8609	Low-Income Housing Credit Allocation and Certification
HUD-2880	Applicant/Recipient Disclosure
HUD-92264A-ORCF	Maximum Insurable Loan Calculation
Notice H 2016-15	Processing Guide for Previous Participation Reviews of Prospective Multifamily Housing and Healthcare Programs' Participants (or successors thereto)

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Chapter 13
Master Lease

13.1 Introduction

HUD has worked diligently to ensure its insurance fund remains stable by addressing the concentration of credit with any single operator. In 2001, HUD issued new processing procedures for multiple-facility applications. Although each facility is still evaluated individually, borrowers face increased scrutiny when they seek financing for multiple facilities within an 18 month time frame.

HUD will now require a master lease for three or more properties and/or $15 million or more in aggregate loans to projects under the same ownership.

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. Master leases, along with portfolio corporate credit reviews (see Production, Chapter 17) are the primary tools the Office of Residential Care Facilities (ORCF) uses to identify and mitigate concentration risk associated with portfolio projects.

13.2 Terms and Concepts

Portfolio: 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

Single Asset Entity: For each individual project, the mortgaged property shall be the only asset of the Borrower and Operator (please see Production, Chapter 2.5.B and 2.5.C for SAE requirements).

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

13.3 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 subject to 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.

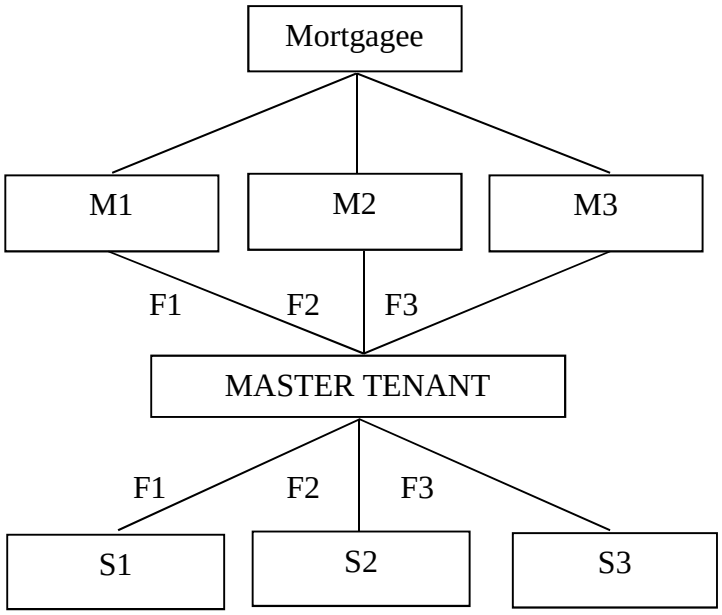
C. **Underwriting of Projects included in a Master Lease**

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 Appendix13.1 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 13.2 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 13.3.

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.

F. **Alternatives to Master Lease.** The master lease requirement applies to projects that are utilizing, or will utilize, a lessee-operator "PropCo/OpCo" structure. For organizational structures with no operating lease, however, HUD looks to an alternative means of mitigating the concentration of risk inherent in the common ownership (e.g., a Limited Guaranty and Security Agreement).

13.4 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. 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).

B. 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;
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 Section 13.3.E. above - Alternative Forms of Project Structures and Variations in Master Lease Structures; and
5. The applications for mortgage insurance are submitted within any rolling 18-month timeframe that begins when the first application is assigned to an ORCF underwriter. The submission of an application creates an open window for a master lease. 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 master lease and to fully evaluate the risk to the General Insurance Fund.

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.

13.5 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.

13.6 Master Lease Review

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 Section 232 Program 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, and
7. Master Tenant Security Agreement.

HUD requires a Master Lease Review Package that must include the items listed above. 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.**

A. Lender shall provide a narrative which describes the following:

1. The terms and conditions of the master lease;
2. 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;
3. Any proposed payments (fees, income, etc.) to or from the master tenant;
4. The lease agreements between borrower and the master tenant, and the lease agreements between the master tenant and the subtenants;
5. 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
6. 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.

B. Lender shall provide a spreadsheet with the following:

1. The names of the facilities to be included under the master lease;
2. The proposed mortgage amount for each facility;
3. The recommended appraised value of each facility;
4. The proposed debt service coverage ratio for each facility including the mortgage insurance payment;
5. The number of beds at each facility;
6. The CMS Star Rating at each facility, if applicable;
7. The current balance of each facility's replacement reserve account; and
8. Any other reserve funds that will be available to the owner/operator to fund project costs.

C. 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.

D. ORCF Review: ORCF, in cooperation with OGC, will review the following items to ensure

agreement with the contents of the lender's application:

1. Master Lease and Subleases;
2. Base rent amount;
3. Escrow amounts (for example, taxes, MIP, property insurance, etc.);
4. Term of the master lease;
5. HUD mandated immediate and/or critical repairs;
6. HUD required replacement reserves; and
7. Any other required reserves.

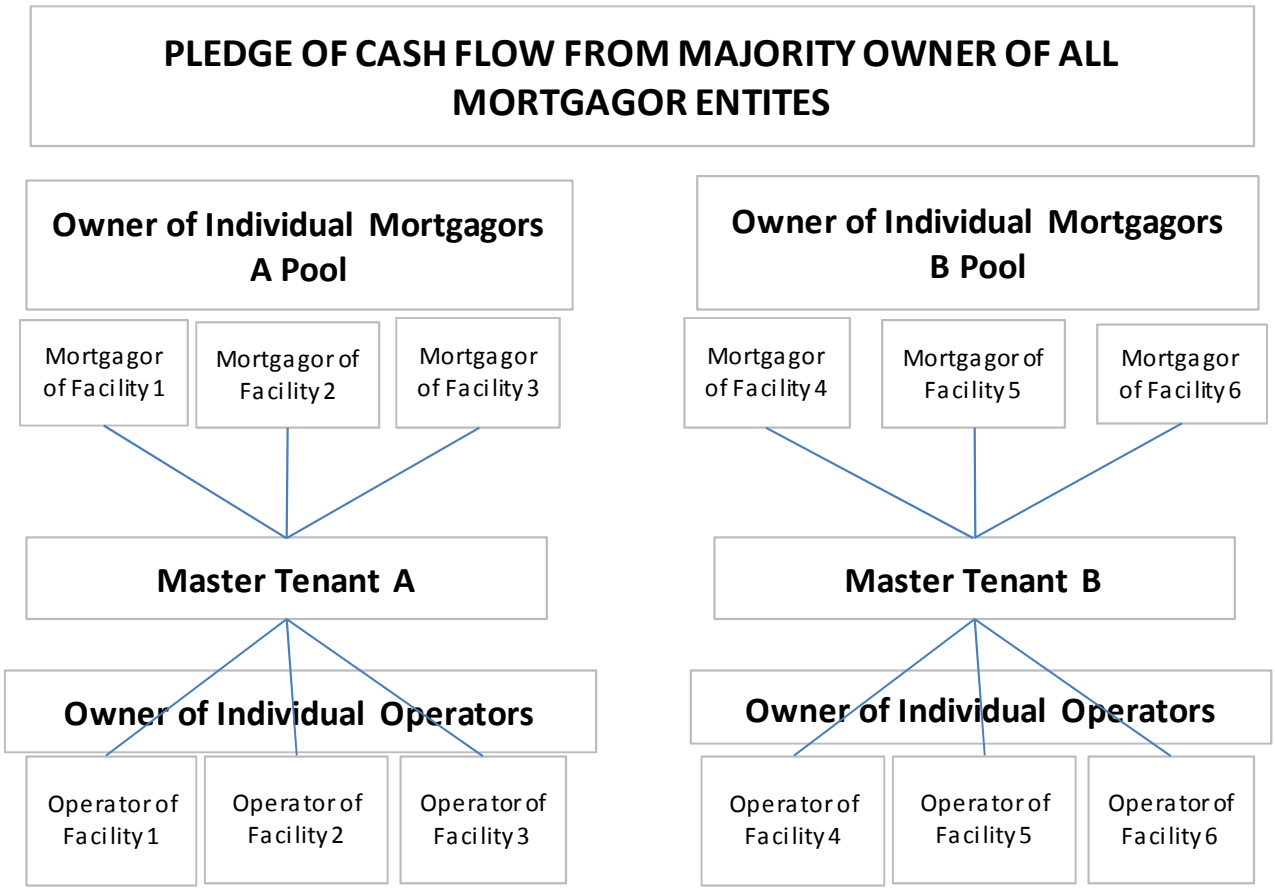
Section II
Production

Appendix 13.1
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



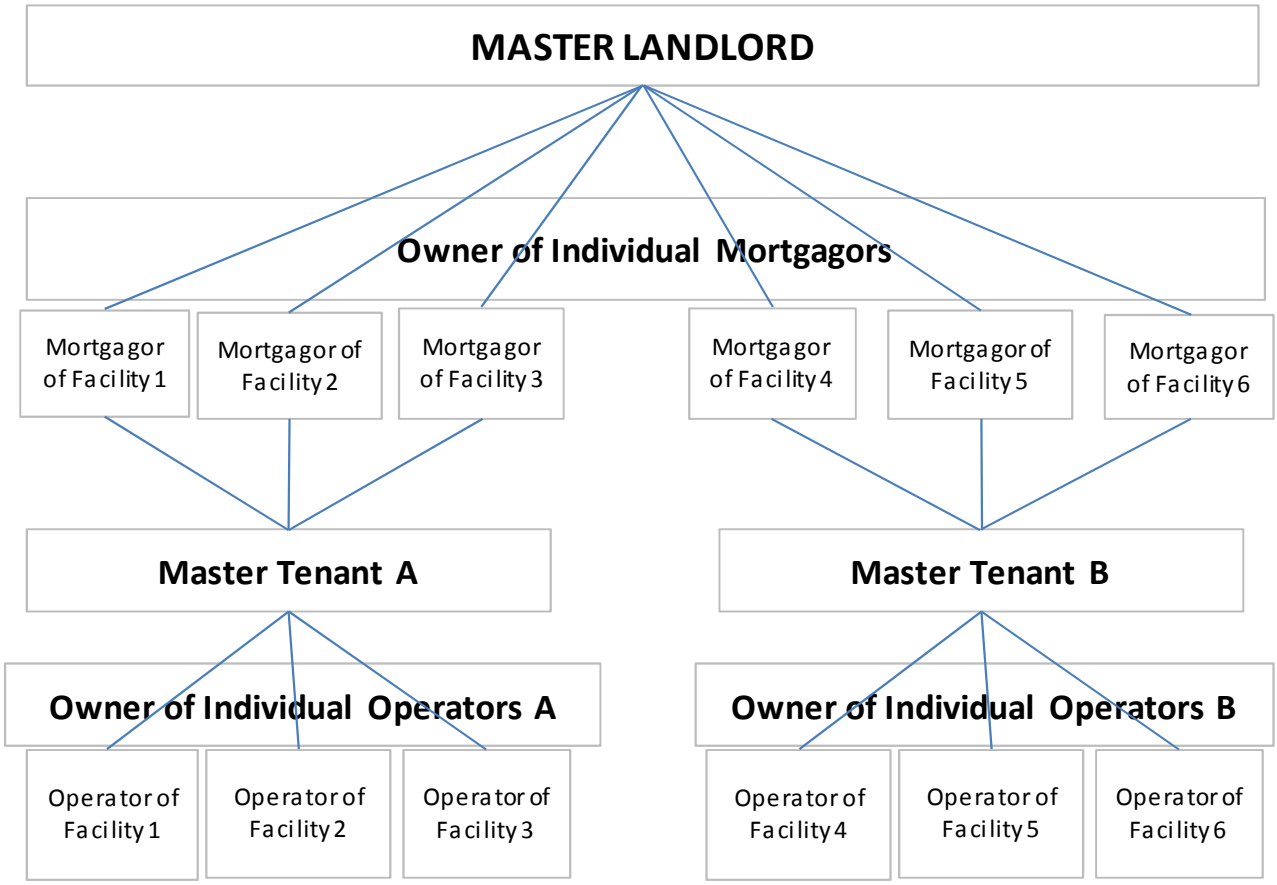
Section II
Production

Appendix 13.2
Master Landlord Structure

Master Landlord Structure

All Borrower Entities are the Same

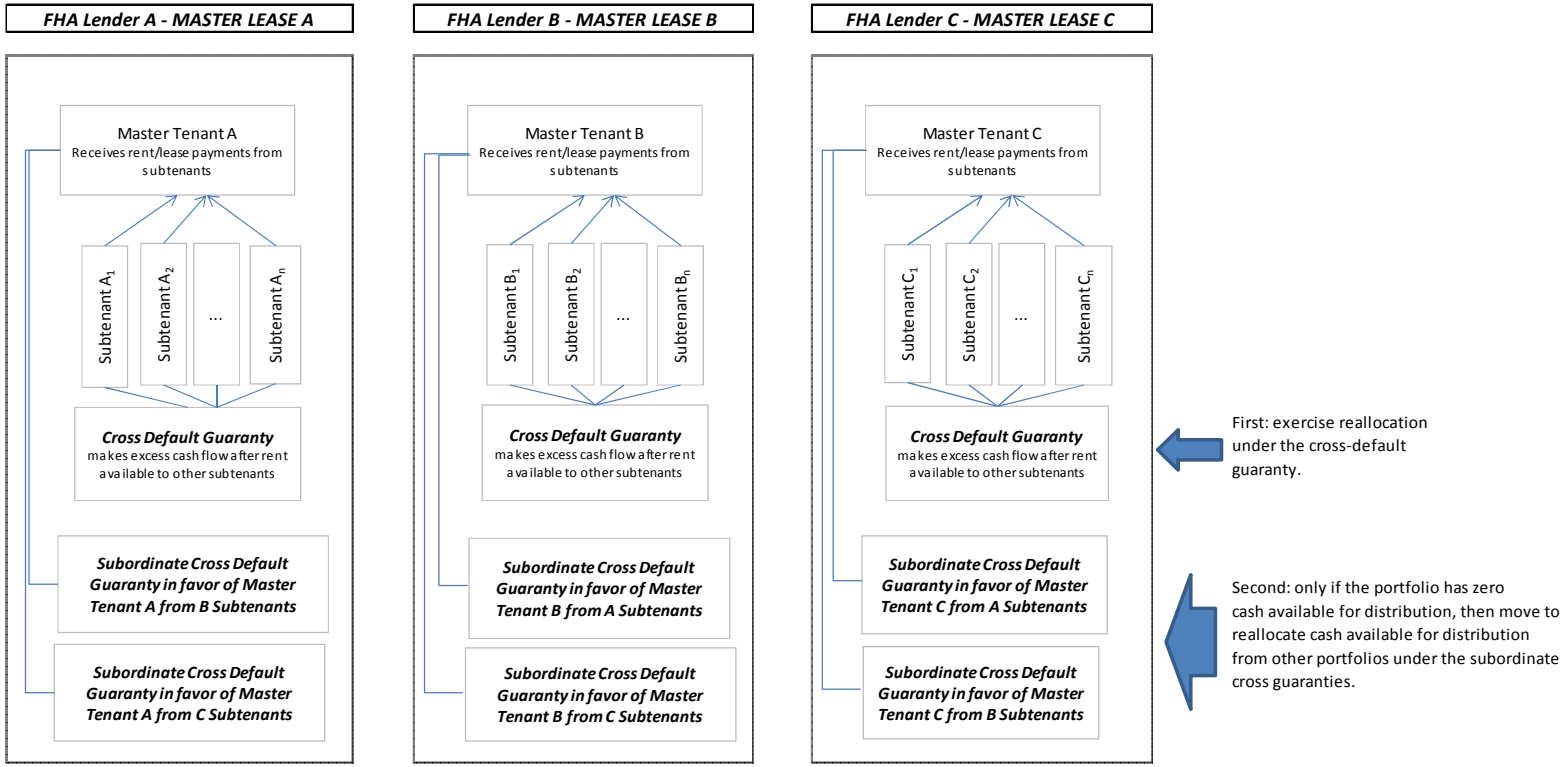
All Operator Entities are NOT the Same - Separate and Unaffiliated from Each Other



Appendix 13.3

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.

Section II
Production

Chapter 14
Insurance Requirements

14.1 Introduction

This chapter provides the Office of Residential Care Facilities' (ORCF), overall policy with respect to the various types of insurance required in connection with the Section 232 Office of Residential Care Facilities program. Professional Liability Insurance (PLI) required of Healthcare Facilities was formerly addressed by Housing Notice 04-15. PLI is a requirement in a Section 232 project, but it is sufficiently distinct from the other types of required insurance. It is addressed separately in Appendix 14.1 to this chapter.

A. **General Insurance Requirements – Applies to All Policies.** ORCF requires each Property to be covered by property and liability insurance for the life of the mortgage loan. The named insured for each policy must be the responsible party for that type of insurance policy.

B. **All policies must:**

1. Be written on a per occurrence basis except for earthquake and professional liability coverage, which may be written on a per claims/claims made basis;

2. Have a cancellation provision requiring the carrier to notify the Lender at least 30 days in advance of policy cancellation for any reason except non-payment of premium;

3. Include a cancellation provision that provides for at least a 10-day written notification for non-payment of premium; and

4. Name the Department of Housing and Urban Development (HUD) as an additional insured, on all required liability policies except for professional liability insurance policies; and

5. Contain a mortgagee clause acceptable to HUD and a Lenders Loss Payable Endorsement solely naming the Lender. An acceptable mortgagee clause would be:

   Lender Name, Its successors and/or assigns, As their interest may appear, Lender's Street Address or PO Box, Lender's City, State and Zip Code.

*It is understood that HUD shall not be named on any Hazard Loss Drafts. Monitoring and management of Hazard Losses shall be the responsibility and obligation of the Lender.

C. **Policy Requirements:**

1. Each policy must either have a term of at least one year at the time of closing the mortgage loan; or

2. Have a term with less than 12 months remaining at the time of closing the Mortgage Loan, so long as the policy contains the required coverage or the required coverage is being added to the existing policy. The Lender must collect funds at Closing and during the months following Closing to ensure adequate funds will be on deposit with the Lender to pay the next premium by its scheduled due date.

D. **Financing of Premiums:**
All premiums covering the first full year for existing or new property insurance policies must be paid in full at Closing. Premiums for General Liability and Professional Liability policies may be paid through an alternative payment plan (e.g., monthly or quarterly) approved in writing by the Lender and the insuring entity. The Borrower shall not finance premiums for renewals of any policy covering the physical damage to collateral of the loan.

E. **Evidence of Insurance:**
The Borrower must provide to the Lender evidence of insurance for the Property on or before the date of Closing of the Mortgage Loan or the policy's renewal date. Evidence of insurance coverage for the Property must be provided as follows:

- ACORD 28 – "Evidence of Commercial Property Insurance" (most recent version or per state requirements if applicable), combined with ACORD 25 – "Certificate of Liability Insurance";

- ACORD 75 – "Insurance Binder"; or

- Mortgage Bankers Association (MBA) Evidence of Insurance – Commercial Property Form. In states where the MBA form is filed and approved, the appropriate state form must be used. Otherwise, the most recently revised MBA form should be used, which can be found at: http://www.mba.org

  If the borrower cannot procure any of the three above, HUD and Lender will accept a letter signed by the Borrower and the licensed insurance broker/agent certifying that all coverage requirements and terms and conditions meet HUD's requirements. Temporary coverage, such as an insurance binder (Acord 75 - "Insurance Binder"), has an expiration date that must be monitored by the Lender and renewed on or before its expiration date.

- Permanent Evidence – The following are acceptable forms of permanent evidence of insurance:

- The original or duplicate copy of each current insurance policy, which must be received, reviewed and placed in the Lender's Servicing File within 90 days after the delivery of the Mortgage Loan or the date of the insurance policy renewal. Except for an NFIP policy, only the complete insurance policy is sufficient evidence of coverage. Insurance policy declarations pages, single policy endorsements, insurance binders and certificates of insurance are not an acceptable form of permanent insurance coverage. The Policy Declaration page of an NFIP policy is acceptable evidence of the flood insurance coverage referenced thereon.

- For Properties securing a Mortgage Loan with an Unpaid Principal Balance ("UPB") of $10 million loan or below, the "MBA Evidence of Insurance – Commercial Property Form" is acceptable under the following conditions:

    - Form must be complete in its entirety;
    - Form must have an original signature of an individual authorized to execute the "Evidence of Insurance" on behalf of the insurance carriers issuing each policy of Property Insurance described on the form; and
    - In states where the form is filed and approved, the appropriate state form must be used, otherwise the most recently revised MBA Evidence of Insurance – Commercial Property Form should be used.
- For Properties securing a Mortgage Loan with an UPB in excess of $10 million and/or for multi-layered Blanket Policies, including Master Property Insurance Programs, a duplicate copy of the primary insurance policies must be received along with a letter (signed and dated on company letterhead) from an individual authorized to execute any evidence of insurance on behalf of the insurance carriers issuing each policy of Property Insurance, and stating that all policies follow the same Terms, Conditions and Exclusions as the primary policy. Any differences must be specified.

- HUD and Lender recognize that some insurance carriers use "boiler plate" policies that do not change from year to year. In these cases, the Lender may keep a specimen kit or library of such policies and endorsements, requesting only the renewal Declarations Page along with a list of endorsements as permanent evidence of insurance. The Lender must confirm in writing that the policies on file are current.

- The Lender will be liable to HUD if a binder expires, the Borrower has not provided sufficient evidence of permanent coverage, and an uninsured loss occurs.

14.2 Blanket Policies

Use of a blanket or package policy (or policies) of insurance covering the property and other properties and liabilities of the Borrower is acceptable, provided that:

A. The policy provides the same or better insurance coverage as a single property insurance policy;

B. The property is listed and identifiable in the policy or associated schedules; and

C. The policy complies with all other applicable requirements contained in this Chapter.

14.3 Property/Casualty Insurance Carriers

A property/casualty insurance carrier must meet the following rating requirements even if it is rated by one or more rating agencies or conditions:

A A.M. Best Company general policyholder's rating of ”A-” or better and a financial performance index rating of “VI” or better in Best's Insurance Reports or Best’s Key Rating Guide.

B. Financial Stability Rating of “A” of better from Demotech.

C. Various state-wide pools (if it is the only coverage that can be obtained) or flood companies approved under the National Flood Insurance Program (NFIP). Carrier must be licensed to do business in the United States.

14.4 Insurance Data Requirements

On an annual basis, the Lender must complete and retain an insurance compliance checklist in the Servicing File, in either electronic or hard copy format. The Lender must retain information relating to all insurance coverages for each Mortgage Loan. Such information must be provided to HUD upon request. For each type of required insurance coverage (See Sections 14.5-14.7), the following must be included:

- **Name of Insurer;**
- **Name of Insured/Borrower;**
- **Coverage Amount;**
- **Deductible;**

- **Expiration Date;**
- **Policy Term;**
- **Description of Property Insured: and**
- **Coinsurer and percent, if applicable.**

14.5 Property Insurance Requirements

This section covers the requirements that policies for property insurance must satisfy.

A. **Property Damage** ("Special Form")

What's Required	"Special Form" (formerly referred to as "All Risk") Property Insurance
When Does it Apply?	All property types.
Amount of Coverage	• 90% of Estimated Replacement Cost. Policy must be free from coinsurance.
Maximum Deductible	• $25,000 per occurrence for a portfolio (aka blanket) or single asset Mortgage Loan with a Property having less than or equal to $100 million in total replacement values, as listed in the policy. • 1% or $250,000 per occurrence for a portfolio or single asset Mortgage Loans with a Property having greater than or equal to $100 million in total replacement values, as listed in the policy.

1. The 90% of Estimated Replacement Cost Value (as defined by the Insurable Value Calculation contained in the 3rd party Project Capital Needs Assessment) includes the cost of excavations, foundations, piers, or other supports which are below the surface of the lowest basement floor or where there is no basement, which are below the surface of the ground, underground flues, pipes, and drains. If the Builders Risk Insurance or the Permanent Fire and Extended Coverage Insurance does not insure these items, then an amount acceptable to the Mortgagee will be deducted from the Assistant Secretary for Housing-Federal Housing Commissioner's estimate of the 90% of Estimated Replacement Cost for the purpose of estimating the amount of Builders Risk Insurance or the amount of Permanent Insurance.

   If the Estimated Replacement Cost is not provided in the PCNA, a report using valuation software such as Marshall and Swift or similar industry recognized software may be submitted to provide the Estimated Replacement Cost.

   Please note that "Replacement Cost New," a value sometimes found on the appraisal, should **not** be used for the purpose of the Estimated Replacement Cost calculation because "Replacement Cost New" may include uninsurable items.

For Estimated Replacement Cost Value of New Construction projects, please see the Lender's Architectural Reviewer and Cost Analyst's Statement of Work located on the Section 232 Program website.

2. The following exclusions from "Special Form" insurance policies are acceptable:
   a. War or Military Action,
   b. Nuclear Hazard,
   c. Volcanic eruptions,
   d. Fraudulent or dishonest acts committed by the insured,
   e. Dispersal, release or escape of contaminants, or pollution (biological and chemical agents), Windstorm, flood and earth movement exclusions also are acceptable, provided a separate policy or coverage is obtained for these exclusions, as specified elsewhere in this chapter.

B. Ordinance and Law Coverage

What's Required	Ordinance and Law Coverage
When Does it Apply?	Properties that contain any type of non-conformance under current building, zoning, or land use laws or ordinances and cannot be rebuilt "as is". Note "As Is" means the ability to be rebuilt with the same building footprint and square footage, within the municipality's required time frame and without increasing the nonconformity or as otherwise defined by the municipality. The Lender should pay special attention to required time frame and its feasibility.
Amount of Coverage	• Coverage A - Loss of Undamaged Portion of the Property: Equal to 100% of the full replacement cost of the Property less the damage threshold of the local building ordinance. If threshold is not available, 100% of the full replacement cost of the Property. • Coverage B - Demolition Cost: Minimum 10% of the full replacement cost of the Property. • Coverage C - Increased Cost of Construction: Minimum 10% of the full replacement cost of the Property. Applicable deductibles shall be no greater than property insurance deductible.

C. Boiler and Machinery/Equipment Breakdown Insurance

What's Required	Coverage from loss arising from the operation of pressure, mechanical, and electrical equipment.
When Does it Apply?	Properties where any centralized HVAC, boiler, water heater or other type of pressure-fired vessel is in operation and regulated by the state where the Property is located. If boiler or boilers located at the subject property are other than

	steam boilers, specific Boiler Explosion Insurance generally is not required. If there is a steam boiler or boilers in operation in connection with the subject property, specific Boiler Explosion Insurance is required.
Amount of Coverage	At least 90% replacement cost (as described in Section 14.A.1) of the building(s) that house the equipment. Coverage must be free from coinsurance.
Maximum Deductible	No more than the deductibles on the property insurance policy.

14.6 Liability Insurance

A. **HUD requires that each Property and Borrower be covered by Liability Insurance for the life of the Mortgage Loan.** This section covers the guidelines and requirements that policies for Liability Insurance must meet.

B. **In the case of new construction, substantial rehabilitation, or additions, both the General Contractor and the Borrower must be covered by Commercial General Liability Insurance.**

C. **Commercial General Liability Insurance**

1. Commercial General Liability Insurance for bodily injury, property damage and personal injury, such liability policies must not contain an exclusion for contractual liability assumed by the Borrower in any Mortgage Document or related agreement that indemnifies HUD.

2. Applies to all property types

3. Minimum Coverage
    a. Primary coverage amount: $1 million per occurrence/$3 million minimum general aggregate limit per location, plus
    b. Minimum Umbrella Liability Insurance (above the primary) is required for 10 or more facilities for an additional $5,000,000.
    c. The minimum required coverage limit shall be satisfied by adding any combination of primary and umbrella/excess per occurrence and aggregate limits so that the sum of both equals the sum of the limits required in a. plus b. above
    d. Use of Blanket Policies must comply with the requirements of this Program Guidance.
4. Commercial General Liability Insurance Maximum Deductibles:
    a. $25,000 deductible/SIR (self-insured retention) for portfolio and/or single asset Mortgage Loans with Properties less than or equal to $100 million in total replacement values, as listed in the Property policy

b. $100,000 deductible/SIR for portfolios and/or single asset Mortgage Loans with Properties greater than or equal to $100 million in total replacement values, as listed in the Property policy.

D. **Professional Liability Insurance – refer to Appendix 14.1**

What's Required	Professional Liability Insurance
When Does it Apply?	All properties.
Amount of Coverage	Minimum of $1 million per occurrence / $3 million aggregate. Determination of coverage must comply with Appendix 14.1.
Maximum Deductible	Refer to Appendix 14.1

E. **Directors' and Officers' Liability Insurance**

What's Required	Directors' and Officers' Liability Insurance
When Does it Apply?	Cooperative Corporations Only.
Amount of Coverage	Minimum $1 million per occurrence.
Maximum Deductible	Same as required for Commercial General Liability insurance.

F. **Commercial Auto Liability Insurance**

What's Required	Commercial Auto Liability Insurance that covers owned, non-owned, hired and leased vehicles (whichever shall apply), including personal injury protection and uninsured motorist liability.
When Does it Apply?	If the borrower owns or hires any vehicle in its name or if individuals use their own vehicles for business purposes, then Commercial Auto Liability Insurance must cover those vehicles. This also applies during the construction period.
Amount of Coverage	$1 million combined single limit. Coverage limit must be reinstated after each loss.

14.7 Additional Insurances

The following sections specify additional insurance coverage required by HUD for each Property.

A. **Business Income Coverage**

What's Required	Business Income Coverage is required for all property insurance coverage including windstorm, flood and earthquake, even if written on a stand-alone basis. See Windstorm Coverage, for additional information regarding the windstorm.
When Does it Apply?	All property types.
Amount of Coverage	• Actual loss sustained or minimum of most recent 12 months net

	income plus ongoing expenses and other ongoing obligations, including the full mortgage payment, MIP and reserve deposits. • 180-Day Extended Period of Indemnity. Provides an additional 180 days of business income or rent loss coverage if, after the damaged Property is ready for occupancy and is occupied, the occupancy level of the Property is lower than it was immediately before the Property was damaged.
Maximum Deductible	Two weeks per occurrence.

B. **Earthquake**

What's Required	Earthquake Insurance
When Does it Apply?	Earthquake Insurance is required for all properties located in Seismic Zones 3 or 4 that meet the Property risk factors listed below: • Properties located in Seismic Zones 3 or 4: o reinforced masonry buildings and pre-cast concrete or tilt-up buildings constructed prior to1994; o reinforced concrete frame or reinforced concrete shear wall buildings constructed prior to 1976; o wood frame buildings on non-braced cripple walls (sometimes referred to as crawl space walls – short wood perimeter walls used to elevate a Property above-ground to allow access to the substructure and utility lines or to level a building constructed on a slope); o wood frame buildings without anchorage to foundation; or, o any building with a weak (soft) story at the first level above grade. • Properties located in Seismic Zone 4 only: o buildings on sites with significant liquefaction potential (e.g., low-lying areas along bodies of water such rivers, lakes, bays, the coast or waterways) unless provided with deep foundations (piles or piers); or, o buildings with tuck-under parking constructed prior to 1988. • PML Study A level I, Seismic Risk Assessment (Probable Maximum Loss [PML] Study) is required for any Mortgage Loan: ▪ greater than $25 million, or ▪ secured by a Property having one or more of the above risk factors. The PML study will be performed by the engineer performing the PNA so long as such engineer is also qualified to perform geological assessments. **<u>Acceptable Level of Seismic Risk</u>**

	The acceptable level of seismic risk is represented by a Probable Maximum Loss (PML), using a 10%/50 year exceedance probability, which does not exceed 20% (a level less than or equal to 20% is acceptable). If the Property has a PML that exceeds 20%, but is less than or equal to 40% (using the 10%/50-year exceedance probability standard), a waiver will be required. **<u>Ineligible Properties</u>** A Mortgage Loan secured by a Property in Seismic Zones 3 or 4, and having one or more of the following risk factors is not eligible for mortgage insurance: ▪ unreinforced masonry buildings; ▪ buildings constructed on hillsides with slope exceeding a 30 degree angle; and ▪ a PML greater than 40%, using the 10%/50-year exceedance probability standard.
Amount of Coverage	• 100% of the full replacement cost of the Property Improvements. Business income coverage for actual loss sustained for a minimum of 12 months net income plus ongoing expenses and other ongoing obligations, including the full mortgage payment, MIP and reserve deposits plus a 180- day extended period of indemnity (as otherwise specified in this Program Guidance). Business Income coverage is required even if written on a stand-alone basis.
Maximum Deductible	10% of the total insured value as listed on the policy, maximum $250,000 per location.

C. **Builder's Risk Insurance**

What's Required	Builder's Risk Insurance (comprehensive form). The Builders Risk Insurance policy or policies shall show the Borrower as the Insured and shall also show as additional insured the general contractor and other contractors, as their interests will appear.
When Does it Apply?	All property types during construction or substantial rehabilitation.
Amount of Coverage	100% of the completed value, on a non-reporting basis.
Maximum Deductible	$25,000 per property.

D. **Workers' Compensation**

What's Required	Statutory Workers' Compensation and Employer's Liability Insurance
When Does it Apply?	Where employees of the Borrower, Management Agent, where applicable and Operator, where applicable are required to be covered by workers' compensation laws of the state where the Property is located.
Amount of Coverage	• Employer's Liability with a limit of $1 million; and,

	• Statutory Limits for compensation.

E. **Fidelity Bond/Crime Insurance**

What's Required	Fidelity Bond, Employee Dishonesty coverage or Crime Insurance. This insurance reimburses the insured for losses resulting from dishonest acts of any employee, officer or board member. The policy must cover: • All principals of the borrower, management entity, if applicable, the operating entity, where applicable and • All persons who participate directly or indirectly in the management and maintenance of the project and its assets, accounts, and records. Coverage shall be through one or more bonds, and one bond may cover more than one project, including projects whose mortgages are not insured or held by HUD. The agent's principals and supervisory and front-line staff will be covered under the same bond.
When Does it Apply?	All properties.
Amount of Coverage	• 2 months of Gross Potential Income of project • If coverage is for more than one project, the minimum is computed using the project with the highest gross potential income.
Maximum Deductible	$25,000 per property.

F. **Sinkhole/Mine Subsidence Insurance**

What's Required	Sinkhole/Mine Subsidence Insurance
When Does it Apply?	All properties in areas prone to these geological phenomena.
Amount of Coverage	100% replacement cost.
Maximum Deductible	$25,000 per property.

G. **Windstorm Coverage**

What's Required	If the "Special Form" property damage insurance excludes any type of wind-related event, a separate windstorm insurance policy must be obtained. Coverage obtained through state insurance plans or other state-managed windstorm and beach erosion insurance pools is acceptable if that is the only windstorm coverage available in an insurance market.
When Does it Apply?	All properties.
Amount of Coverage	100% replacement cost. Business income: Actual loss sustained or minimum most recent 12 months net income plus ongoing expenses and other ongoing obligations, including the full mortgage payment, MIP and reserve deposits. Business Income coverage is required even if written on a

	stand-alone basis.
Maximum Deductible	10% of the total insured value, as listed on the policy, maximum up to $250,000 per occurrence. *Business Income should not be subject to a deductible or waiting period greater than two weeks.

H. **Flood Insurance**

1. The Lender must determine, for every insured mortgage, whether any of the improvements are located in a Special Flood Hazard Area (SFHA). SFHAs are areas designated by the Federal Emergency Management Agency (FEMA) as Zone A or V. An application for mortgage insurance shall not be approved for a property located in a FEMA identified special flood hazard area in which the community has been suspended from or does not participate in the National Flood Insurance Program.

What's Required	Flood
When Does it Apply?	Flood insurance is required for any building fully or partially located in SFHA, Zone A or V. Even if that part of the building within the SFHA is not subject to coverage (e.g., a deck), the entire building is considered to be in the SFHA. If no part of a building is located in an SFHA, then flood insurance is not required, even if the unimproved portions of the Property are in an SFHA.
Amount of Coverage	100% of replacement cost of Improvements located in an SFHA; and Business income coverage for actual loss sustained or a minimum of most recent 12 months net income plus ongoing expenses and other ongoing obligations, including the full mortgage payment, MIP and reserve deposits plus a 180-day extended period of indemnity (as otherwise specified in this Program Guidance) for Improvements located in an SFHA. Business Income coverage is required even if written on a stand-alone basis. -Full replacement cost can be achieved by a standalone policy equal to 100% replacement cost; or by securing an NFIP policy along with an Excess Flood or Difference in Condition ("DIC") insurance to provide the difference up to the full replacement cost of the property, including Business Income and Rental Value coverage. If 100% of the full replacement cost coverage is unavailable (as demonstrated by letters of declination from three unrelated third party insurance companies), Lender may accept the maximum amount of coverage available per building of NFIP coverage. The unavailability of replacement cost compliance

	coverage shall be confirmed annually by Lender and records of this confirmation shall be retained with the Lender's mortgage file. If 100% replacement cost coverage is available but the premium is commercially unreasonable, then, upon approval by HUD, Lender may accept the maximum amount of coverage available per building of NFIP coverage. The commercial unreasonableness of the replacement cost coverage shall be analyzed annually by Lender and appropriate records retained in the Lender's mortgage file. Moreover, acceptance of the NFIP coverage does not negate the requirement for business income coverage. A separate policy must still be obtained to cover the business income exposure associated with a flood, in the amounts set forth above.
Maximum Deductible	5% of the replacement cost of the Mortgaged Property.

a. Flood insurance must be in the form of the standard policy issued by either a member of the National Flood Insurance Program (NFIP) or a private company authorized to participate in the NFIP's "Write Your Own" program (WYO). Conditions may change over time and zones may be remapped, resulting in the reclassification of non-flood areas. The Lender must ensure that flood insurance is obtained if any property improvements are later determined to lie within a remapped SFHA.

b. If conditions warrant, HUD or the Lender will require flood insurance for Property Improvements located outside of an SFHA but within an area designated by FEMA as Zone X, such as a Property that is in an area subject to flooding due to storm water or within close proximity to an SFHA boundary.

2. Flood Insurance Determination: For every Mortgage Loan, the Lender must *determine whether any of the Property Improvements are located in an SFHA and must document each determination on a Standard Flood Hazard Determination form issued by FEMA (FEMA Form 086-0-32). The Lender must obtain flood-zone determinations from a qualified third-party flood-zone determination firm. The* Lender must place a completed copy of the Standard Flood Hazard Determination form in the Lender Servicing File for the Mortgage Loan. HUD expects the Lender to exercise care and sound judgment when it selects and contracts with a third-party flood-zone determination firm.

   Because conditions may change over time, the status of a zone may change. As a result, the Lender must obtain from its flood zone determination firm "life-of-loan" monitoring and coverage, which means that the monitoring company will notify the Lender if and when flood insurance is required for a monitored

Property. The Lender must ensure that the monitoring company it selects agrees to continue monitoring for all of the covered Properties in the event that the Lender sells or otherwise transfers its servicing rights to another Mortgage Loan servicer.

3. The flood insurance policy must be issued by either a member of the National Flood Insurance Program (NFIP) or a private company authorized to participate in the NFIP's "Write Your Own" (WYO) program. For a list of FIP Insurers and FIP WYO insurers, please visit the FEMA website.

Section II
Production

Appendix 14.1
Professional Liability Insurance

Residential care facilities face an increased liability risk because they provide day-to-day resident care. In 2004, HUD adopted professional liability insurance (PLI) standards for healthcare facilities insured under Section 232 in Housing Notices H04-01 and H04-15. This Appendix supersedes all previous guidance on PLI.

I. SECTION 232 PROGRAMS THAT REQUIRE PROFESSIONAL LIABILITY INSURANCE

PLI requirements apply to the following:

A. New applications on behalf of residential care facilities seeking mortgage insurance under:
   1. Section 232 for new construction or substantial rehabilitation of a residential care facility,
   2. Section 223(f) for the purchase or refinance of an existing facility.

B. All residential care facilities currently insured under Section 232 and seeking approval:
   1. to refinance the facility using the Section 223(a) (7) program,
   2. to refinance the facility using the Section 223(f) program,
   3. finance a supplemental loan under Section 241(a),
   4. of a transfer of physical assets (TPA) involving Section 232 residential care facilities.

The PLI requirements of this Appendix may be reduced or modified for existing FHA-insured facilities. See Section V for details.

II. WHO REQUIRES PLI

The legal entity that holds the license from the state permitting it to operate the residential care facility and/or the entity responsible for the day-to-day operation of the facility and hands-on resident care (Operator). The Operator must have PLI coverage in compliance with the guidance in this chapter.

A. An entity is considered to be the Operator if any of the following apply:

1. The entity's name appears on the state issued facility operating license,

2. The entity holds the provider agreements with third party payors (Medicare, Medicaid or private pay),

3. The entity contracts to provide patient services (admissions agreement),

4. The entity holds the state-issued Certificate of Need,

5. A Management Agent that functions as the Operator, as defined above, will be considered an Operator and subject to PLI requirements.

B. If a Management Agent is the entity that functions as the Operator, as defined above, then it will be considered an Operator. However, if the Management Agent is the entity that only provides administrative oversight and performs accounting, financial management, purchasing and other corporate services, and it has no property interest in the license, the license was issued and will be renewed without regard to the Management Agent's participation and another entity is fully responsible for all licensed activity at the facility, then PLI is not required of this entity.

C. If the Operator is a subsidiary or an affiliate of another entity or in a corporate structure where more than one residential care facility is owned and/or operated, then the term Operator shall refer to the parent or controlling entity. The parent or controlling entity must have PLI in compliance with the guidance in this chapter on all entities that it controls, operates or manages even if some of those facilities do not have FHA mortgage insurance.

The term "parent or controlling" entity refers only to business concerns such as corporate or partnership entities. It does not refer to natural persons operating in their individual capacities unless the owning entity is a sole proprietorship.

III. TYPES OF ACCEPTABLE INSURERS

The PLI insurance must be provided through an insurance carrier that has a Financial Strength Rating of "A-" or higher from A.M. Best or Financial Stability Rating of "A" or higher from Demotech.
Acceptable forms of insurance include:

A. Commercial Insurance Policy

The PLI may be provided under a commercial insurance policy. The insurance carrier or provider must have a Financial Strength Rating of "A-" or higher from A.M. Best Company or a Financial Stability Rating of "A" or higher from Demotech (the Financial Rating). The insurance company issuing the PLI policy must be

domiciled or licensed in the United States and must be authorized to provide PLI insurance in the state where the policy is issued as an admitted and/or surplus lines carrier.

B. Self-Insurance

Self-insurance is permissible subject to the guidance provided in Section IV.B. below. For self-insurance, an insurance carrier or provider (also referred to as the "fronting entity") will be required to issue an insurance policy backed by liquid financial assets. The carrier or fronting entity must be domiciled and authorized to provide insurance in the United States. The insurance fronting entity must have an acceptable rating from A.M. Best or Demotech.

C. State Insurance Providers

1. Joint Underwriting Associations (JUA) are insurance providers that are authorized by state legislatures, regulated and financially controlled by state governmental entities. JUA's or state insurance providers must meet the following criteria to be eligible providers of PLI for the purposes of this Appendix:

    a. The JUA and/or the state insurance provider must have been authorized by an act of the state legislature and must be regulated by the state government in the state where the PLI policy is issued.
    b. The insurance provider must have been in continuous operation for four years or longer,
    c. The JUA and/or the state insurance provider must provide audited or state approved financial statements for the past three years.
    d. The JUA and/or the state insurance provider must have capital or surplus that is at least 2.5 times the amount of annual claims, and
    e. ORCF may consider other factors at its sole discretion in order to make a reasonable determination regarding the acceptability of a JUA or a state insurance provider, and may accept ratings by A.M. Best or Demotech as specified in this chapter in lieu of these requirements.

2. Patient Compensation Funds

A Patient Compensation Fund (PCF) is a fund enacted through legislation by some states that provides coverage for judgments or settlements in a medical liability cause of action above a defined amount. States that have these funds have different criteria defining which settlements and judgments are eligible. In assessing the ability of an applicant to meet its PLI requirement, ORCF may accept insurance provided by a PCF as long as the Operator is a participant.

IV. REQUIRED MINIMUM COVERAGE LIMITS, SELF-INSURANCE, AND MISCELLANEOUS PROVISIONS

A. Minimum Coverage Requirements

ORCF requires a level of PLI that is sufficient to meet professional liability claims and obligations. ORCF has established minimum acceptable levels for the deductible, the coverage amount per occurrence, and an aggregate cap for the term of the policy. The per occurrence and aggregate levels shall reflect historical claims amounts and trends.

ORCF may determine that higher per occurrence or aggregate amounts of PLI coverage are necessary based on its review of the claims history and/or pending claims. More stringent coverage may be required if the Operator's claim history is trending negative, or if the proposed insurance does not appear to be adequate to meet anticipated annual or long term claims payment obligations. Other circumstances that might lead to more stringent PLI requirements include the financial condition of the Operator or the results of an actuarial study.

1. The minimum required coverage for all residential care facilities is:
   a. $1,000,000 per occurrence and,
   b. An overall aggregate amount that is adequate to fund outstanding claims with a minimum of $3,000,000 and,
   c. The per-occurrence deductible shall not exceed $25,000.

2. Waiver. If the proposed financing is infeasible due to the cost or availability of PLI, applicants may petition ORCF to amend the minimum coverage requirement. The Operator's claims history combined with evidence that the cost of a compliant policy would create a financial burden to the project.

3. Per Occurrence vs. Claims Made. The PLI policy may be either:
   a. An "occurrence" policy, which provides coverage regardless of when the claim is reported, as long as the occurrence giving rise to the claim occurred during the original policy period; or

   b. A "claims-made" policy, which provides coverage for claims that are brought to the insurer during the policy period or during a designated, extended reporting period beyond the policy expiration date. Since the term of the policy is normally one year, the Operator must also provide extended reporting period insurance coverage ("tail coverage") if the policy renewal does not cover claims from prior years or, in lieu of the tail coverage, the Operator can provide a dedicated cash equivalent escrow fund for the full amount of the expected claims. The tail insurance provides coverage for an extended period that shall be based on the maximum statute of limitations for filing claims of negligence, injuries, wrongful death, and/or improper care for the various States where the facilities are located.

B. Self-Insurance

The fronting insurance provider shall obtain an escrow of liquid assets from the Operator (i.e. cash, cash equivalents, readily marketable securities or a letter-of-credit) that is sufficient to finance current and anticipated claims expenses under the self-insurance policy. The amount of the escrow will be determined from an actuarial study obtained by the Operator.

1. The escrow must be pledged exclusively for the PLI policy, but the self-insurance policy may also have additional pledges of liquid assets for workers compensation, property, auto and general liability insurance.

2. The escrow must be placed directly under the control of the fronting entity. A letter-of-credit may be substituted for liquid assets; however, the letter of credit must be assigned directly to the fronting entity and must be issued by an acceptable financial institution.

3. An acceptable financial institution is one that has assets of not less than $125,000,000 and/or 50 times the amount of the letter of credit (whichever is higher), is organized under the laws of the United States or a State thereof and is regulated and examined (for banking institutions) by the Comptroller of the Currency, the Federal Deposit Insurance Corporation, or the Federal Reserve System and has a long-term bank deposit rating of "A-1" or better by Moody's Investor Services, "A+" by Standard and Poor's or "A+" by Fitch Ratings. If the letter of credit provider is an affiliated non-insurance entity of an insurance company, ORCF may also accept a Long Term Issuer Credit Rating from A.M. Best of "A+" or higher assigned to such entity. (A Long Term Issuer Credit Rating assigned to a non-insurance entity by A.M. Best should not be confused with a Financial Strength Rating issued by A.M. Best, which refers to the capability of an insurance company to meet its financial obligations to policyholders.)

4. ORCF will accept a maximum per-occurrence self-insured retention (SIR) of $100,000. ORCF may require a lower SIR, to an amount not less than $25,000, if it determines that this is necessary after completing its review of the PLI Package (Section VII, below).

C. Lower Minimum Required Coverage in Certain States.

Some states have enacted legislation which limits the amount that can be recovered as the result of a professional liability claim. ORCF may allow reduced PLI coverage for facilities in those states after review on a case-by-case basis, and a waiver will be required.

D. Additional Requirements for Certain Operators and Facilities.

If an applicant utilizes self-insurance, a JUA, and/or is the Operator of 50 or more residential care facilities, ORCF will conduct a comprehensive PLI review. Section VII below lists the materials to be submitted for this review.

V. EXISTING FHA INSURED FACILITIES

A. ORCF will review all applications under Section 232 that seek:

1. To refinance an existing FHA insured residential care facility pursuant to Section 223(a) (7) or Section 223(f),

2. To finance a supplemental loan under section 241(a),

3. Approval of TPA involving Section 232 residential care facilities.

B. If the current PLI does not meet the requirements in this chapter, ORCF will determine if it is adequate to cover anticipated liabilities and claims. If satisfactory, ORCF will accept the existing PLI. However, if the PLI review provides evidence that the current PLI is not adequate to meet anticipated claims, the PLI insurance requirements of this Appendix will apply.

C. Applicants may petition ORCF to reduce the minimum coverage requirement, if the residential care facility is already FHA-insured and is seeking to lower the level of PLI coverage. The FHA lender should submit a request to ORCF, and include the information with the Firm Application. The Operator's claims history must provide justification for the request to lower the minimum coverage amount and the additional cost of the insurance for the project must reflect a financial burden to the project.

VI. NEW CONSTRUCTION / SUBSTANTIAL REHABILITATION

A. If the residential care facility is being financed as a new construction or a substantial rehabilitation, evidence of insurability for professional liability (preferably an insurance quote) should be presented to ORCF prior to initial closing. For Operators of multiple residential care facilities, a PLI policy covering those facilities must be provided to ORCF. A PLI policy acceptable to ORCF must be in place for the Operator prior to the issuance of a certificate of occupancy and commencement of operations of the new or substantially renovated facility.

B. If the Operator or parent does not currently operate a residential care facility, it must present evidence of insurability for professional liability. The evidence must consist of written documentation from an insurance company or an insurance broker specializing in residential care facilities. The documentation must indicate that the Operator is eligible to be insured under a policy that meets ORCF's minimum coverage requirements. It must also include a current estimate of the cost of the PLI

policy. The insurance policy must be in place prior to the issuance of a certificate of occupancy and the commencement of operations of the new or substantially renovated residential care facility, if the facility is not operational at the time of the firm commitment.

C. In the case of new construction or substantial rehabilitation, the estimated cost must be adjusted to reflect the anticipated cost at the estimated date that the coverage will be bound.

VII. MATERIALS REQUIRED TO BE SUBMITTED TO ORCF (the PLI PACKAGE)

The following will be submitted for the PLI review:

A. Information about the PLI insurance coverage:

1. Copy of the insurance ACORD – showing the limits of coverage (both facility and aggregate limits if there is more than one facility) and deductible/SIR and facilities with bed counts included under this coverage;
2. Evidence of insurance company('s) rating. (Printout of Financial Rating.)

B. Current list of all residential care facilities that the Operator operates and the percentage ownership if that ownership exceeds 25%.

C. Financial statements for the most recent three years for the Operator and consolidated financial statements for the parent of the Operator.

D. A six-year loss history of professional liability claims filed or expected to be filed against it for all facilities controlled by the parent Operator. The six-year loss history should be provided in annual summary form (prepared by the insurance company or third-party administrator) and should:

1. Provide a current inventory of all paid or settled claims,

2. Break out the expected cost of claims in a year by year summary in separate line items the amount of the actual and/or anticipated awards including claims expenses, and any funds reserved for estimated claims,

3. Show total actual or estimated claims costs for compensatory damages, medical expenses, punitive damages and legal expenses incurred processing the claim,

4. Total number of insured beds for each of the six years,

5. Identify all potential or expected professional liability claims in excess of $15,000 that have been or may be filed for all periods within the statute of limitations for the State where the claim occurred,

6. Include a brief discussion or chart that provides the timeframe for the statutes of limitations for filing claims of negligence, injuries, wrongful death, and/or improper care based-the law in the states where the parent Operator's facilities are located.

E. State licensing surveys for the last three years for all individual facilities of the Operator if the Operator has less than five facilities. If the Operator has five or more facilities, provide copies of state licensing surveys where there has been a pattern of serious unresolved deficiencies (deficiencies where there is actual harm to residents commonly referred to as "G" or higher level deficiencies) that were not removed within a one month period. Please provide a narrative discussion regarding the topic, the risk and how it will be mitigated.

F. A recent actuarial study for the parent Operator if available, or if the parent Operator utilizes self-insurance, and include audited (if available) financial statements for any captive insurance company.

Note: This information is considered proprietary and is exempt from Freedom of Information Act requests.

G. For a substantial rehabilitation of an existing residential care facility, the mortgagee shall provide evidence that the facility had PLI coverage for a period equal to the State's statute of limitations for filing claims. If during the statute of limitations period there was no insurance coverage or the coverage failed to provide for events that could lead to claims filed in later years, the Operator must provide an estimate of the extent of unfunded insurance liability by occurrence.

H. If the residential care facility has been purchased by a new owner and the new owner and/or Operator has any direct or indirect liability for operations of the residential care facility prior to the date of sale transaction, the Operator must provide an estimate of the extent of unfunded insurance liability by occurrence, if any. If the new owner or Operator has no obligations to pay claims incurred prior to the to the purchase date, the lender should state this in the Lender Narrative.

Note: Prior claims information should be provided regardless of who may have owned or operated the facility prior to seeking FHA mortgage insurance. This information is important because it provides historical information about the previous Operator. It can indicate the quality of care and management capability that has been present in the facility and identify important Operator issues that need to be reviewed during the ORCF underwriting process.

VIII. MORTGAGEE REVIEW OF PLI PACKAGE AND OPINION

The mortgagee shall include as part of its underwriting analysis a recommendation to ORCF concerning the acceptability of the sponsor's PLI and risk management programs. These should include at least the documents Section VII above, the firm application checklist.

IX. ANNUAL REVIEW BY MORTGAGEE

Annually, the mortgagee will review the current PLI status of the Operator, including:

A. An update of the loss history; and

B. A copy of insurance ACORD, PLI policy, certificate or memorandum of insurance or other evidence of the required insurance coverage.

The purpose of this annual review is to confirm that there have not been negative trends in the professional liability incidents, claims or insurance coverage (without HUD's approval) since the time of underwriting. Please refer to Section III, Asset Management, Chapter 3.10.7 for specific details regarding the annual review.

Section II
Production

Chapter 15
Accounts Receivable Financing

15.1 Introduction

It has become customary for Operators of healthcare facilities to use a financial mechanism known as Accounts Receivable ("AR") financing to ensure that there is adequate funding available to meet the daily cash flow needs of their projects. Typically, an Operator provides a bed and medical services to residents and is reimbursed for the services to eligible residents by Medicaid and Medicare sometime after the services are provided. The timing of Medicaid and Medicare reimbursements varies from state to state and can be subject to significant delays. Other patients either pay for such services with their own resources (private-pay) or have long-term care or other commercial insurance.

AR Financing usually takes the form of a working capital loan secured by Medicare, Medicaid, and other governmental healthcare insurance program receivables (collectively "Governmental Receivables"), and private pay and commercial insurance receivables (collectively, "Non-Governmental Receivables"). The loan is provided by a qualified bank or other financial institutions or firms (the "AR Lender") to or for the benefit of one or more healthcare facilities. Without AR Financing in place an Operator may not be able to meet its immediate and short-term financial obligations. With AR Financing, Operators have a financial mechanism that can provide funds to finance ongoing operations until Medicare, Medicaid or other third-party payments are received. AR Lenders have developed sophisticated day-to-day monitoring systems that track the financial activities of an Operator. These systems provide comprehensive daily and weekly financial reports designed to immediately identify unusual financial patterns that adversely impact the financial condition of a healthcare facility. Most AR Lenders have immediate response systems in place to identify, correct, and/or manage financial problems as they begin to develop.

**In November 2008, HUD issued H08-09 Accounts Receivable Financing. The guidance in this chapter supersedes this notice.*

15.2 Applicable Programs

ORCF will evaluate AR Financing loan requests utilizing the guidance provided in this chapter and Chapter 16 (Cash Flow Structures/DACA's and DAISA's) for the programs covered by this handbook.

1. Section 232 for new construction or substantial rehabilitation,
2. Section 232 pursuant to Section 223(f)[1] for purchase or refinance,
3. Section 232 pursuant to Section 223(a)(7) for refinancing,
4. Section 241(a) Supplemental Loans in connection with a 232 loan under one of the categories described above, and
5. Section 223(d) Operating Loss Loans in connection with a 232 loan under one of the categories described above.

HUD approval must be obtained for any AR Loan or any material modification of an existing AR Loan, and the AR Lender must execute an Intercreditor Agreement for AR Financing Projects (Form HUD-92322-ORCF) ("Intercreditor") with the FHA Lender. A proposed cash flow chart must be included with all submissions. See Production, Chapter 16 for guidance on cash flow charts.

A. **Review of Accounts Receivable Financing**. An AR loan request may be submitted at any time during the life of an FHA insured mortgage, including with a request to refinance a loan. If the AR loan is being put in place in conjunction with an FHA-insured loan closing, review of the AR approval request takes place as part of the firm commitment process and loan closing. If the AR loan is being put in place in conjunction with a Change of Operator, review of the AR approval request will be conducted by the Asset Management Account Executive. In all instances, including post-closing requests, the request must be submitted by the FHA Lender, not the Operator or Borrower.

B. **Portfolios**. In all of the above instances, it should be determined if a portfolio review acceptance letter applies and whether the proposed AR financing is consistent with such letter and any flow charts or documents approved in connection therewith. See Production, Chapter 16 and Production, Chapter 17.

C. **Pre-approvals and Intercreditor Insertions**. The parties may propose as part of their AR loan review request that HUD pre-approve certain future modifications or that HUD permit certain additional types of obligations to be secured by an AR Lender first lien on Operator project collateral, which if approved, will be set forth in the Terms Memo attached to the firm and inserted into the Intercreditor. AR Lender and Operator are also required to disclose all proposed cross-defaults, which if approved, are set forth in the Terms Memo and inserted into the Intercreditor. (see below, in Section 15.4).

[1] Negative working capital (accounts payable exceeding accounts receivable) must not be included as existing indebtedness in proposed Section 232 refinance transactions.

D. **Exceptions**. ORCF understands that some borrowers or operators have existing AR loans that were put in place prior to applicable ORCF guidance have not been reviewed by ORCF. If any such Borrower or Operator submits a TPA request, an application to refinance existing debt or any other request that requires OCRF approval, OCRF will review the existing AR loan documents to determine if any of the documents require revision, and/or if additional documents, which incorporate ORCF requirements, have to be executed by the applicable parties. Additionally, if an AR loan was obtained in violation of a Borrower or Operator regulatory agreement, administrative or enforcement action may be taken.

When ORCF receives an application for an (a)(7) refinance where the original application was endorsed prior to various policy directives (e. g. Notices, Mortgagee Letters or Handbooks), HUD requires the project to come into compliance with all current policies. However, there may be justification in certain lease structures where the Borrower is a lessor and Operator (lessee) is a third-party, arms-length Operator for ORCF to waive strict adherence to its current policies:

1. Borrower/Operator, Identity-of-Interest or Related Party Operators must comply with current accounts receivable financing policies when applying for a refinance under 223(a)(7)

2. If feasible at the time of the (a)(7) transaction, third party Operators must comply with current accounts receivable financing policies. Otherwise, the Lender must request a waiver. ORCF may grant the waiver subject to the following conditions:
    a. A special condition will be added to the firm commitment requiring a mortgage debt service reserve (amount to be determined by ORCF) to be in place until the accounts receivable financing can be brought into compliance with current policy;
    b. At lease renegotiation (excluding renewals that do not involve the modification of a Material Term, as defined below) or termination, the accounts receivable financing must be brought into compliance with current policy.
    c. These two provisions will be added to the Borrower and Operator's Regulatory Agreements.

15.3 Accounts Receivable Financing Application Considerations

ORCF reviews requests to consent to AR Financing for existing and new projects that are approved by FHA for mortgage insurance under the Section 232 programs. OCRF's primary consideration in reviewing a request to consent to AR Financing is the impact that the terms and conditions of the financing will have on the financial viability of the healthcare project. A well-structured AR Financing agreement will support the financial viability of a project by providing funding at a cost and with terms and conditions that facilitate, rather than jeopardize, the ability of the Operator to meet its financial obligations. Accordingly, prior to submitting a request for

ORCF to consent to an AR loan, ORCF suggests that the Borrower, Operator, AR Lender, and FHA Lender meet with ORCF to discuss a request for consent to AR Financing.

A. **In General**. The principles set forth in this Section are programmatic considerations applicable to all proposed AR arrangements. However, all arrangements will be evaluated as a whole and variances that do not conflict with HUD Program Obligations may be permitted that do not materially and adversely affect FHA Lender's or HUD's interests in the discretion of ORCF.

B. **Revolving Loan**. As the function of the AR Loan is to address liquidity shortfalls for ongoing operating expenses, ORCF expects that the AR Loan will be a revolving loan; i.e. that the Operator can borrow, repay, and re-borrow without any penalty or premium, provided the outstanding balance stays within the agreed Credit Limit (see below in Section 15.3.C).

C. **Borrowing Base/Maximum Commitment**. ORCF generally expects that the AR Loan will limit the maximum amount that may be outstanding at any time to the lower of:

1. A specific dollar amount (the "Maximum Commitment"), or
2. A borrowing base (the "Credit Limit"). The Credit Limit formulation must be acceptable to ORCF.

AR Loans involving multiple HUD projects are often based on an aggregate borrowing base with each Borrower liable to the AR Lender for the entire amount of the loan. HUD generally permits such arrangements, provided that each Operator has access to the full line of credit. If the AR Loan Documents are structured so that each Operator's access to the line is limited, then the extent of the AR Lender's cross-collateralization may also need to be limited.

D. **Borrowing Base Percentages, Aging and Receivables Mix**. ORCF will accept for review an AR Financing loan with a borrowing base that is consistent with prudent business practices for such loans. Generally, the percentage of state, local and/or federal governmental healthcare insurance program receivables (collectively, the "Governmental Receivables") included in the borrowing base should not exceed 85%, and the Governmental Receivables should not be aged greater than 120 days. Governmental Receivables aged between 120 days and up to 180 days may be accepted by ORCF if: there are extenuating circumstances that cause an excessive delay in the governmental payor's payment of reimbursements, and ORCF determines that the delay in the payment does not jeopardize the financial viability of the project. A request for aging between 120 days and up to 180 days must be supported by an analysis of the historical and projected data on the timing of the reimbursements found acceptable to ORCF.

The proposed borrowing base may also include prudent percentages of Non-Governmental Receivables that do not exceed prudent aging limits; however, the aging, types and percentages included must be acceptable to ORCF. Generally, prudent aging limits on these types of receivables will be shorter than those for Governmental Receivables. The inclusion

of any Medicaid Pending (i.e. receivables related to residents that have not yet been certified as eligible by Medicaid but have submitted their documentation) in the borrowing base must be justified, and must be subject to aging limits. Eligible receivables must not include receivables that are generated outside the ordinary course of business, and must be limited to those generated by the FHA-insured project subject to the A/R line; for example, they cannot include other receivables generated by a non-single asset Operator with respect to projects not approved by HUD for inclusion in the AR loan.

E. **Parties**. The Operators of those FHA-insured projects approved by ORCF for inclusion in the AR Loan may be Borrowers under the AR Loan. The Operators are customarily the lessee entities. Occasionally, there is no lease and the HUD Borrower is also the Operator; in which event the HUD Borrower must sign the Healthcare Regulatory Agreement – Operator (Form HUD-92466A) ("Operator's Regulatory Agreement") and Operator Security Agreement (Form HUD-92323-ORCF), in addition to the Healthcare Regulatory Agreement – Borrower (Form HUD-92466-ORCF) ("Borrower's Regulatory Agreement") and Security Instrument/Mortgage/Deed of Trust (Form HUD-94000-ORCF) ("Security Instrument").

If there is a management agent or service provider involved, a determination must be made as to whether such entity is the licensee or party to the Medicaid/Medicare or other provider agreements, and/or resident contracts. In such event, such party is in effect an Operator in its own right, and must sign and provide all the documents (and meet all the requirements) required of an Operator.

Production, Chapter 16 provides guidance regarding other parties that may be required to execute or join into the deposit account agreements, the FHA Lender security documents, the Healthcare Regulatory Agreement – Master Tenant (Form HUD-92337-ORCF) ("Master Tenant's Regulatory Agreement"), the Borrower's Regulatory Agreement and/or the Operator's Regulatory Agreement. Production, Chapter 16 also provides guidance on Borrower Representatives.

The FHA Lender, the AR Lender, the Borrower and the Operator are parties to the Intercreditor; HUD is not a party. If a Master Lease is involved, the Master Tenant will generally also be a signatory to the Intercreditor. Occasionally, other parties (such as a Borrower Representative) may be required to sign as well.

F. **Use of Proceeds**. AR Loan proceeds are used for working capital purposes related to the operation of the FHA-insured projects. AR loans may include letter of credit sub-limits if disclosed to and approved by ORCF.

AR loan draws based on a facility's receivables are project assets of such facility, regardless of whether they are held in commingled or in Borrower representative accounts. The Intercreditor requires that AR loan proceeds be used only for AR debt service, then the operating expenses of the project (including lease payments), and only then, subject to any restrictions in the AR Loan Documents and all applicable Regulatory Agreements, for distributions. HUD regulations and the Operator's Regulatory Agreement restrict the ability of an Operator to use any funds derived from the operation of the project (which would

include loan draws based on such project's borrowing base) for distributions or non-project purposes in the following instances:

1. Upon receipt of a Notice of Violation under the Operator's Regulatory Agreement;

2. If a quarterly/year to date financial statement demonstrates negative Healthcare Facility Working Capital, as defined by HUD, or if the Operator fails to timely submit such statement, until such time as a current quarterly, year-to date financial demonstrates positive Healthcare Facility Working Capital or until otherwise authorized by HUD.

In the above instances, loan draws based on a project's receivables (as well as any other funds derived from or in connection with the operation of the Project) cannot be used for any purpose other than the Operator making payments on its lease (or other Borrower-Operator agreements), making payments under the HUD Loan Documents (including any cross-guaranty assigned to FHA Lender under a Master Lease structure) and under any approved AR Loan, and making payments for goods and services of the project, provided such payments for goods and services satisfy the limitations in the Operator's Regulatory Agreement.

If the HUD Borrower is the Operator, the Borrower's Regulatory Agreement provides that distributions or other payments other than project expenses cannot be made from borrowed funds except to the extent permitted by the Operator's Regulatory Agreement and other HUD Program Obligations.

Particularly in instances where AR loan draws are being made on an aggregate basis, the Operators included in such line, and any Borrower Representative approved by HUD that may be receiving such aggregate draws for further distribution, must ensure that AR loan proceeds are allocated among the projects subject to the AR line in a manner consistent with the foregoing restrictions.

G. **Single AR Loan.** HUD permits only a single AR Loan for a project. However, as provided in the Operator Security Agreement, HUD will deem a syndicated or participated loan as a single AR Loan provided that HUD is provided satisfactory assurances that the lead/administrative agent has authority to bind all such Lenders to the Intercreditor, and will be the sole party entitled to enforce the Intercreditor and the rights in project collateral.

H. **Projects included in the AR Loan**. Only FHA-insured projects that HUD approves for inclusion in the AR Loan may be included as Borrowers in the AR Loan. No additional projects or Borrowers can be added without prior HUD approval. AR Loans range from single stand-alone loans including only one FHA project to large syndicated AR loans including many HUD projects and multiple FHA Lenders. If a portfolio review is required or has already occurred, the portfolio approval letter (and any cash flow charts or documents approved in connection therewith) must always be reviewed.

While only FHA-insured projects approved by ORCF may be included as Borrowers on the AR line, the AR Lender may also secure the AR Loan with non-project collateral or non-HUD projects and guarantees, provided that, the costs of administering or enforcing such non-HUD project collateral documents cannot be charged to AR loan or Borrower(s) on the HUD projects (see below, in Section 15.4.D).

I. **Lien Priority and Intercreditor**. ORCF requires that the FHA-insured loan be secured by a first lien and security interest on the project, and requires the Operator to execute a security agreement and assignment of rents in favor of the FHA Lender which covers all of the Operator's property related to project, including but not limited to all of the Operator's Governmental and Non-Governmental account receivables arising from or related to the FHA-insured project or projects. However, ORCF will allow AR Lender to take a first priority interest in the project's accounts, including Governmental and Non-Government account receivables, as set forth in the Intercreditor, provided that the AR Lender executes an Intercreditor.

Under the Intercreditor, the FHA Lender subordinates its security interest in the Operator's account receivables related to the projects, to the security interests of the AR Lender. Those items of Operator project-related collateral upon which the AR Lender is permitted to have a first lien are known as the AR Lender Priority Collateral.

ORCF may also permit the AR Lender to secure its loan with a subordinate security interest on other assets of the Operator related to the project provided that the AR Lender agrees not to exercise its remedies as to non-AR Lender Priority Collateral of the project. AR Lenders must not secure AR loans with liens on the project real estate or fixtures or on any rent account dedicated solely to lease payments or on the Operator's interest under the lease.

The parties to the Intercreditor are required to set forth all disclosures in the Intercreditor Agreement. Submitting the AR loan documents to HUD does not constitute a disclosure to and approval by HUD.

J. **Cross-Collateralization.** Provided that each Borrower has access to the AR Loan, and subject to the Intercreditor, HUD permits the AR Lender to cross-collateralize its HUD-approved AR Loan with Operator collateral related to all the FHA-insured projects approved by HUD for inclusion in the AR line. The AR Lender cannot use the accounts receivable or any other collateral related to the included FHA-insured projects to secure or pay loans to non-FHA projects/Operators, or to secure or pay debts of FHA-insured projects not approved for inclusion in the AR line.

An AR Loan that involves both FHA-insured facilities and non-FHA Insured facilities is not acceptable. It must be restructured to HUD's satisfaction so as to separate the non-HUD projects/parties and the HUD projects/parties into separate loans. This is often encountered:

1. Where an Operator is not a single asset entity and it operates both FHA-insured and non-FHA Insured projects, or

2. Where an Operator's control group operates both FHA and non-FHA Insured projects.

The non-HUD AR line/projects are permitted to also secure the HUD-approved AR Loan; but the FHA-insured projects cannot secure the non-FHA Insured projects obligations. HUD permits, though does not require or encourage, the AR Lender to cross-default the AR Loan for the FHA-insured projects to the occurrence of an Event of Default on the non-FHA Insured line. Any proposed cross-defaults must be disclosed to and approved by ORCF with approved cross-defaults being set forth in the Intercreditor. These include any proposal to cross-default the AR Loan for the FHA-insured projects to Events of Default on the non-HUD line, as well as any other proposed cross-defaults. Unapproved cross-defaults will not be permitted.

K. **AR Loan Obligations Secured by Project Collateral**. AR Loan Documents frequently contain expansive definitions of the obligations secured by the collateral. Notwithstanding any such definition, the Intercreditor limits the types of obligations that may be secured by project collateral to: the Revolving AR Loan up to the Maximum Commitment Amount approved by HUD and other obligations directly related to the benefit of the Facility, with some disallowable obligations explicitly excluded. The Maximum Commitment Amount is inserted into the Intercreditor. The Intercreditor Agreement limits what obligations the project collateral secures. Non-qualifying obligations may be unsecured and/or secured by non-project collateral or guarantees.

HUD recognizes that there may be instances where other obligations are of a nature that may be appropriate to secure with project collateral. Accordingly, the definition of AR Loan Obligations in the Intercreditor permits additional specific obligations to be added that are not inconsistent with HUD Program Obligations if approved by ORCF. The parties should submit such a request and provide justification for it at the time the request for approval of the AR Loan is made. Such request must specify whether the additional obligation will be constrained by the Borrowing Base. If approved by ORCF, and subject to any conditions to such approval, such specific additional obligations will be inserted into the Intercreditor in the space provided for such a purpose.

If the AR Lender is not required to use the new form of Intercreditor under applicable guidance or waivers, then the definition of the Obligations secured in the AR Loan Documents must be appropriately limited.

L. **Cash Flow Structures.** The proposed cash flow structure must be acceptable to HUD (including any commingled account features, which accounts will be subject to deposit agreements, etc.). The two primary types of AR Loan structures, together with guidance on acceptable structures and deposit account agreements, are set forth in Production, Chapter 16.

15.4 Document Requirements and Reviews

Set forth below is a list of the key documents that ORCF reviews when considering a request for consent to AR Financing. Checklists or punch lists may from time to time be posted on the Section 232 Program website. The HUD closing attorney must also review the proposed AR Loan Documents and they must be acceptable. Certain documents are required HUD forms, which must be used where applicable. Such HUD forms can be found on HUDCLIPS (see Appendix 15.1). Certain samples of non-mandatory forms may be posted from time to time on the Lean closing documents website.

A. **Lender Narrative, Section 232/223(f) Refinance (Form HUD-9002-ORCF), Addendum to Underwriting Narrative—Accounts Receivable (AR) Financing, Section 232/223(a)(7), 223(d), 241(a) (HUD-9001i-ORCF).** If the AR financing is proposed as part of an FHA-insured Loan Closing, or as a post-closing item, the appropriate HUD form of Lender Narrative with AR Loan Addendum must be submitted.

B. **Requests for Pre-Approval of Certain AR Loan Modifications and of Proposed Cross-Defaults**. Both the Operator and the AR Lender must agree not to alter the AR Loan terms in certain material ways without the FHA Lender's and/or HUD's consent. Although the Operator's Regulatory Agreement and Intercreditor set forth the specific material terms requiring consent prior to modification, and specific allowable modifications that do not need HUD and/or FHA Lender consent, as a general matter, HUD considers modifications to the AR Lender Loan Documents to be material if such modification:

1. Adds or releases guarantors to the AR Lender Loan,
2. Adds an interest reserve to the AR Lender Loan,
3. Amends the interest rate payable on the outstanding principal balance of the AR Lender Loan (other than, and in addition to, increases in the interest rate pursuant to variable interest rate provisions thereof),
4. Increases or decreases the previously HUD-approved principal amount of the AR Lender Loan,
5. Grants any non-HUD-approved loan term extension,
6. Amends or expands the type of obligations secured by the AR Lender Loan, and/or
7. Any term or condition that may be deemed material at the sole discretion of HUD,
8. Increases the Maximum Commitment Amount, or
9. Alters the borrowing base formula.

HUD recognizes that, due to the customary short term nature of AR Loans, the parties may desire flexibility to extend on the same terms and conditions (or with solely a rate change within defined parameters) without having to come back to HUD for approval. ORCF will consider pre-approving AR Loan extensions up to a pre-determined date on the same terms and conditions and/or solely with interest rate changes subject to certain parameters that do not involve a Material Term.

If such flexibility is desired, the initial AR Loan request must include a proposal that outlines the parameters of any proposed loan extension and/or interest rate change. The proposal must include a justification for the request and a financial analysis that demonstrates the effect of the loan extension and/or rate change on the financial viability of the project. ORCF will review the request and the approval of said request will be in the sole discretion of ORCF. If the request for the loan extension and/or rate change is approved, it is inserted into the Intercreditor, and the Operator will be required to: notify ORCF when any such pre-approved extensions and/or rate changes occur; timely provide OCRF with complete copies of the revised AR Loan Documents; and provide a certification that only changes pre-approved by ORCF were made to the AR Loan Documents. Proposed cross-defaults must be disclosed and if approved by ORCF, will be inserted into the Intercreditor. Please see 15.3.J above.

C. **The AR Loan Documents**. The AR Financing Loan Agreement between the Operator(s) and the AR Lender, and all material documents evidencing or securing such AR Loan, that establish the terms and conditions and fees associated with the AR Financing loan, must be submitted.

D. **AR Loan Guarantees and Equity Pledges**. The AR Lender's first priority lien in AR Lender Priority collateral may not secure term loan facilities, equipment loan facilities or any indebtedness, liability or obligations arising under a guarantee, except for guaranteed obligations to the extent the obligations guaranteed consist solely of approved AR Loan Obligations. The guarantors must waive any subrogation, contribution, reimbursement or similar rights until the FHA-insured loan has been paid in full; and the guaranties must be otherwise acceptable to ORCF.

   Any guarantee or equity pledge by a principal of an FHA-insured project, as determined under applicable HUD guidance, must not include provisions inconsistent with HUD Program Obligations, and must likewise require the prior written approval of HUD prior to any transfer of such ownership interests or the exercise of control (such as through the exercise of voting rights) and previous participation clearance.

   The HUD Borrower entity cannot pledge collateral to secure an AR loan to the Borrower-Operator(s).

E. **Organizational Narrative and Chart**. A narrative that describes the legal structure of the Borrower entity and the operating entity and discloses all tiers of ownership. If the Borrower or Operator has multiple tiers of ownership, the narrative shall include an organization chart identifying all parties and their relationship to one another.

   If the parties to the AR Financing loan have closely related interests, there may be a prohibited Identity of Interest (IOI). Upon review, if ORCF determines that the AR Financing loan arrangement benefits closely related interests at the expense of the financial viability of the project, a Conflict of Interest will in fact exist (see Introduction, Chapter 1.6.D). If ORCF determines that there is in fact a conflict of interest, the Operator and all affected parties will be asked to submit a proposal of how the conflict will be mitigated. In consultation with HUD OGC, ORCF reserves the right to determine if the proposed

mitigation plan is acceptable. Therefore, it is important that all relationships among the parties to the AR Financing loan submission be identified, including, but not limited to, the following parties:

1. All principals of the Borrower,
2. All principals of the Operator,
3. FHA Lender,
4. All parties to the AR Financing loan,
5. Depository banks,
6. General contractor, if applicable,
7. Management agent, if applicable,
8. Consultants, if applicable, and
9. If the law firms rendering the opinions have an identity of interest with any of the above, and/or if any of the attorneys therein are guarantors of, or otherwise involved with, the AR loan.

F. **Flow of Funds Chart**. An accounts receivable cash flow of funds chart (see Production, Chapter 16 for guidance and samples) that describes the collection and flow of funds from the Operator's initial deposit of its receivables through disbursement and the Operator's uses of the AR Financing loan proceeds. Once the cash flow chart is approved by HUD and FHA Lender, it is attached as Exhibit C-1 to the Operator Security Agreement.

G. **Healthcare Regulatory Agreement – Operator**. Document that outlines the requirement for professional liability insurance, the submission of AR Financing, financial reports and compliance with HUD Program Obligations.

H. **UCC Termination Statements**. In the event an existing AR Lender (or any existing non-compliant line) is being replaced or restructured, the forms of releases, UCC terminations statements or similar documents acceptable to the HUD closing attorney must be submitted in advance of closing, and the plan for addressing such termination must be acceptable to ORCF and the HUD closing attorney.

I. **Intercreditor Agreement**. Document that sets forth the respective priorities and agreements of the FHA Lender and the AR Lender with respect to the Operator collateral.

J. **Deposit Account Instructions and Service Agreement (DAISA-Governmental Receivables)**. Agreement on each deposit account identified in the approved cash flow chart into which governmental receivables will be initially deposited. See Production, Chapter 16 for guidance and the Section 232 Program website for a sample format.

K. **Deposit Account Control Agreement(s) (DACA-Non-Governmental Receivables)**. Agreement for each deposit account identified in the approved flow chart for which a DACA is required, which also may be referred to as a Blocked Account Agreement. See Production, Chapter 16 for guidance and the Section 232 Program website for a sample format.

L. **Subordination Agreement/SNDA (Form HUD-92333-ORCF)/ Subordination, Non-Disturbance and Attornment Agreement of Operating Lease (SNDA) (Form HUD-91110-ORCF)**. Agreement which provides for the subordination of the Master Lease or Operator's Lease (the "Lease") to the FHA-insured mortgage and, if a SNDA is approved, provides for non-disturbance of a third party Operator under certain conditions. The SNDA provides protection to the Operator only if the Operator is not in default under the terms and conditions of the Lease.

M. **Operator Legal Opinion**. Operator's counsel provides this to the Operator using the Guide for Opinion of Operator's Counsel and Certification (Form HUD-92325-ORCF). It provides that counsel has reviewed executed copies of the Intercreditor, AR Loan Documents and affiliated credit documents.

N. **Operator Security Agreement.** (Form HUD-92323-ORCF). Paragraph 20 of this document is entitled, "Provisions Regarding Accounts Receivable Loan."

15.5 Important Safeguards and Conditions

In addition to looking for documents such as those listed above, ORCF's consent to a typical AR Financing loan is also based on evidence that important safeguards and conditions are established and agreed upon by the parties. The particular terms that should be included depend on an evaluation of the proposed transaction as a whole; however, set forth below are some of the important safeguards and conditions that should be considered.

A. Whether funds advanced under the AR Financing loan are used as provided in the ORCF-approved Intercreditor and applicable ORCF Program Obligations.

B. Whether cross-collateralization of AR Financing is permitted only for those healthcare projects subject to FHA mortgages that are identified in the request for ORCF's consent to the AR Financing loan.

C. Whether any cross-defaults (but not cross-collateralization) are consistent with ORCF policy and are acceptable risks for the project. The AR Financing request submission must identify the cross-defaults that the AR Lender is seeking.

D. The FHA Lender and AR Lender have entered into an Intercreditor or in those instances where an alternate format is permissible, an agreement between creditors that contains terms and conditions acceptable to HUD and materially consistent with the programmatic considerations.

E. Whether the AR Lender has sufficient experience (generally, at least three years) in providing AR Financing and the necessary experience and financial controls in place to monitor the financial operations of the Operator.

Section II
Production

Appendix 15.1
Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care

Form Number	Form Name
HUD-9001i-ORCF	Lender Narrative 223a7.223d.232i –Addendum to Underwriting Narrative, Accounts Receviable (AR) Financing, Section 232/223(a)(7), 223(d), 241(a)
HUD-9002-ORCF	Lender Narrative 223f, Section 232/223(f) Refinance
HUD-91110-ORCF	Subordination, Non-Disturbance and Attornment Agreement of Operating Lease (SNDA)
HUD-92322-ORCF	Intercreditor Agreement (for AR Financed Projects)
HUD-92323-ORCF	Operator Security Agreement
HUD-92325-ORCF	Guide for Opinion of Operator's Counsel and Certification
HUD-92337-ORCF	Healthcare Regulatory Agreement – Master Tenant
HUD-92420-ORCF	Subordination Agreement – Financing
HUD-92466-ORCF	Healthcare Regulatory Agreement – Borrower
HUD-92466A-ORCF	Healthcare Regulatory Agreement – Operator
HUD-94000-ORCF	Security Instrument/Mortgage/Deed of Trust
Notice H 08-09	Accounts Receivable ("AR") Financing
N/A	Sample Format for Deposit Account Control Agreement (DACA)
N/A	Sample Format for Deposit Account Instructions and Service Agreement (DAISA)

Section II
Production

Chapter 16

Cash Flow Structures, Deposit Account Control Agreements (DACAs), and Deposit Account Instruction Service Agreements (DAISAs)

16.1 Introduction

This chapter sets forth general principles to guide HUD staff review of proposed cash flow structures, Deposit Account Control Agreements (DACAs), Deposit Account Instructions and Service Agreements (DAISAs) and lease cost/debt service payment methods. It is the requesting parties' responsibility to establish structures and submit documents that comply with applicable ORCF Section 232 Program rules and that are acceptable to HUD. Operators of healthcare facilities typically generate accounts receivable that arise from governmental healthcare insurance programs (e.g., Medicaid, Medicare, Veterans' Administration Programs, or other governmental entities) ("Governmental Receivables") as well as from commercial insurers, private payors, or miscellaneous revenue ("Non-Governmental Receivables").

A. **Governmental Receivables**. Healthcare insurance programs typically require that Government Receivables be paid directly to the healthcare provider and/or electronically deposited into a deposit account subject to the provider's control (as opposed to the Lender's control). These programs typically also limit the ability to directly assign such receivables. HUD expects that Governmental Receivables will be initially deposited into a separate account that will be subject to the control of the provider and governed by a Deposit Account Instructions and Services Agreement (DAISA).

B. **Non-Governmental Receivables**. HUD expects that Non-Governmental Receivables will be initially deposited into an account that is subject to a Deposit Account Control Agreement (DACA) (sometimes referred to as a "Blocked Account Agreement"). HUD also expects that the DAISA will provide that funds from the DAISA account will be periodically (i.e. daily unless otherwise approved by HUD) swept from the DAISA account into the DACA account.

C. **Cash Flow Structures**. Depending on the structure and nature of a particular transaction, the cash flow chart typically includes the placement and number of DAISA and/or DACA accounts, the type of DACA used, and the manner in which lease costs/HUD mortgage loan debt service are made. Occasionally state law or a particular healthcare program may affect

how a particular transaction can be structured. Regardless of the cash flow structure, the deposit accounts must comply with any applicable HUD Program Obligations, including any requirements that such accounts be federally insured (or if balances exceed such insurance limits, be held at an institution subject to any ORCF Section 232 Program regulatory exceptions). This may be of particular concern where commingled accounts, with large daily balances, are proposed (see below, in Section 16.4.G). Deposit accounts must not be held outside the United States, and must be denominated in U.S. currency.

[NOTE: Submission and approval of the cash flow chart and the use of at least one DACA (and DAISA, if there are governmental receivables) is required regardless of whether AR financing is proposed.]

D. **Lockboxes**. A lockbox is a mechanism that allows a financial institution to collect and process account receivables by having an operating entity's payments sent directly to a location accessible by the financial institution. Lockboxes are often used when payments to multiple operating entities are made to the same account.

16.2 Submission and Review

ORCF will evaluate cash flow structures, DACAs and DAISAs pursuant to the guidance provided in this chapter for the following programs:

A. Section 232 for new construction or substantial rehabilitation,
B. Section 232 pursuant to Section 232/223(f)[1] for purchase or refinance,
C. Section 232 pursuant to Section 232/223(a)(7) or Section 232 pursuant to 223(f) pursuant to 223(a)(7) for refinancing,
D. Section 241(a) for supplemental loans in connection with a 232 loan under one of the categories described above, and
E. Section 223(d) operating loss loans in connection with a 232 loan under one of the categories described.

Review of cash flow structures, DACAs and DAISAs may take place at various times, such as during the firm application process, post-closing or at a later point in time during the life of the FHA-insured loan.

F. **During the Firm Application Process**:

1. **Section 232/223(a)(7) and Section 232/223(f) –** HUD expects review to take place as part of the review of the application and document submission for closing.

2. **Section 232 New Construction** – HUD will generally not require DACAs or

[1] Negative working capital (accounts payable exceeding accounts receivable) must not be included as existing indebtedness in proposed Section 232 refinance transactions.

DAISAs to be put in place until the project reaches 70% completion. The application and initial closing submission should still include the cash flow chart and, when available, any AR Loan Documents. DACAs and DAISAs must be in place, in any event, by the earlier of: i) the date of final closing, or ii) the closing of any AR Loan.

3. **Section 232 Substantial Rehabilitation** – HUD generally requires the submission of cash flow charts, DACAs and DAISAs as part of the application and document submission for initial closing.

4. **Section 241(a) Supplemental Loans and 223(d)** - Operating Loss Loans in connection with 232 loans in any of the above categories– HUD generally requires the submission of cash flow charts, DACAs and DAISAs as part of the application and document submission for initial closing.

G. **Post-closing**. See Asset Management Chapter 10 for guidance, except for the following:

1. **Transfers of Physical Assets or change in Operator**. Reviews are required in connection with a transfer of physical assets (TPA) or change in Operator. The TPA occurring in conjunction with an FHA-insured loan closing should be directed to the HUD Underwriter assigned to the project.

2. **After a Cut-Off Time has occurred involving AR Financing.** Once a Cut-Off Time occurs, FHA Lender can require the establishment of separate deposit accounts into which payments with respect to Accounts arising after the Cut-Off Time are to be deposited consistent with the terms of the Intercreditor Agreement. The Lender shall diligently exercise its rights under the applicable contractual documents so as to best protect the FHA-insured collateral.

H. **Portfolios.** In all the above instances, it should be determined if a portfolio acceptance letter applies and whether an overall cash flow chart was approved during portfolio review, so that it can be determined:

1. If the proposed structure is consistent therewith, and
2. If a DACA and/or DAISA form has been previously approved in conjunction with the portfolio approval.

If a project involves accounts receivable financing and is part of a portfolio that requires a portfolio review, review of the proposed cash flow structure will generally take place at the time of the portfolio review and a cash flow chart should be submitted at that time. Review of the associated documents, including DACAs, DAISAs, Intercreditor Agreement (for AR

Financed Projects), etc. may take place when the projects are assigned to an ORCF Underwriter.

I. In all of the above instances, if an existing AR Lender is being replaced, the parties must make arrangements acceptable to HUD for termination of any existing DAISAs or DACAs in favor of such AR Lender.

J. **Exceptions**. ORCF understands that in the case of Section 232/223(a)(7) applications, there may be justification for ORCF to waive strict adherence to its current policies with regard to executing DACAs.

1. Waivers may be considered for a DACA on a Section 232/223(a)(7) application if the subject facility seeking refinance pursuant to 223(a)(7) is operated by a non-IOI Operator and was finally endorsed prior to the issuance of HUD Housing Notice 2008-09.

2. FHA Lenders, at the time of the Section 232/223(a)(7) transaction, must obtain a DACA on the Operator's receivable bank account. Otherwise, the Lender must request a waiver. ORCF may grant the waiver subject to the following conditions (these provisions will be added to the Healthcare Regulatory Agreement – Borrower (Form HUD-92466-ORCF) (Borrower's Regulatory Agreement) and Healthcare Regulatory Agreement – Operator (Form HUD-92466A-ORCF)):
    a. A special condition will be added to the firm commitment requiring a mortgage debt service reserve (amount to be determined by ORCF) to be in place until a DACA can be placed on the Operator's receivable bank account,
    b. At lease renegotiation (excluding renewals that only involve an extension of the term) or termination, a DACA will be required of the Operator,
    c. If accounts receivable financing is utilized in the future, a DACA will be required on the Operator's receivable bank account.

16.3 Cash Flow Charts

HUD recognizes that healthcare facility Operators, particularly when master leases, accounts receivable financing, and portfolios are involved, employ a variety of cash management systems and cash flow structures. On all Section 232 transactions, the Operator must submit to HUD a cash flow chart that depicts the flow of funds arising from operation of the project, from receipt through payment of project/lease costs and FHA-insured loan debt service. Once the cash flow chart is approved by HUD and the FHA Lender, it is attached to the Operator Security

Agreement (Form HUD-92323-ORCF) as an exhibit. (Borrowers that are also Operators are required to sign the Operator Security Agreement.)

The Appendices to this Chapter include sample cash flow charts showing the completion of Section 232 project cash flow charts. HUD expects a cash flow chart submitted pursuant to Section 232 to address and depict the following:

A. All of the accounts through which project funds flow, or which are related to the project, (including investment accounts, if any) must be shown. The account into which Government Receivables are initially deposited and the account into which Non-Government Receivables are initially deposited must be identified.

B. The depository bank name, account number and all parties named on each account must be depicted. If anyone other than the Operator is named on the account, the parties must explain who such person is and its relationship to the Operator. If the DAISA account is not in the name of the Operator, the parties must further demonstrate that such arrangement is permitted by the applicable governmental healthcare programs.

C. Which accounts will be subject to DAISAs or DACAs, the parties to each, and the nature of each DACA (immediate control versus future notification) must be depicted (see below, in Section 16.6 for an explanation of the distinction between these two types).

D. If AR financing is involved, the flow of AR loan disbursements and repayments must be shown. The cash flow chart must also show whether or not funds will go through any AR Lender account (e.g. for daily pay-downs) and the account into which AR loan draws (and any remittances of excess funds not necessary for pay-down) will be deposited.

E. How lease costs/FHA loan debt service will be paid must be addressed and any tenant or master rent accounts that are proposed should be depicted. A “tenant rent account” is an account established solely for the purpose of funding lease costs, through AR loan draws or otherwise.

F. If there is AR financing involving multiple projects, the cash flow chart must depict the above as to all projects within the AR line.

G. If a master lease is involved, the chart must depict the Master Tenant’s position in the cash flow process (including any Master Tenant accounts and any deposit account agreements proposed to govern such accounts). Alternatively, the cash flow chart must demonstrate and the Intercreditor Agreement must address in a manner acceptable to HUD how the rent will be paid, and the Borrower(s) and Master Tenant must agree to the arrangement as evidenced by their signature on the ICA. .

16.4 Cash Flow Structures

A. **Definitions**. In cash flow structures, there are two categories of deposit accounts discussed: "upstream" accounts and "downstream" accounts.

1. An "**upstream**" account is any account through which funds flow prior to reaching a particular account.

2. A "**downstream**" account is any account through which funds flow after leaving a particular account.

B. **General provisions**. In many instances, HUD requires only a single DAISA account and a single DACA account, provided that such DACA account represents the account into which all of the non-Government Receivables are initially deposited and into which the DAISA funds are swept.

1. Typically, accounts which are "downstream" of an account subject to a DACA in favor of FHA Lender do not require a DACA in favor of the FHA Lender. In other words, if the cash flow chart shows that *all of the funds* being deposited into an account have already passed through a DACA account, then a separate DACA on such other account(s) is usually not required. There may be exceptions to this depending on the nature of the cash flow structure.
   For example, a DACA is not required on "downstream" payroll accounts that are funded solely with funds that have first gone through an account subject to a DACA to which FHA Lender is a secured party.

2. A DACA would not be required on accounts into which funds that belong solely to residents, as opposed to the Healthcare Facility/Operator, are deposited (provided that any portion of any resident funds that are deposited into such accounts and to which the facility or Operator becomes entitled shall be promptly deposited into a DACA account to which FHA Lender is a party at the earliest point permitted by applicable law and the facility's contracts with residents).

C. **Exceptions**. HUD may determine that a DACA is required on additional accounts:

1. For underwriting reasons,
2. If a Tenant Rent Account is used,
3. For a Master Tenant account (the account into which the lease payments from the individual facility Operators are made),
4. On an operating account, if a DACA upstream of the AR Lender account is used; such an upstream DACA typically calls for a daily sweep of funds into AR Lender's account. Such an upstream DACA may have an alternative instruction as to where to sweep the funds at such time as AR Lender no longer is entitled to exercise control of the account under the Intercreditor Agreement (usually to the operating account). Further, due to the daily sweep of such upstream account, the bulk of funds will generally be in the downstream operating account;

5. On a Borrower Representative Account (described below),
6. If the AR Lender is also the depository, additional DACA's may be required to evidence such bank's agreement that it will waive or limit any rights of set-off, recoupment, banker's lien or contractual security interest in such other accounts (with the exceptions set forth below, in Section 16.6); and
7. In such other instances that may be appropriate given the structure of the transaction.

D. **Types of Cash Flow Structures**:

1. If the project is a single "stand-alone" project, involving just one FHA mortgage loan and one Operator, the cash flow chart will typically be as set forth on Appendix 16.1.

2. There are different types of AR financing, and the flow chart must make clear which type is contemplated. In one type, the AR loan borrower (typically, the Operator) simply draws on the AR loan when needed and pays it down as necessary to stay within its loan limits. The funds do not flow through an account held in the name of the AR Lender. AR Lender might also be the depository bank, but the accounts are held in the Operator's name. AR Lender, in its capacity as secured party, can access such funds only on a default (through enforcement of its DACA or set-off rights). These type arrangements are often seen where an Operator does not need a steady stream of loan availability in order to maintain its liquidity but rather is using the line as needed to protect against more minor cash flow shortfalls. A sample flow chart showing this can be found at Appendix 16.1.

3. In another type of AR Loan, the project's revenues flow through an AR Lender account, where they are applied by AR Lender to the outstanding balance of the AR loan on an ongoing basis. In this type of arrangement, it is usually contemplated that the Operator will be routinely making draws and that AR loan draws will be funding most, if not all, operating expenses. A sample flow chart showing this can be found at Appendix 16.2.

E. **Cash Flow Structures & Governmental Receivables**. Regardless of type, Governmental Receivables must flow through a DAISA account before going through the AR Lender's account.

1. For the cash flow structure type outlined above, in Section 16.4.D.3, funds may also go through a project specific, or commingled "upstream" DACA account prior to reaching the AR Lender account. See Appendix 16.3 for a specific example of this scenario.

2. An upstream DACA account must not be the project operating account. Rather, the project operating account may be an account that is downstream of the AR Lender. Thus, if such an upstream DACA is used, it may call for a periodic (often daily) sweep of funds into the AR Lender account until such time as AR Lender is no longer entitled to give a Control Notice (i.e. until such time as the right to give the Control Notice shifts to FHA Lender). The sweep of funds to AR Lender must not be

permitted once FHA Lender is entitled to give the Control Notice. The parties must plan in advance how funds will flow into the downstream operating account once the AR Lender is no longer in the picture.

3. In any instance where there is no upstream DACA, there must be a downstream DACA at the first account which funds go through after leaving the AR Lender's account.

4. If the AR Lender requires a DACA on a downstream account, the FHA Lender should generally also be a party. See Appendix 16.2 for a specific example of this scenario.

F. In the rare case where a project receives no Governmental Receivables (i.e. 100% private pay), the cash flow structure will only have a DACA.

G. **Commingled Accounts**: If it is proposed that funds from more than one project will flow into an account (a "commingled account," as shown in Appendix 16.4) the parties must demonstrate that:

1. Systems must be in place which will permit the identification of funds belonging to each project at all times. Under the Operator's Regulatory Agreement if HUD determines that deposits cannot be reliably and readily traced by facility, HUD may direct Operator to deposit such funds in a segregated account.

2. Operator compliance with the financial reporting required under 24 CFR 5.801 will also necessitate that the Operator(s) maintain accounts in a manner that will allow HUD and the FHA Lender to discern the funds attributable to each facility.

3. Generally, HUD does not permit Governmental Receivables from different projects to be initially deposited into a commingled account. Any proposal to commingle Governmental Receivables from different projects, in addition to meeting the above standards, must demonstrate that such commingling is permitted or required by the applicable healthcare program payor rules.

4. The use of commingled accounts is subject to HUD's written approval and must be identified on the cash flow chart, which must show all the facilities whose funds are proposed to flow through such account. An approved commingled account would be subject to the provisions of a DACA in accordance with Section 16.6. The Operators involved must be affiliated. Generally, accounts that commingle FHA-insured facilities with non-FHA insured facilities will not be permitted. Generally, the use of commingled accounts in connection with a master lease structure may be acceptable. The Operator Security Agreement and A/R Financing Certification (Form HUD-90020-ORCF) require that the account into which Governmental Receivables are

initially deposited be separate from the account into which Non-Governmental Receivables are initially deposited. So this sort of commingling is rarely permitted.

H. **Borrower Representatives on AR Line**: Occasionally AR Loan Documents (or documents for a centralized deposit account held by one of the Operators or an affiliate) may call for a single person or entity (usually called the "Borrower Representative") to be the sole party authorized to make draws on behalf of multiple Operators; and may also call for such draws to all be initially deposited into a commingled account in the name of the Borrower Representative and/or for such draws to be deposited into separate project accounts as directed by Borrower Representative. Generally, this is encountered where an AR Loan includes many Operators (or will include, if it anticipates adding additional FHA facilities in the portfolio). Sometimes the Borrower Representative is proposed to be one of the Operators, and sometimes it is proposed to be a separate entity that is affiliated with the Operators. The cash flow chart must always depict any such proposed arrangement and any Borrower Representative accounts. Such arrangements raise a number of considerations and must be acceptable to HUD.

All documents evidencing the relationship between the Borrower Representative (in its capacity as such) and the Operators must be submitted for HUD's consideration. The Borrower Representative must not be a creditor of the Operators; i.e. the documents should establish that the Borrower Representative is making such draws as agent for the other Operators and is not borrowing funds in in its own capacity then "re-lending" such funds to other Operators. The Borrower Representative must be obligated to make and disburse draws to the respective facilities in a manner consistent with HUD Program Obligations, applicable HUD Regulatory Agreements (Borrower's Regulatory Agreement, Operator's Regulatory Agreement or Healthcare Regulatory Agreement – Master Tenant (Form HUD-92337-ORCF), and the Intercreditor Agreement with respect to each Facility. Additionally, the Borrower Representative will be required to sign a certification to disclose the named entity on the accounts managed or controlled by the Borrower Representative.

16.5 Lease Cost/Debt Service Payment Methods

The cash flow chart must show how "Current Impositions" (i.e. the rent, taxes and insurance, and deposits to escrows or reserves required under the Lease or other Borrower-Operator Agreement) will be paid. If the FHA Borrower is also the Operator, there are no lease payments so the chart will show only payment of debt service and deposits to escrows and reserves required by the FHA-insured loan documents. The method detailed in the cash flow chart must be consistent with and match the description in the Intercreditor Agreement. The Operator's, Borrower's (and where applicable, Master Tenant's) execution of the Intercreditor Agreement evidences their agreement to the lease cost payment method, and also evidences the AR loan borrower's authorization to the AR Lender to direct the proceeds of lease cost draws as provided therein.

A. **Acceptable Payment Methods**. Generally, the following methods are acceptable and consistent with the Intercreditor Agreement:

1. **Direct from AR Lender to FHA Lender**. The Operator directs AR Lender to disburse AR loan advances to pay Current Impositions or the current loan costs directly into an account in the name of the FHA Lender.
2. **Disbursement into Operator Designated Account**. If the proceeds of such an advance are not being paid directly to the FHA Lender, the FHA Lender must be able to receive by automatic debit or otherwise have the right to withdraw from an Operator account amounts at least equal to the Current Impositions or the current mortgage loan costs. If the FHA Lender is only receiving current mortgage loan costs, the Operator should be required to pay excess Current Impositions to the Borrower.
    a. **Disbursement into Tenant Rent Account**. The Operator may establish a "Tenant Rent Account" whose sole purpose is for payment of Current Impositions and which is funded directly by AR loan draws (or by the Operator). The Operator must be obligated to timely cause to be deposited sufficient funds each month to pay such costs. AR Lender should disclaim any interest in such an account, and it will be subject to a DACA solely in favor of FHA Lender. An example of this scenario can be found in Appendix 16.2.
    [NOTE: In this scenario, it is acceptable to use an immediate control DACA (as defined below) which permits the bank, after FHA Lender's debit for debt service, to remit any excess to the FHA Borrower's account. FHA Lender should be able to revoke such permission.]
    b. **Disbursement into Operating Account**. Alternatively, draws for Current Impositions sometimes will be disbursed directly into the project's general operating account. This alternative is generally acceptable for stand-alone or smaller transactions (so long as the FHA Lender has the ability to debit this account for Current Impositions) and may be less acceptable for more complex transactions. An example of this scenario can be found in Appendix 16.1.

3. **Disbursement into Master Tenant Account**. If a master lease structure is used, such advance may be made directly from AR Lender into the Master Tenant's account. An example of this scenario can be found in Appendix 16.3.

    In this scenario, it may be appropriate to use an immediate control DACA in favor of FHA Lender which permits Master Tenant, after FHA Lender's debit for debt service, to remit any excess to the respective FHA Borrowers. FHA Lender should be able to revoke such permission.

    Sometimes Current Imposition payments are proposed not to be made to the Master Tenant directly but are rather debited by the FHA Lender(s) directly from an Operator designated account. The Master Lease requires that rents be paid to the Master Tenant, who in turn pays the FHA Borrowers. Accordingly, if HUD approves such a proposal:
    a. If AR Financing is involved, the Intercreditor Agreement must evidence approval by Master Tenant and Borrowers of such method of payment.

b. If AR financing is not involved and HUD approves a structure under which funds do not flow through Master Tenant, Master Tenant's and Borrower's agreement to such method of payment should be documented.

FHA Lender agrees to apply amounts received on account of Current Impositions toward payment of the FHA Borrower's monthly debt service obligation under the FHA Loan and to fund applicable escrow and reserve requirements, with the balance remaining of the payment so collected, if any, to be remitted by FHA Lender to the FHA Borrower (or such excess may be remitted to the FHA Borrower by the DACA Bank or Master Tenant after the FHA Lender debit if permitted by the DACA or by such other remittance method as may be approved by HUD).

16.6 Deposit Account Control Agreements (DACAs)

A Deposit Account Control Agreement (DACA) is an agreement between a debtor/account owner, a secured party, and the bank maintaining the account that the bank will comply with instructions from the secured party directing the disposition of funds in the deposit account without further consent by the debtor/account owner.

A. **General Parameters**. Under the Uniform Commercial Code (UCC), a Lender must have a DACA with the depository bank to perfect its security interest in such deposit account as original collateral. There is an exception if the Lender is also the institution where the account is held (i.e. the Lender has possession of the account). However, even if FHA Lender is the depository bank, HUD generally still requires a DACA that clearly describes the priority of the liens.

   AR Lender must also agree to limit its ability to assert other security interests, set-off, recoupment, or banker's liens in project accounts held by it as the depository (see Section 16.4).

   In the event it becomes appropriate to do so, the FHA Lender shall "spring" any DACAs in a timely manner. In the event that the FHA Lender ultimately assigns the loan to HUD, it shall also assign the DACA to HUD.

B. **Types of Deposit Account Control Agreements**. There are two primary types of DACA's: future notification, or "springing," DACA's, and immediate control DACA's.

   1. **Future Notification DACAs**. In a future notification, or "springing," DACA, the Operator is permitted to use the account as it normally does and to make withdrawals. The bank follows the Operator's instructions as to the account until such time as the secured party notifies the depository bank that it is exercising exclusive control (such a notice is referred to herein as a "**Control Notice**"). Once the Control Notice is given, the bank must follow only the secured party's instructions as to the disposition of funds in the account. Typically, the secured party can only give such a Control

Notice and "spring" the DACA (and any associated lockbox) once an event of default occurs under its loan documents.

a. The FHA Lender DACA is typically a "future notification" DACA.
b. The Operator Security Agreement contemplates that, unless otherwise approved by HUD, the FHA Lender DACA will be a future notification type DACA that can be triggered only on default.

2. **Immediate Control DACAs**. In an immediate control DACA, the secured party exercises control immediately and the bank is obligated from the date of the agreement's execution to comply with the instructions of the secured party, and/or the Operator/account holder is precluded from making withdrawals. (Sometimes a DACA will be labeled "future notification" but the Lender gives the Control Notice at closing or within the document; these are, in effect, immediate control DACAs).
   a. If a Tenant Rent Account is used for the lease cost payment method, it may be appropriate to use an immediate control DACA in favor of FHA Lender on the Tenant Rent Account. Likewise, if a Master Lease is involved and lease payments are being made into a Master Tenant Account, it may be appropriate to use an immediate control DACA in favor of FHA Lender on such Master Tenant account.
   b. Where there is a DACA in place upstream of an AR Lender account, such DACA may call for daily sweeps into the AR Lender's account and no withdrawals by the Operator.
      i. Typically, if the FHA Lender is party to this DACA, FHA Lender's ability to exercise control will still be linked to its future notification if the parties intend that this account serve as a general operating account once AR Lender control terminates.
      ii. In this scenario, it may be appropriate to require a DACA on the downstream project operating account.

C. **Key elements of DACA**. HUD does not have a required form of DACA, though one or more sample forms are posted as unofficial guidance. These sample forms are only examples, and the responsible parties may use a different form, at their discretion, provided the form used addresses the key elements and is consistent with HUD Program Obligations.

Key elements for DACA's include those set forth below. Elements that include "must" are expected to be included in all forms. The remaining elements should be included, but HUD has discretion to permit deviations (and additional provisions) that do not materially affect HUD's interests.

1. **Parties to DACA**:
   a. Where no AR Loan is involved, the FHA Lender must be the only secured party named in the DACA. Parties will generally be the Bank, FHA Lender, and the Operator (or named account holder). The depository bank must be an organization engaged in the business of banking.
   b. Where an AR Loan is involved, both the AR Lender and FHA Lender can be named as secured parties in a single DACA, or a First Lien DACA (in favor of

AR Lender) and a Second Lien DACA (in favor of FHA Lender) may be used.

c. HUD must not be a party to a DACA (unless the loan is held by HUD).
d. If a party other than the Operator is named on, or has an interest in, a deposit account in the flow of funds, such arrangement must be acceptable and comply with any restrictions in the FHA-insured loan documents. If required by FHA Lender and/or HUD, such third party must execute such joinders, security agreements, DACA's or other documents to bind such party's interest.

2. **Notification of Security Interests**. The DACA must include a provision notifying the Depository that the FHA Lender has a security interest in the deposit account and all checks, funds, monies or other items now or hereafter deposited therein and any lockboxes associated therewith.

3. **No Other DACAs**. The DACA should include representations to the effect that there are no other control agreements affecting the account and that none will be placed on the account (other than the DACA(s) approved as part of the transaction).

   In any instance where a First Lien DACA and Second Lien DACA are used, the First Lien DACA must refer to and permit the Second Lien DACA (and vice versa).

4. **Accounts Covered**. The DACA must identify the account (or accounts) that are subject to the DACA. The account number(s) must match the cash flow chart (and the DAISA must be checked to ensure that it is sweeping funds into an account identified in the DACA). If the DACA covers more than one account, it should provide that FHA Lender can give a Control Notice as to any or all accounts.

5. **UCC Control Language and Execution**. To establish "control" within the meaning of the Uniform Commercial Code, the DACA must provide that Depository Bank will comply with FHA Lender's instructions as to disposition of funds without further consent of the debtor (typically the Operator). This language is referred to as "UCC Control Language". The DACA must be authenticated; i.e. it must be fully executed by all of the parties. Notarization is not required, unless required by state law. Provisions in the DACA allowing Depository Bank to file an interpleader action should not include disputes between depositor and FHA Lender/HUD.

6. **When Each Secured Party Is Entitled to Give Control Notice**. If both AR Lender and FHA Lender are parties to the same DACA, the DACA must clearly set forth when the Depository is obligated to follow the FHA Lender's (as opposed to AR Lender's) instructions, which must be consistent with the "change in control" or termination of DACA provisions in the Intercreditor Agreement.

   In any instance where a First Lien DACA and Second Lien DACA are used, the First Lien DACA must terminate or provide for a change in control over to the Second

Lien DACA consistently with the "change in control" and termination provisions in the Intercreditor Agreement.

7. **Giving and Implementing Control Notices**:
    a. The DACA must clearly set forth the manner for sending a Control Notice and should identify when it is deemed given or received. The manner of giving a Control Notice must include expeditious means (i.e. it should not be limited to delivery by mail, but also include personal delivery or other prompt means).
    b. The depository bank should agree to implement the notice as soon as is reasonably practicable. The key is to be able to identify when the block begins, which must not be subject to significant delay. Implementation periods of longer than three business days after notice will not be acceptable.
    c. Once a Control Notice goes into effect, depository bank must agree to (a) disregard further instructions delivered by the Operator/account holder and block Operator's/account holder's access to the account (except for the purpose of making and accepting deposits) and (b) rely solely on instructions of the Secured Party giving the Control Notice.

8. **Set-Off, Recoupment, Bank Liens and Security Interests**. The depository bank, in its capacity as Depository Bank, must agree to limit any rights of set-off, recoupment, banker's lien, or contractual security interest in the account and Account Collateral. Generally, these should be limited to:
    a. If depository bank is also the AR Lender the obligations secured by the AR loan/security agreement, provided any such setoff must be subject to the Intercreditor Agreement;
    b. Its customary and usual fees in its capacity as depository bank related to the DACA account; and
    c. Returned items, customary collecting bank, or similar items related to the DACA account.

    Because DAISA funds are swept daily and may be subject to legal restrictions that limit the bank's ability to debit from such account, the foregoing (b) and (c) may include fees, returned items, etc. related to the DAISA account as well.

9. **Termination of DACA**:
    a. By Operator: Operator (debtor) should not be able to terminate the DACA (unless via a joint instruction with the Secured Party or Parties).
    b. By depository bank: The depository bank must be obligated to give notice to FHA Lender prior to its voluntary termination. A notice period of at least 30 days is expected (unless for breach, when a shorter period may be acceptable). Longer notice periods are favored.
    c. By secured parties: Either secured party can terminate their interest under the DACA by notice. The provisions on when AR Lender must terminate are controlled by the Intercreditor Agreement and do not need to be addressed in the DACA, but the DACA must be consistent with the Intercreditor Agreement. A termination by AR Lender must not terminate FHA Lender's

interest under the DACA (or if a First Lien/Second Lien DACA are used, the Second Lien DACA); nor result in disposition of funds out of the account.

d. Disposition of Funds on Termination: Generally, if the DACA is being terminated by the Operator or the bank, the DACA should direct the bank to direct the funds in the account on termination to an account designated by the Secured Party or Parties. This would typically be a replacement account set up by the Operator.

10. **Other Key Elements**. See Section 16.8 for additional key elements that apply to both DACAs and DAISAs.

16.7 Deposit Account Instructions and Service Agreements (DAISAs)

A Deposit Account Instructions and Service Agreement (DAISA) refers to the instructions provided to the bank by the account holder that details how the bank is to dispose of governmental healthcare funds in the deposit account. A DAISA must be used with respect to the deposit account(s) into which Government Receivables will be initially deposited. It is the parties' responsibility to assure that the DAISA comports with applicable healthcare program restrictions.

A. **Key elements of a DAISA**. Currently HUD does not have a required form of DAISA, though it may post one or more sample forms as unofficial guidance. The sample forms are only examples, and the responsible parties may use a different form provided it addresses the key elements and is not inconsistent with HUD Program Obligations.

Key elements for DAISA's include those set forth below. Elements that include "must" are expected to be included in all forms. The remaining elements should be included, but HUD has discretion to permit deviations (and additional provisions) that do not materially affect HUD interests.

1. **Parties to DAISA**. If no AR Lender is involved, parties are typically the depository bank and Operator, and FHA Lender. If an AR Lender is involved, parties typically include the depository bank, Operator, FHA Lender and AR Lender. HUD must not be a party. If a party other than the Operator is named on or has an interest in the account, such arrangement must be acceptable to HUD and the parties must demonstrate this is permitted or required by the applicable government healthcare program. If required by FHA Lender and/or HUD, such third party must execute such DAISA's, joinders, security agreements, or other documents to bind such party's interest.

2. **Notification of Security Interests**. The DAISA should include a provision notifying the Depository that the FHA Lender has a security interest in the deposit account and all checks, funds, monies or other items now or hereafter deposited therein and any lockboxes associated therewith (especially if FHA Lender is not a party).

3. **No DACAs**. The DAISA should include representations to the effect that there are no control agreements affecting the account and that none will be placed on the account (other than those approved for the transaction).

4. **Accounts Covered**. The DAISA must identify the account(s) that are subject to the DAISA, which must match the cash flow chart, and any lockboxes associated with the account.

5. **Sweep Instructions**. The account holder (*not* the secured party) must instruct the depository bank to initiate a funds transfer ("daily sweep") of available funds each business day (or, if expressly approved by FHA Lender and HUD when the DACA is approved, the account holder instruction may be for less frequent sweeping of the funds, but typically not more than 48 hours) into another account that is identified in the DAISA (typically, this will be the DACA account, unless HUD has approved a direct sweep into an AR Lender account). The account holder (not the Secured Party) should also instruct the bank not to permit account holder to make withdrawals from the account.
    a. The DAISA must not grant either Lender the right to direct disbursement or to give instructions. It is not a control agreement and must not include the UCC Control Language or provisions allowing Lenders to give control notices.
    b. Generally, Operator's sweep instructions should be revocable and the DAISA should be terminable by the Operator (account holder) in order to comply with governmental healthcare program restrictions.
        i. Restrictions on the account holder's revocation or termination rights that are tantamount to FHA Lender control over the account should be avoided. For example, the DAISA should not condition the account holder's right to revoke its instructions on FHA Lender consent *under the DAISA*. However, such a revocation or termination remains a default under the Operator Security Agreement if FHA Lender's consent is not obtained under such security agreement.
        ii. Provisions which delay implementation of a changed instruction and/or which require prior notice to FHA Lender are encouraged, though lengthy periods may be inconsistent with healthcare program restrictions and should generally be avoided. Exculpatory clauses restricting bank's liability for failing to give such a notice are acceptable.

6. **The Bank must agree to limit rights of setoff, recoupment or any security interest or banker's lien**. Limited exceptions (such as for their reasonable and customary fees, returned items, posting errors, etc.) may be acceptable but should be limited to items and fees related to this account only. No exceptions should be made for contractual security interests. AR Lender must waive its right to set off its loan against the DAISA account to the extent required by applicable law or governmental healthcare insurance program rules.

7. **Termination of DAISA**:
    a. By Operator: Operator (debtor) shall be able to terminate the DAISA in order to comply with Medicaid and Medicare anti-assignment requirements. However, failure to procure the FHA Lender's prior written consent to such termination may result in a default under the Operator Security Agreement.
    b. By depository bank: The depository bank must be obligated to give notice to FHA Lender prior to its voluntary termination of the DAISA. A notice period of at least 30 days is expected (unless for breach, when a shorter period may be acceptable). Longer notice periods are favored.
    c. By secured parties: The DAISA account is subject to the control of the healthcare provider, not the Lenders. Generally, the Lender is a party solely for the purpose of notifying the depository bank of its interest. Accordingly, the secured party has very few rights under a DAISA (for example, it may have the right to be provided bank statements and on-line access to monitor account activity, and/or to be notified of certain key events, like revocation of a sweep instruction on the account). The DAISA may provide for notification by the secured party to the bank when it no longer has any interest. However, such a notification should not have the effect of terminating the DAISA, as FHA Lender is continuing to rely on the sweep instruction. There may be exceptions (for example, if there is a separate DAISA to which FHA Lender is a party that remains in place and/or a new DAISA entered into concurrently).
    d. When AR Lender is the depository bank: the DAISA should refer to the AR Lender in its capacity as depository bank where appropriate.

8. **Other Key Elements**. See Section 16.8 for additional key elements that apply to both DACAs and DAISAs.

16.8 Key Elements for Both DACAs and DAISAs

A. As referenced above, there are some elements that HUD expects to see in both DACAs and DAISAs. Those elements are as follows:

1. **Access to Account**. For the DACA, and for any DAISA to which FHA Lender is a party, depository bank must agree to provide FHA Lender upon FHA Lender's request (which need only be made once and not on a recurring basis) access to daily activity in the account and copies of periodic account statements delivered to Operator.

2. **Account Maintenance Requirements**. If the depository bank is also the AR Lender, and it requires that Operator maintain its deposit accounts with it, then the DACA/DAISA must provide language to the effect that if the depository bank terminates the DACA/DAISA for reasons other than breach thereof, the Operator must be able to move its relationship notwithstanding any restriction to the contrary in its other agreements (or this can be addressed by AR Lender in its loan documents).

3. **Minimum Balance Requirements**. Occasionally, the parties may wish to include a minimum balance requirement in the DACA or DAISA:
    a. To provide a source of payment for bank permitted debits, such as its fees,
    b. To provide a source of funds for overpayment reconciliation for a government healthcare program, or
    c. For other reasons.

    Such an arrangement must be brought to ORCF's attention during underwriting, be reasonable in amount, and be acceptable to FHA Lender and HUD.

4. **Conflicts**:
    a. The DACA and DAISA <u>must</u> provide that in the event of a conflict between the DACA and the bank's deposit agreement(s), the terms of the DACA and DAISA control.
    b. Certain future events may be permitted by a DAISA or DACA but will still be defaults under the HUD Loan Documents. For example, to comply with government healthcare program rules, the DAISA normally permits the Operator to revoke its sweep instructions and/or to terminate the DAISA. These acts remain defaults under the FHA Loan Documents. The execution of such DAISA or DACA by FHA Lender, and HUD's approval of same, shall not be deemed any waiver thereof or consent thereto. The DAISA or DACA should contain language to make this clear. But regardless of whether such language is included, such a waiver shall not be implied.

5. **Bank Fees**. These should be limited to usual, customary and reasonable fees in the normal course of business of the bank.

6. **Indemnification obligations**. These should typically be limited to the Operator (debtor) and, if required by the depository bank, a guarantor(s).

    Indemnities binding FHA Lender are not encouraged. However, if FHA Lender agrees to such obligations, they should typically be limited to third party claims arising from compliance by Bank with FHA Lender's written instructions after a Control Notice is given and reimbursement of returned items to the extent FHA Lender received the proceeds thereof. The Operator should be primarily responsible for indemnities. HUD must be expressly excluded from all such indemnification obligations.

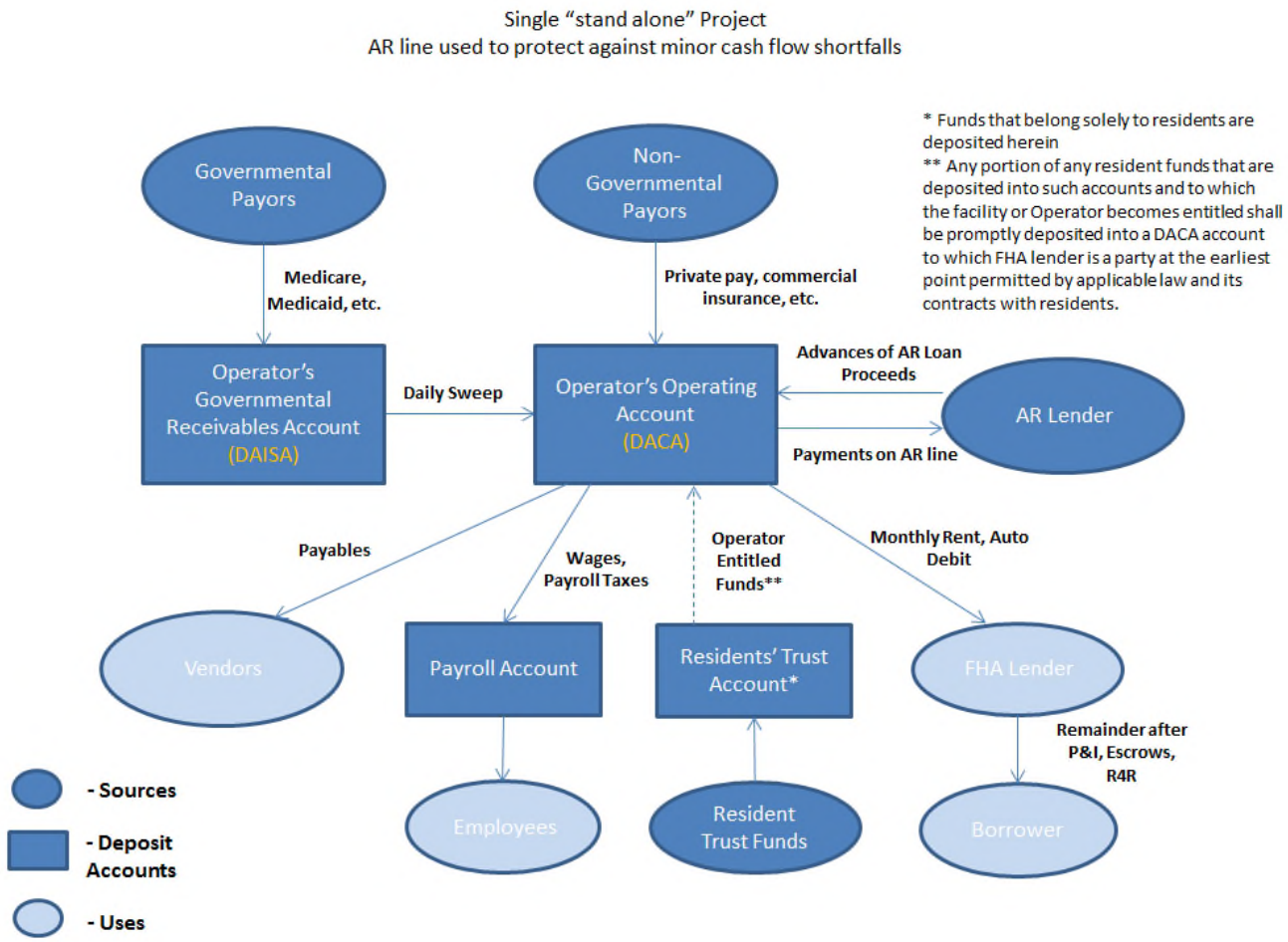
    Any indemnification provided by the FHA Lender (and preferably, by Operator) to the Depository Bank should exclude indemnification for indirect damages, lost profits, or special, punitive or consequential damages, and at a minimum, bank's gross negligence or intentional misconduct. If AR Lender is also the depository, it should be clear the indemnity is geared towards its capacity as depository and not as secured party.

7. **Boilerplate**. Should include standard provisions dealing with governing law, execution of counterparts, execution by facsimile (or other electronic) signature, etc. Provisions which would not permit venue in a federal district court are not permitted.

8. **Assignment**: The DACA must permit assignment of the DACA by the FHA Lender. The assignment provisions must not be materially inconsistent with, or unduly burden, HUD assignment of claims procedures. For example, an assignment clause which requires the assignee to execute an assumption shall not apply to an assignment to HUD.

Section II
Production

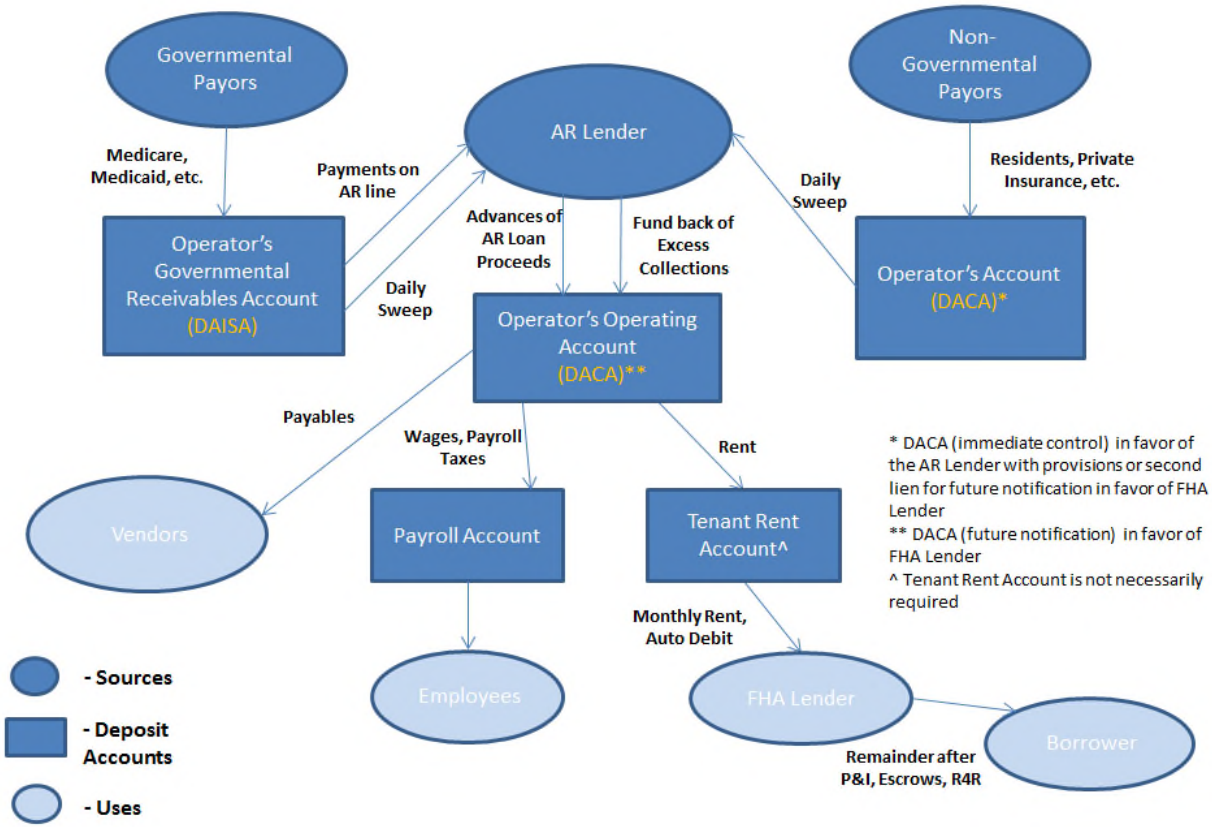
Appendix 16.1
Sample Cash Flow Chart



Appendix 16.2

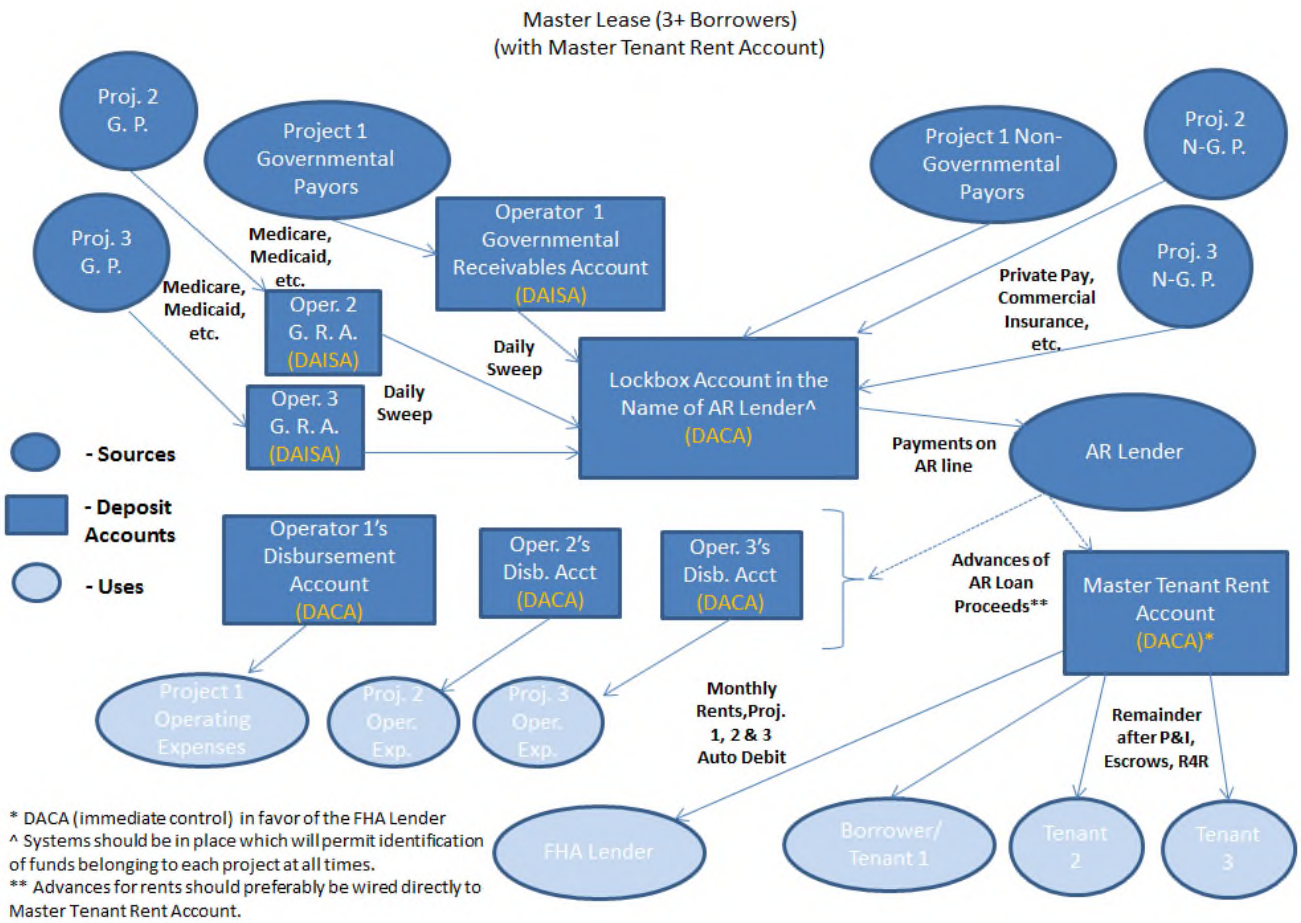
Sample Cash Flow Chart

All Funds Flow Through AR Lender, Operator routinely makes draws



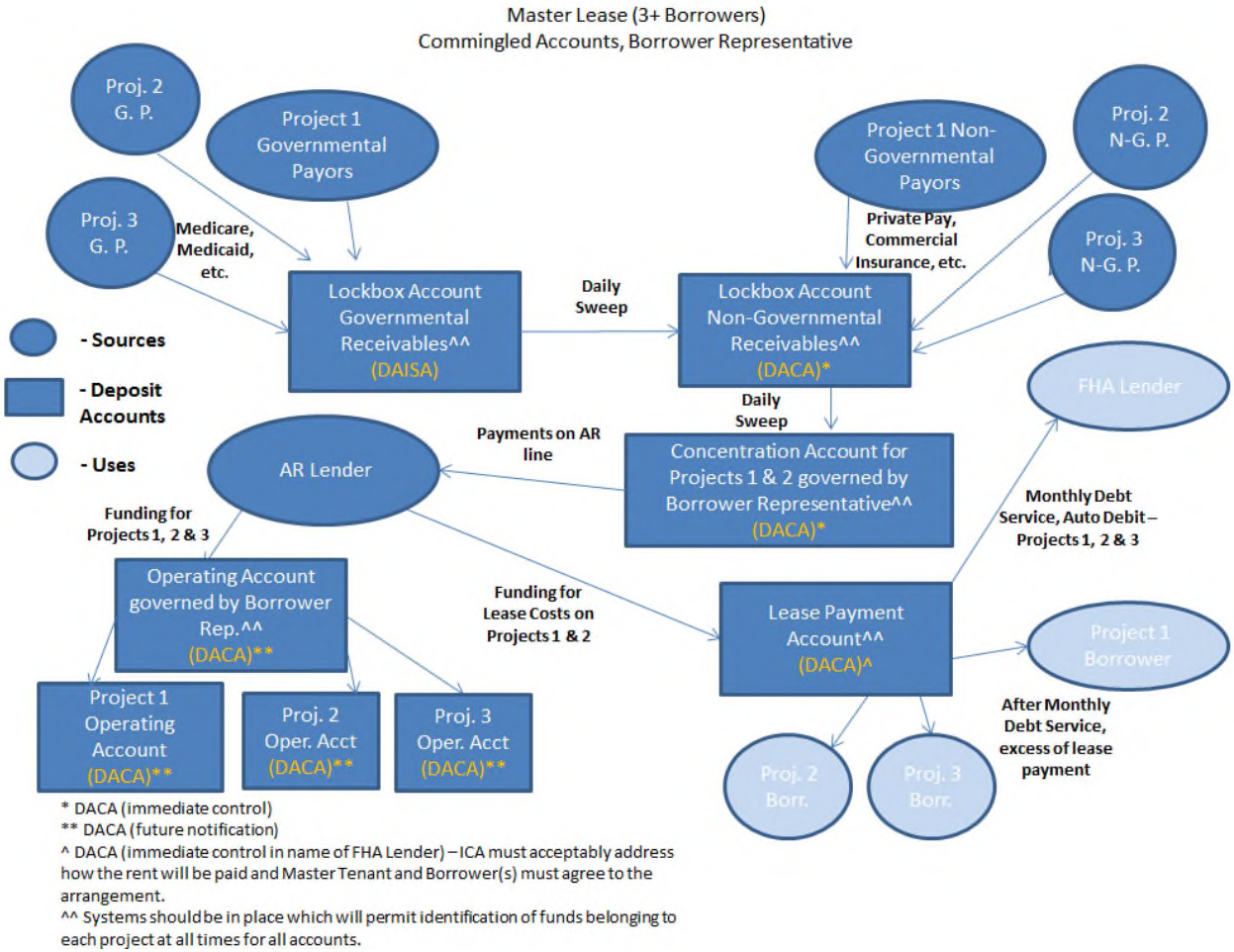
Appendix 16.3

Sample Cash Flow Chart



Appendix 16.4

Sample Cash Flow Chart



Section II
Production

Appendix 16.5
Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care

Form Number	Form Name
HUD-90020-ORCF	A/R Financing Certification
HUD-92322-ORCF	Intercreditor Agreement (for AR Financed Projects)
HUD-92323-ORCF	Operator Security Agreement
HUD-92337-ORCF	Healthcare Regulatory Agreement – Master Tenant
HUD-92466-ORCF	Healthcare Regulatory Agreement – Borrower
HUD-92466A-ORCF	Healthcare Regulatory Agreement – Operator
Notice H 08-09	Accounts Receivable (“AR”) Financing
N/A	Sample Format for Deposit Account Control Agreement (DACA)
N/A	Sample Format for Deposit Account Instructions and Service Agreement (DAISA)

Section II
Production

Chapter 17
Portfolios

17.1 Background and Overview

This chapter provides an overview of HUD's policy with respect to portfolios - multiple projects with the same ownership and 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 enhances 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/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.

Portfolio corporate credit reviews and master leases (see Production, Chapter 13) are the primary tools ORCF uses to identify and mitigate concentration risk associated with portfolio projects.

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.

17.2 Terms and Concepts

Portfolio: 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 17.4 below).

Single Asset Entity: For each individual project, the mortgaged property shall be the only asset of the Borrower and, except as otherwise permitted by HUD, the Operator (please see Production, Chapter 2.5.B and 2.5.C for SAE requirements).

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

17.3 Criteria for Portfolio Corporate Credit Review

A portfolio corporate credit review is required for all midsize and large portfolios (See Section 17.4 below). Portfolio corporate credit review procedures apply to owners and operators of residential care facilities and their affiliates in the following circumstances:

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. 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).

17.4 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 rolling18-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.

17.5 Certification of Multiple Projects

The lender will obtain a Certification of Multiple Projects, found as part of both the form Consolidated Certification—Borrower, and form Consolidated Certification—Principal of the Borrower. The Certification of Multiple Projects must include all HUD projects that the borrower and/or principal participates or proposes to participate in an application for Section 232 mortgage insurance, a TPA, or change in ownership or control of facility operations. 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 17.4;

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 in Production 6.1, 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; 24 CFR 200.62)."

5. Provide on the signature page of the Certification the following: This Certification has been made, presented and delivered for the purpose of influencing an official action of the FHA, and of the Commissioner, and may be relied upon by the Commissioner as a true statement of the facts contained therein.

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.

17.6 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 17.7 and be presented following the list in Section 17.8 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 exits 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 17.7 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.

17.7 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 or fair housing 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 Production, Appendix 14.1;

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 Borrower and Operator 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.

17.8 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 17.7 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 17.5.
2. Portfolio corporate credit review and all supporting documentation as described in Section 17.7.
3. Previous Participation Certification. Please reference Housing Notice H 2016-15 (or successors thereto) for additional information on the Previous Participation requirements.
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 in Production, Chapter 13.
6. Information demonstrating compliance with liability and property insurance requirements. PLI must be in compliance with Production, Appendix 14.1 (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.

Section II
Production

Chapter 18
Insurance Upon Completion

18.1 Introduction

Insurance Upon Completion (IUC) is an option available to Section 232 New Construction, Substantial Rehabilitation and Section 241(a) projects where HUD insures only the permanent loan. This differs from Insured Advances (IA) projects where HUD insures both the construction and permanent loans. There is no closing prior to start of construction as there is on IA projects. Instead, there is one closing following construction completion and cost certification. On IUC projects, construction must not start until after the issuance of a Firm Commitment. As with IA projects, ORCF completes a full underwriting review of IUC projects prior to issuance of a Firm Commitment. IUC and IA projects follow the same process and requirements: Firm Application, Firm Commitment, Pre-Construction Conference, Construction, Cost Certification, and Closing. Specific information pertaining to IUC within each stage is outlined below.

18.2 Firm Application

When the firm application is submitted, the Lender must notify ORCF of their intent to use IUC. Lenders may utilize either the Direct-to-Firm or the Two-Stage application process for IUC projects. See Production, Chapter 1 for information on the Direct-to-Firm and Two-Stage application processes.

Construction must not start until issuance of a Firm Commitment and completion of the Pre-Construction Conference.

Items that need to be addressed for IUC projects prior to issuance of a Firm Commitment and completion of the Pre-Construction Conference include:

A. Prior to issuance of a Firm Commitment, HUD will complete the following reviews:

1. Firm Application Underwriting Review,
2. Appraisal Review,
3. Part 1 Legal Review,
4. Title/Survey review, and

5. Environmental Review.

B. **Working Capital**. Projects must meet Working Capital escrow requirements except for the extra 2% construction contingency portion of the working capital requirement. This escrow must be established prior to closing, and must be accounted for in the Firm Application submission (see Production, Chapter 2).

C. **Initial Operating Deficit Escrow (IOD).** The Lender must prepare an Initial Operating Deficit analysis as part of the firm application. The IOD is to be funded at closing, and can only be used to cover post-closing losses. Prior to closing, ORCF may require the IOD to be increased based on actual performance at the project.

D. **Minor Movable Escrow.** A Minor Movable escrow is not required. Prior to closing all Minor Movables must be in place.

E. **Bond Premium/Assurance of Completion.** Not required.

F. **Latent Defects Escrow.** A latent defect escrow of 2.5% of the construction costs is required. This must be in the form of a bond, escrow or letter of credit. The cost of the bond or letter of credit may be included in the Contractor's Fees if reviewed and deemed reasonable by the third party architectural and cost analyst.

G. **Off-Site and Demolition.** Off-site and Demolition escrows are not required for IUC projects, however, in the firm application the Lender must explain the work to be completed and the costs associated with that work. The cost of this work is not eligible at cost certification.

H. **General Contractor Underwriting Review.** ORCF will look to the Lender and Third Party Architectural and Cost reviewer to ensure that the general contractor meets HUD requirements. If the General Contractor does not meet all of ORCF's requirements, or is unable to certify to everything in the Consolidated Certification – Contractors (Form HUD-90018-ORCF), the developer and Lender must acknowledge that they are willing to accept this risk during the course of construction. Experience of the General Contractor remains a serious consideration for IUC projects. ORCF will review the following:

1. Previous Participation Certification. See Housing Notice H 2016-15 (or successors thereto) for additional information on the previous participation certification and review process.

2. Financial Capacity to assure that there is sufficient capacity to cover the latent defects escrow.

3. General Contractor's experience and ability to complete the project.

I. **Builder's Risk.** ORCF does not require Builder's Risk Insurance. Should the Borrower choose to include Builder's Risk Insurance, it must be listed as either a Borrower's Other Fee or a Contractor's Other Fee in the firm application.

J. **Interest during Construction.** ORCF will allow for a reasonable amount of Interest during Construction to be included in the HUD Replacement Cost calculation on the Form HUD-92264a-ORCF. The approved amount will be included in the firm commitment. Any increase requires HUD approval.

K. **Mortgage Insurance Premium (MIP).** No MIP is paid during construction. An excel spreadsheet for calculating MIP is embedded in the Lender Narrative Cost Certification Supplement (see the Section 232 Program website). This must be reflected in the Lender's Maximum Insurable Loan Calculation (Form HUD-92264A-ORCF) ("MILC").

18.3 Firm Commitment

ORCF will issue the firm commitment on the Commitment to Insure Upon Completion following Loan Committee approval. For IUC projects, this firm commitment will include, but not be limited to:

A. The firm commitment must be valid and outstanding until closing on the permanent mortgage.

B. **Expiration Date.** The firm commitment's expiration date should provide for sufficient time to complete construction, cost certification and drafting and review of the closing documents. Typically, this is 1.5 times the construction period, but the Lender should recommend an expiration date based on the complexity of the project.

C. **Extensions.** See Production, Chapter 9 for the extension of Construction period and Firm Commitment expiration date, if required to permit project completion and Final Closing. ORCF may re-evaluate the market and/or other elements of the project prior to granting extension requests.

D. **Amendments.** Should the Firm Commitment require any amendments or changes after issuance see Production, Chapter 9.2.

18.4 Pre-construction Conference

For IUC projects:

A. The Pre-construction Conference must precede the initial start of construction. See Production, Chapter 10.3 for Pre-Construction Conference requirements. The ORCF Closer

should attend the Pre-construction Conference as they will be involved from this point until Final Closing.

B. The following are to be submitted by the Lender and reviewed by the ORCF Underwriter and the HUD Closing Attorney prior to the Pre-construction Conference:

1. Building Permits.

2. Construction Contract (Form HUD-92442-ORCF). The following must be made part of the contract:
   a. General Conditions, AIA Document A201;
   b. Supplementary Conditions of the Contract for Construction (Form HUD-92554-ORCF); and
   c. Davis-Bacon Wage Rates (supplied by HUD Office of Labor Standards and Enforcement (OLSE)).

3. Contractor's Prevailing Wage Certificate portion of the Contractor's Requisition Project Mortgages (Form HUD-92448).

4. Certification regarding Architect's E&O Insurance (with Certificate of Insurance attached) for design and supervisory architects.

5. Construction Progress Schedule.

6. Agreement and Certification (Form HUD-93305-ORCF). This document must be executed by the Borrower, Lender and ORCF prior to the Pre-construction conference.

7. Inspection Fee.

C. If the project is currently occupied:

1. A Management Conference with the assigned Account Executive and Lender should occur prior to the Pre-construction Conference.

2. From start of construction through Final Closing, the Borrower and/or Operator must provide ORCF and Lender with ongoing operating statements as requested, and must notify the AE of State Surveys that occur at the project.

D. If the project is new construction and/or is not currently occupied, a Management Conference with the assigned AE should occur prior to occupancy.

18.5 Construction Monitoring

During Construction, for IUC:

A. **Construction monitoring.** Reporting must be done in accordance with Production, Chapter 10.4.

B. **Labor and FHEO liaison.** See Production, Chapter 10.13.

C. **Contractor's monthly requisitions**. Not applicable to IUC projects.

D. **Offsite construction.**

1. Monitoring is recorded by the HUD inspector on the HUD Representative's Trip Report (Form HUD-95379-ORCF).

2. Advance of funds monitoring is not applicable to projects insured upon completion.

E. **Construction contract changes and Architect's supplemental instructions (see Production, Chapter 10.9 – 10.12 and Chapter 10.5.D).** Construction changes are processed in the same manner as insurance of advances, except as modified below:

1. An escrow is not required for additive change orders, because HUD has no risk exposure until closing. The Borrower must be able to provide the additional funds required and must not have any outstanding obligation in connection with construction other than the insured mortgage at the time the mortgage is presented for insurance.

2. Surety approval is not required for the approval of additive change orders regardless of the percentage of contract increase.

F. **Seventy percent (70%) Construction Completion.** When onsite construction is 70% complete (before closing of the credit instruments), the Lender must prepare a property insurance schedule and requirements. Evidence must be provided that the facility has all required Fidelity, Property, and Professional Liability Insurance coverages. The insurance coverages must be current and in conformance with all ORCF requirements. If the policy is about to expire within one month of closing, provide proof of renewal. See Production, Chapter 14 for details on insurance coverage and requirements.

G. **Permission to Occupy.** Applies as in Production, Chapter 10.7.A.

H. **Final HUD Representative's Trip Report.** Applies as in Production, Chapter 10.7.B.

I. **Warranty Inspections.** Nine- and Twelve-month warranty inspections apply as in Production, Chapter 10.7.C.

18.6 Cost Certification

Cost certification is required for all insured Section 232 and 241(a) applications except as noted in Production, Chapter 11.4. The purpose for certification is to establish the Borrower's actual costs, including contractor's cost, to establish the "Maximum Insurable Mortgage" (MIM) for closing of the FHA-insured mortgage. A MIM letter will be issued upon conclusion of the cost certification package review. For more information on the cost certification process, please see Production, Chapter 11.

Specifically, the cost certification is required to be submitted in advance of closing. This is to ensure the MIM amount is determined and finalized before closing documents are prepared. For specific information on:

A. Entities that must cost certify (see Production, Chapter 11.6),
B. Required Forms and Documentation (see Production, Chapter 11.10),
C. Required Cost Certifications (see Production, Chapter 11.11), and
D. Allowable Costs in Borrower's Certificate of Actual Cost (see Production, Chapter 11.13).

18.7 Closing

Once construction has been completed and certification of costs has been presented to and approved by ORCF, the Borrower must proceed to closing. ORCF will issue a MIM Letter, upon completion of the cost certification review, providing the final mortgage determination. Once the letter is issued, immediate preparation for closing should begin. Closing documents are to be submitted within 30 days of the date of the MIM Letter.

A. Requirements for Closing for IUC projects are set out in the IUC Closing Checklist (see the Section 232 Program website) and the MIM letter. Required documents include, but are not limited to, the following:

    1. **Proof of Completion.** For the purpose of closing the mortgage transaction, completion means that the project has been completed in accordance with the drawings and specifications, except for approved items of delayed completions covered by an acceptable Escrow Agreement, and the entire project has been accepted for occupancy by local authorities, by the Lender, and by ORCF.

    2. **Labor Standards and Enforcement Clearance.** The Office of Labor Standards and Enforcement (OLSE) must confirm that all Davis Bacon violations have been cleared. If there are outstanding violations, the OLSE Specialist will inform the Lender and ORCF Closer that deposits to the U.S Treasury must be established as a condition of closing to ensure payment of wages. HUD's OLSE must provide approval to proceed to Final Closing (see Production, Chapter 4, Appendix 4.1 HUD Labor Standards and Enforcement Protocol).

3. **Public Approvals.** If issues have arisen regarding the zoning of a project, the HUD Closing Attorney may require submission of additional evidence to verify compliance with local zoning laws and/or building codes.

4. **Construction Contract.** The following must be part of the Contract:
    a. General Conditions, AIA Documents A201,
    b. Supplementary Conditions of the Contract for Construction,
    c. Davis Bacon-Wage Rates (supplied by HUD Labor Relations);
    d. HUD Amendment to the B108,
    e. Cost Certification criteria from Construction Contract (Form HUD-92442-ORCF), Article 4, where an identity of interest exists, or a "cost plus" form of contract is used.

5. **As-Built Drawings and Specifications.** A complete "As-Built" set of drawings and specifications, incorporating change order to date, and one electronic "Master Set" on CD.

6. **Agreement and Certification, (Form HUD-93305-ORCF).** This document must be executed by the Borrower, Lender, and ORCF prior to the Pre-construction Conference.

7. **Title Policy**. Title Policy or title evidence must be dated the day of closing and show:
    a. Insured property free of all encumbrances except those found acceptable by HUD;
    b. Proof that no unpaid obligations exist except as previously approved by ORCF.

8. **As-Built Survey.** Current ALTA/ACSM surveys are required for all closings. The final As-Built survey, or its most recent update, must be dated with 120 days of the closing. The term "dated" means the surveyor's certification must show that the survey was made "on the ground" within 120 days prior to closing. The survey must show the exact location of all building, water, sewer, gas and electric mains, and all easements for such existing utilities. The survey must be prepared, signed and sealed by a licensed surveyor and must include a certification in the format set out in Survey Instructions and Borrower's Certification (Form HUD-91111-ORCF).

9. **Contractor's Prevailing Wage Certificate.** The Contractor's Prevailing Wage Certificate portion of the Contractor's Requisition Project Mortgages (Form HUD-92448) must be submitted at the time the mortgage is presented to ORCF for insurance.

10. **Operating Deficit.** If an operating deficit was required in the Firm Commitment, the Borrower must provide funds to meet the deficit at closing. The Firm Commitment

requirements concerning funding are not waived, in whole or in part, unless specifically approved by ORCF. Amendments or modifications between the start of construction and closing will not be waived without prior written approval of ORCF. Assurance of funds to meet an operating deficit is required as noted above, in Section 18.2.C. The following completed forms may be required to assure funds are available to carry the project to a sustaining occupancy after closing:

a. Escrow Agreement Additional Contribution by Sponsors (Form HUD-92476-A),
b. Escrow Agreement (Form HUD-92476.1),
c. Bond Guaranteeing Sponsors' Performance (Form FHA-2477), and
d. IOD Analysis based on current lease-up performance.

11. **Builder's Warranty against latent defects.** At closing, the general contractor must address latent defects by:
    a. Entering into the latent defects agreement with HUD (Form HUD-92414-ORCF (REV 03/13), and either:
    b. Funding a cash escrow deposit equal to 2.5% of the construction contract, or
    c. Providing an irrevocable, unconditional letter of credit issued to Lender by a banking institution, or entering into the Latent Defects Escrow (Form HUD-92414-ORCF), which requires a latent defects escrow of 2.5% of the total amount of the Construction Contract, in the form of a surety bond, cash escrow or letter of credit.

12. **Final Draw.** Unlike Insured Advances projects, IUC projects will only have one draw. In the IUC Closing Package, the Borrower will provide the Requisition For Disbursement of Funds (Form HUD-92403-CA). This form shall be consistent with the approved Maximum Insurable Mortgage amount listed in the MIM Letter and the Closing Statement.

13. **Amortization.** Amortization starts the first day of the second month following the date of Final Closing.

14. **After Final Closing.** Following final closing, the Closer will ensure all post-closing documents are received. The Closer will notify the assigned AE that the project has completed Final Closing.

Section II
Production

Appendix 18.1
Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care

Form Number	Form Name
FHA-2477	Bond Guaranteeing Sponsors' Performance
HUD-2205A-ORCF	Borrower's Certificate of Actual Cost
HUD-90018-ORCF	Consolidated Certification – Contractors
HUD-91111-ORCF	Survey Instructions and Borrower's Certification
HUD-92264A-ORCF	Maximum Insurable Loan Calculation ("MILC")
HUD-92403-CA	Requisition For Disbursement of Funds
HUD-92408-ORCF	HUD Amendment to B108
HUD-92414-ORCF	Latent Defects Escrow
HUD-92442-ORCF	Construction Contract
HUD-92448	Contractor's Requisition Project Mortgages
HUD-92453-NH	Commitment to Insure Upon Completion
HUD-92476-A	Escrow Agreement Additional Contribution by Sponsors
HUD-92476.1	Escrow Agreement
HUD-92554-ORCF	Supplementary Conditions of the Contract for Construction
HUD-93305-ORCF	Agreement and Certification
HUD-95379-ORCF	HUD Representative's Trip Report
AIA Document A201	General Conditions
AIA Form B108	Owner-Architect Agreement
Notice H 2016-15	Retrospective Review—Improving the Previous Participation Reviews of Prospective Multifamily Housing and Healthcare Programs Participants (or successors thereto)
N/A	Additional Standard Special Conditions to Insurance Upon Completion (NC/SR/BR)
N/A	Closing Checklist for Insurance Upon Completion

Section III
Asset Management

Chapter 1
Asset Management Overview

1.1 Introduction - Overview and Objectives

Since assuming responsibility for administering the Section 232 residential care facility portfolio from the Office of Multifamily Housing in December 2008, the Office of Healthcare Programs (OHP), and specifically the Office of Residential Care Facilities (ORCF), has instituted changes to improve the servicing and mitigate the risk of Section 232 insured loans. As part of these changes, ORCF strengthened the regulatory agreements and requirements for deposit and control agreements (DACAs) and accounts receivable (AR) financing, and increased scrutiny of Operators' operating processes and financial statements. ORCF has also established requirements for master leases and debt service reserves.

The primary responsibilities of the Asset Management and Lender Relations Division of ORCF are to service insured mortgages, monitor risk and minimize claims. Each Account Executive (AE) works in partnership with the Borrower and Lender to ensure each FHA-insured loan is financially and operationally strong, that each property provides a safe, quality place of residence, and that the loan remains viable for the term of the mortgage.

Monitoring of Section 232 assets includes reviewing state inspection surveys, analyzing Borrower FASS submissions and Operator financial submissions, reviewing Physical Assessment Subsystem (PASS) physical inspections and monitoring Centers for Medicare and Medicaid Service (CMS) ratings.

ORCF implemented enhanced monitoring oversight and aggressive risk mitigation to further ensure sustainable HUD properties for the life of the mortgage.

All AEs in Asset Management report to a Workload Manager (AKA Branch Chief). Each Workload Manager (WLM) holds weekly huddles with their staff to help resolve issues in processing requests or support each team in their efforts to provide good customer service. All WLMs meet bi-weekly with the Director of Asset Management who oversees the entire Asset Management Program. A complete listing of the AEs, their WLMs and all contact information is available at the Section 232 Program website.

1.2 Account Executive and Lender Alignment

To the extent possible, AEs are aligned with specific Lenders. Lenders with significant portfolios of Section 232 loans have a team assigned to their portfolio, with one person designated as the Lender Lead. This centralized concept ensures consistent servicing for the Lender and Borrower, regardless of geographic location for either the property or the AE. The allocation of a Lender's portfolio is reviewed annually to ensure that Asset Management continues to provide successful customer service and effective risk management.

1.3 Team Structure

ORCF's Asset Management and Lender Relations Division is organized with WLMs leading teams of AEs. The Turnaround Team, or the Risk Mitigation Branch, concentrates on loans that are HUD-held, or in serious financial and/or operational condition. Moreover, several other WLMs lead teams of AEs that service all other performing loans.

1.4 Asset Management Branch and Risk Mitigation Branch

The AEs use multiple tools in the management of the Section 232 portfolio, two of which are highlighted below:

A. **Annual Macro-Analysis Report**. This report is compiled from CMS-provided Operator financial data, CMS Star Rating Report and Special Focus Facility Report for Skilled Nursing Facilities; ORCF internally-provided Borrower financial data (audited financial statements that are required to be electronically submitted by the Borrowers) and physical condition data from the Integrated Real Estate Management System (iREMS). It rates each Section 232 project within ORCF's portfolio and provides a baseline to determine if additional oversight is necessary.

B. A continuous review of each property in the AE's portfolio based on project activity within a particular month to proactively analyze and respond to issues. This involves ongoing review of several critical sources of information which include:

    1. Mortgage Default and Delinquency Report (MDDR). Payment delinquency and default information on HUD-Insured loans is provided by the Lender to ORCF.

    2. CMS Star Rating Report. This report is drawn from the CMS "Nursing Home Compare" website, which indicates its ratings on a 1 through 5-star rating for Medicare-certified nursing homes nationwide.

3. State Surveys. This report, provided by the State for each nursing home, details the property's annual operational and financial status.

4. Real Estate Assessment Center (REAC) Inspection results.

5. Reserve for Replacement (R4R) Requests. If a request is made to suspend or reduce a monthly payment, or to use funds from the account to fund a mortgage payment or operating expenses, the AE will look at the monthly cash flow to determine if additional actions are necessary.

6. Stop Order from State Agency based on an annual state inspection by the licensing agency.

7. Borrower's annual audited financials filed with ORCF.

8. Quarterly financial reports from Operators.

9. Specific compliance issues for a property identified by ORCF and the Departmental Enforcement Center (DEC).

10. Asset Management Group and individual Team Calls where policies are reviewed and live meeting training is provided on new or revised processes or current ORCF initiatives.

Communication between the Lender and the AE is critical to ensuring the ongoing viability of the project. Under certain circumstances, special servicing is warranted to the complexities of the situation. In these cases, loans are transferred to the Risk Mitigation Branch for a closer level of attention. Whenever a transfer of a loan occurs, the Lender will be invited to a conference call to discuss the re-assignment of the loan to the Risk Mitigation Branch along with contact information regarding the new AE on that team. Please refer to Asset Management, Chapter 5 for more information on the Risk Mitigation Branch.

Section III
Asset Management

Chapter 2
Controlling Documents

2.1 Introduction

The Section 232 mortgage insurance documents are the controlling documents which detail program requirements and obligations. These documents are comprised of contracts (Agreements), certifications, forms, and regulations. The documents discussed in this Chapter were published pursuant to the Paperwork Reduction Act (PRA) and are available on the Section 232 Program website.

2.2 Regulatory Agreements

Regulatory Agreement. The regulatory agreement is the contractual document under which the Borrower, Operator and, if applicable, the Master Tenant are regulated by HUD, as long as HUD is the insurer or holder of the mortgage. Therefore, depending on the Borrower and Operator structure, the project may have one or more of the following regulatory agreements:

1. Healthcare Regulatory Agreement – Borrower, or Borrower Regulatory Agreement (Form HUD-92466-ORCF),

2. Healthcare Regulatory Agreement – Operator, or Operator Regulatory Agreement (Form HUD-92466A-ORCF), or

3. Healthcare Regulatory Agreement – Master Tenant, or Master Tenant Regulatory Agreement (Form HUD-92337-ORCF).

Depending on the date an FHA-mortgage was insured, the insured mortgage may have earlier versions of these documents, which do still apply in full force and effect, and this Section III of this Handbook does apply to those insured mortgages.

If the Borrower and Operator are the identical legal entity, then that entity shall sign both the Borrower Regulatory Agreement and the Operator Regulatory Agreement. The regulatory agreement is recorded in the land records and thus is an encumbrance on the property. HUD will agree to release the regulatory agreement when the FHA-insured loan is paid in full, either at maturity or upon prepayment. (The prepayment approval process is in Asset Management,

Chapter 3.3.2.) The Borrower or Operator shall provide its Account Executive (AE) with a written request with a legible copy of the recorded regulatory agreement attached. The AE will forward both documents to Headquarters, Office of General Counsel, Insured Housing Multifamily Mortgage Division for processing.

2.3 Mortgage and Mortgage Note

A. **Mortgage:** A mortgage is a written instrument which evidences an interest in land or real property and provides security for the performance of a duty or the payment of a debt. The FHA mortgage is one in which the loan has been insured by the Federal Housing Administration (FHA).

B. **Mortgage Note**: A mortgage note is executed for all insured mortgages. It is the written document that evidences a loan for which real estate has been offered as security and includes an unconditional promise by the Borrower to repay the debt on a specified date. It is also the document that FHA endorses as evidence of its insurance commitment. It sets forth the original amount of indebtedness to the Lender, the interest rate, and the manner in which the debt will be repaid.

2.4 Uniform Commercial Code (UCC) Filing

Uniform Commercial Code. The Uniform Commercial Code ("UCC," or "the Code"), deals primarily with transactions involving personal property (movable property), but not real property (immovable property). Article 9 governs how security interests may be obtained in personal property that a Borrower and a Lender agree will serve as security for payment of specified debts. Fundamental concepts under Article 9 include: how a security interest is imposed on property ("attachment"); how security interests are made complete ("perfected"); and what remedies are available to the secured party if the debtor defaults in payment or performance of the secured debt or obligation.

2.5 Operating Lease

Operating Lease. The Operating Lease (or Agreement) provides the Operator with the use of the property for a particular period of time and sets forth the Borrower's and Operator's responsibilities and obligations. The terms of the Operating Lease must be consistent with Section 232 of the National Housing Act, Section 232 Regulations and Program Obligations (see Production, Chapter 8).

2.6 Master Leases

Master Lease. Master Leases, also known as Sandwich Leases or Credit Pass Throughs, are used by national and regional healthcare Borrowers. These transactions create a tiered structure with a Master Tenant leasing multiple projects from the Borrowers, and then entering into sub-leases, which are sometimes referred to as master subleases, with the entities that will operate the healthcare facilities. Through the master lease agreement, the Master Tenant agrees, among other things, to pay the Borrowers' rent necessary to satisfy the Borrower's financial obligations under the FHA-insured mortgage. Also, the sublessees (or subtenants) are required, among other things, to agree to contribute additional amounts when needed and as available to cover any shortfall in the rent that the Master Tenant owes to the Borrower (see Production, Chapter 13).

2.7 Accounts Receivable Financing, Deposit Account Control Agreements (DACAs), Operator Bank Accounts and Deposit Account Instruction Service Agreements (DAISAs)

A. **Accounts Receivable (AR) Financing.** A majority of skilled nursing facility operators now use accounts receivable (AR) loan financing mechanisms to ensure that adequate cash flow is available to meet ongoing operating expense needs. Typically, the Operator provides patient services which are reimbursed by Medicaid and Medicare 30 to 90 days after the services are provided. The timing of these reimbursements varies from state to state and can be subject to significant delays. The remaining patients either pay for their services from their own private resources (private-pay) or have private insurance coverage. Absent AR lines of credit, Operators may be at risk of experiencing short-term cash liquidity shortfalls. The AR line of credit provides a source of funds to sustain ongoing operations until Medicaid and/or Medicare reimbursement funds are received. In addition, the AR Lender supplements ORCF's oversight as a third party monitoring the financial operations of the Operator. This results in additional oversight and proactive intervention with the Operator if unusual or troubling financial trends appear (see Production, Chapter 15, and Asset Management, Chapter 10).

B. **Deposit Account Control Agreement (DACA)**. The accounts receivables ("AR") of the Operator of a project subject to a FHA-insured loan, constitutes "project income." There are two types of project income: non-governmental and governmental receivables. The Deposit Account Control Agreement ("DACA") addresses the non-governmental receivables. A security interest in those AR must be executed by the Operator, via a security agreement. Pursuant to UCC §9-104, a DACA is used to perfect ORCF's and the Lender's security interest in the Operator's deposit accounts. A DACA is an agreement made among a secured party (generally, the FHA Lender), a debtor (generally, the Operator, whether the Borrower or lessee), and depository bank (the bank at which the Operator maintains its deposit

accounts) in which the debtor has agreed that the bank will comply with the secured party's instructions regarding disposition of the funds in the debtor's deposit account without further consent by the debtor. DACAs are referred to by various names, including Blocked Account Agreements, Lockbox Agreements and Springing Lockbox Agreements (see Production, Chapter 15 and Chapter 16, and Asset Management, Chapter 10).

C. **Operator Bank Accounts:** It is understood that the Operator will typically maintain at least two separate bank accounts. The first account, the Governmental Healthcare Receivables Account (GHR Account), is an account into which all Medicare/Medicaid receivables are deposited. It is expected that the FHA Lender, depository bank and, where applicable, the AR Lender will enter into a Deposit Account Instructions Service Agreement ("DAISA") that requires the depository bank to "sweep" the GHR Account daily (or less frequently with HUD approval) such that all funds deposited in the GHR Account are transferred to a second account of the Operator, known as the "Operating Account" (see Production, Chapter 16).

D. **Deposit Account Instructions Service Agreement (DAISA) guidelines:** A DAISA refers to the instructions provided to the bank by the debtor that details how the bank is to dispose of governmental healthcare funds in the GHR Account. The DAISA must not grant the FHA Lender the right to direct disbursements from the GHR Account as in a DACA in order to avoid a conflict with applicable healthcare program restrictions (e. g. the Medicare/Medicaid anti-assignment provisions). Unlike a DACA, a DAISA should be terminable by the Operator in order to comply with all applicable healthcare program restrictions (e. g. Medicare/Medicaid anti-assignment provisions). The Security Agreements shall also provide that the Operator must procure the FHA Lender's written consent prior to closing a deposit account subject to a DAISA or terminating the DAISA FHA Lender (see Production, Chapter 15 and Chapter 16, and Asset Management, Chapter 10).

2.8 Management Certification

The definition of a Management Agent, including the distinction between a Management Agent and an Operator, is discussed in Production, Chapter 8 and Asset Management, Chapter 8. A party who is deemed a Management Agent by HUD, rather than an Operator, must execute a Consolidated Certification – Management Agent (Form HUD-90017-ORCF).

Section III
Asset Management

Appendix 2.1
Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care

Form Number	Form Name
HUD-90017-ORCF	Consolidated Certification – Management Agent
HUD-92337-ORCF	Healthcare Regulatory Agreement – Master Tenant
HUD-92466-ORCF	Healthcare Regulatory Agreement – Borrower
HUD-92466A-ORCF	Healthcare Regulatory Agreement – Operator
N/A	Sample Format for Deposit Account Control Agreement (DACA)
N/A	Sample Format for Deposit Account Instructions and Service Agreement (DAISA)

Section III
Asset Management

Chapter 3
General Loan Oversight

3.0.0 Introduction

This chapter addresses details of loan servicing for projects insured under the Section 232 Program covered by this Handbook, and the related necessary actions for the Project (consisting of the Borrower, Operator, Master Tenant (if applicable) and Management Agent), Mortgagee/Servicer and the Office of Residential Care Facilities' (ORCF) Account Executives (AE). For the purposes of this chapter, the term "Mortgagee/Servicer" means the primary servicer responsible for servicing the mortgage loan, whether such party is the originating Lender or third party servicer for the originating Lender.

ORCF provides asset and risk management of all Section 232 insured projects; however Mortgagee/Servicers must also provide routine reviews of their portfolio, which includes quarterly and annual reviews of financial performance as discussed in Asset Management, Chapter 4, as well as special reporting to the AE when a project's performance is at risk. This chapter provides guidance regarding performance benchmarks for each project, and also regarding the necessary actions to be taken by the Mortgagee/Servicer, AE and project in specific circumstances during the life of the FHA insured mortgage.

Many tools and resources are posted on the Section 232 Program website, to include submission checklists, average processing times, and other helpful information that can provide supplemental guidance to this Handbook.

Section 3.1

Servicing and Monitoring of Construction Projects

3.1.1 Introduction

This section provides ORCF asset management guidance for Section 232 and 241(a) mortgage loans that include lease-up of units (new construction, substantial rehabilitation and Section 241(a)) (" Construction Projects").

The risks inherent during the construction and lease-up processes necessitate heightened Mortgagee/Servicer attention during those periods, as well as strong production/asset management coordination within the Mortgagee/Servicer's organization. The risks also necessitate strong Mortgagee/Servicer leadership and coordination with all involved parties. Within ORCF, and in light of the unique risks inherent during construction and lease-up, a Construction Project will typically (though not invariably) be assigned to an AE on a servicing team focused on servicing such properties (a "lease-up" servicing team). Generally the lease-up AE will then service the property until it reaches sustaining occupancy (see Sec. 3.1.3.A.2.f). Although the AE will be the primary facilitator within ORCF, during the lease-up process the AE will, where appropriate, draw upon the participation of the ORCF Underwriter, Closer, Construction Manager, Appraiser and others within ORCF, as well as the assigned closing attorney from the HUD Office of General Counsel (OGC).

In its leadership role, and in close coordination with the lease-up AE, the Mortgagee/Servicer is expected to assemble--and electronically convene frequently (typically at least monthly)-- a resource team to assist the Mortgagee/Servicer in project monitoring. This "Project Monitoring Team" shall include where appropriate and without limitation the Borrower, Operator, Management Agent and ORCF. Drawing upon the information and expertise thus available, the Mortgagee/Servicer shall monitor the actual lease-up progress compared to the projected (underwritten) progress, and shall assure that its Borrower identifies and carries out steps to remedy unfavorable variations between projected and actual progress.

3.1.2 Loan Committee Presentation and Initial Closing

Just as the Mortgagee/Servicer coordinates its own production and asset management functions, so too does ORCF. In that regard, to ensure that the lease-up AE has the opportunity to fully appreciate the issues, objectives and risks of the construction loan, the lease-up AE's assignment will typically begin with attendance and participation in the project's loan committee presentation. Then, upon issuance of a Firm Commitment, the ORCF Closer staff will facilitate

many functions necessary for the Initial Closing, and the AE will work with the Closer and/or the ORCF Construction Manager where needed, leading up to Initial Closing.

3.1.3 Asset Management Functions after Initial Closing

The lease-up AE's activity after Initial Closing varies according to the type of loan, which determines the asset management lead-time provided by construction.

A. **Projects Having No Operations During Construction.** In the case of a Section 232 construction loan where there are not existing operations that will continue during construction (new construction and some substantial rehabilitation projects), the project's construction phase will typically consume many months, during which time the AE's duties will be minimal. When a project of this type reaches the point of 70% completion (calculated as a percentage of construction draws), the AE will commence ORCF's pre-operations asset management functions.

1. **Pre-Operations Activities**. When this type of project is scheduled to open within the following quarter, the AE will begin to work closely with the Mortgagee/Servicer, project participants and ORCF colleagues to help assure a successful transition and business start-up.
    a. <u>ORCF Staff Communications</u>. The AE, the Construction Manager and the assigned Closer will communicate after Firm Commitment to ensure that all parties are aware of the project assignment. If project issues arise, the AE will participate as necessary to ensure appropriate resolutions. To keep the AE informed about construction progress, the Construction Manager will send an email notification to the AE when a new construction project reaches 70% completion.
    b. <u>Pre-Operations Meeting</u>. When a new project reaches 70% completion, the AE will confer with the Mortgagee/Servicer regarding convening a Project Monitoring Team (referenced above in the Introduction, 3.1.1). The Mortgagee/Servicer, in coordination with the AE, will arrange and facilitate a Pre-Operations Meeting of this Project Monitoring Team. Before doing so, however, the Mortgagee/Servicer will, in coordination with the AE, collect project status information as needed and determine the appropriate participants and agenda.
        i. <u>The agenda</u> for this introductory Pre-Operations meeting will generally include, among other topics:
            1. Introductions
            2. Pre-opening checklist, which the Borrower and Operator can use for guidance during start-up (Please see the Section 232 Program website,)
            3. Borrower's summary of the marketing plan and current project status

4. Status of all state permits, i.e. Operating License, Medicaid/Medicare certifications
5. Discussion of the Initial Operating Deficit (IOD) tracking worksheet (Please see the Section 232 Program website)
6. Proper registration in the Business Partner Registration System (BPRS)
7. Assurance of borrower, operator and management agent's familiarity with the requirements of their respective regulatory agreements/certifications and other controlling documents

ii. A suggested draft Pre-Operations Meeting agenda will be provided on the Section 232 Program website.

c. Project Monitoring Strategy and Action Plan. The Mortgagee/Servicer should ensure that, upon completion of the Pre-Operations Meeting, all participants have a clear understanding of the borrower's/operator's plan/strategy to reach sustaining occupancy, including problems identified, steps to address them, persons responsible, and benchmarks/timelines for follow-up. If necessary, the Mortgagee/Servicer may choose to memorialize in writing any conclusions, agreements, follow-up assignments, information requests, additional meetings schedule, etc.

2. **Ongoing Asset Management Activities (After Project Opening)**

a. General. The Mortgagee/Servicer will monitor the project's performance in accordance with the plan established, and will meet with project participants as scheduled. This includes facilitating the (monthly) Project Monitoring Team meetings, in which the ORCF AE and, where appropriate, other ORCF representatives, will participate, and in which actual progress is compared with projected progress, and any corrective steps are identified, along with persons responsible, target completion dates and benchmarks for progress..as appropriate.

b. IOD tracking. The AE must approve any releases of IOD funds and will seek to ensure that the funds are used judiciously by carefully tracking project performance and the availability of remaining funds. Further information regarding IOD funds is provided in the Escrow Accounts section of this chapter.

c. IOD/Lease-up Tracking Worksheet. A project-specific IOD/Lease-up tracking worksheet will be generated based upon the assumptions regarding the project's lease-up, and is to be completed on a cash basis. The AE will forward the IOD/Lease-up Tracking Worksheet to the Mortgagee/Servicer to be forwarded to the Borrower with other materials for the Pre-Operations Meeting. Mortgagee/Servicers must instruct Borrowers to complete and submit the Worksheet on a monthly basis to the Mortgagee/Servicer, who will review and promptly make available to the ORCF AE. The Worksheet will provide the AE with the project performance documentation and justification necessary for releasing funds from the IOD escrow account. This worksheet should be addressed during the Project Monitoring Team meetings. Note that this worksheet is important in lease-up transactions even when an IOD is not

used; the worksheet serves as an important tool for tracking actual versus projected performance.

d. Operating Reports. The Mortgagee/Servicer and AE need regular project performance data to assess the overall health of the project. The IOD Tracking Sheet will provide them with a trended summary of monthly occupancy, revenue and expenses. The AE might also require that periodic financial statements (e.g., Balance Sheet, Statements of Profit/Loss, Cash Flows, Retained Earnings, Computation of Surplus Cash, AP and AR Aging Analysis) be submitted depending on how the project is performing. The HUD Monthly Accounting Reports (MAR) can provide valuable data as well.

e. Performance on surveys, inspections and certifications. Projects must survive initial regulatory scrutiny. Skilled Nursing Facilities (SNF) in all states undergo initial CMS compliance surveys in addition to Medicare and Medicaid certification reviews. Assisted Living Facilities (ALF) and Board & Care Facilities (B&C) are inspected in accordance with respective state rules. Issues with surveys and inspections can lead to lost or delayed revenues at a point where a new project's financial base is fragile. The Mortgagee/Servicer must communicate closely with Borrowers and Operators to remain abreast of progress on early regulatory reviews and must keep the AE informed.

f. iREMS updates to the project record. The AE must carefully track and summarize project start-up status in iREMS. Monthly entries are appropriate.Achievement of Sustaining Occupancy. For servicing purposes, a project of this type attains Sustaining Occupancy when all escrows established at closing (other than long-term escrows) are released but then only if the project also demonstrates, over a six (6) consecutive month period:

   i. An average Debt Service Coverage Ratio (from operations) equal to or greater than 1.45 (including funding of all required escrows)
   ii. Timely and full mortgage payments on a Finally Endorsed loan, and
   iii. No regulatory issues

When Sustaining Occupancy is acknowledged by the AE, the project, if serviced by a lease-up AE, will generally be transferred to an AE on a regular servicing team for routine monitoring and servicing.

B. **Projects Continuing Existing Operations During Construction.** For Section 232 and 241(a) construction loans where existing operations will continue during construction (including some substantial rehabilitation projects), the AE must begin asset management duties with respect to the new loan immediately after Initial Closing. Typically the ORCF servicing (for both the new loan and, if applicable, the existing loan) will be assigned to an AE on the "lease up" servicing team for these transactions. However, on 241a transactions in which the debt service coverage ratio for both loans exceeds 1.45 based on current revenue, the project will not likely be transferred to a lease-up AE for servicing.

1. General. Servicing of these loans generally involves all the elements and challenges of a new construction transaction, *plus* all the requirements related to ongoing servicing of a project currently in operation. Additionally, the element of construction itself can create risk to the project due to resident, visitor and staff safety issues. Furthermore, renovating existing projects often uncovers project issues that were unknown at the time of underwriting, and the scope, duration and cost of construction sometimes changes. Those unexpected changes may raise asset management issues that require the the Mortgagee/Servicer's and AE's attention.

2. Timing. Upon Initial Closing of the loan the AE, having participated in Loan Committtee and gained information about the transaction, will promptly initiate project communications and commence project monitoring and servicing functions related to the new loan.

3. Initial Meeting. Although not a "Pre-Operations" meeting (as was the case above involving a completely new facility), the AE will confer with the Mortgagee/Servicer regarding first convening an initial meeting (conference call) of the Project Monitoring Team (referenced above in the Introduction, 3.1.1). The Mortgagee/Servicer, in coordination with the AE, will arrange and facilitate this initial meeting. Before doing so, however, the Mortgagee/Servicer will, in coordination with the AE, collect project status information as needed and determine the appropriate participants and agenda. That initial meeting will typically cover, without limitation: Review of issues and plans for resolution
    a. Borrower's summary of the plan to continue operations during construction
    b. Review of issues and plans for resolution, if any
    c. Review the status of all permits (e.g., Certificate of Occupancy, operating license, etc.)
    d. Discussion of working capital and IOD/Lease-up tracking, as applicable
    e. Confirmation or discussion to ensure registration in the BPRS
    f. Assurance of borrower, operator and management agent's familiarity with the requirements of their respective regulatory agreements/certifications and other controlling documents, such as quarterly financial reporting
    g. Status of progress toward final closing
    h. Scheduling of the subsequent (monthly) meeting of the Project Monitoring Team

4. Project Monitoring Strategy and Plan. The Mortgagee/Servicer should ensure that, upon completion of the initial meeting, all participants have a clear understanding of the borrower's/operator's plan/strategy to reach sustaining occupancy, including problems identified, steps to address them, persons responsible, and benchmarks/timelines for follow-up. The Mortgagee/Servicer should memorialize in writing promptly after this meeting (and subsequent monthly Project Monitoring Team meetings) any conclusions, agreements, follow-up assignments, information requests, additional meetings scheduled, etc. The Mortgagee/Servicer should ensure that IOD/Lease-up Tracking Worksheet is updated for these meetings, as a tool for comparing actual versus projected progress.

5. Achievement of Sustaining Occupancy. See definition in Sec. A.2.f above. When Sustaining Occupancy is reached, the project, if it had been with a lease-up AE, will typically be assigned to an AE on a regular servicing team for routine monitoring and servicing.

C. **Projects Having Early Commencment of Construction.** With projects that are approved for early commencement of construction, the AE will be alerted to the project by the Underwriter, and the Construction Manager will monitor the construction activities. If a Firm Commitment is issued, the AE will immediately initiate asset management functions. Similar to other construction loans, the AE will work with the Mortgagee/Servicer, who will, drawing on the Project Monitoring Team, make an initial risk assessment, define a monitoring plan, and specify reports requirements.

After Firm Commitment, projects that have been previously approved for early commencement will thereafter be monitored in accordance with the asset management guidelines above for the specific type of construction loan until the project attains Sustaining Occupancy (as discussed above).

Section 3.2
Escrow Accounts

3.2.1 Introduction

A. **Residential Care Facilities:** An FHA-insured project will typically have one or more of the following types of escrow accounts (each one, hereinafter referred to individually, as an "Escrow Account" and collectively, as the "Escrow Accounts"):

1. Reserve for Replacement (Refer to 3.2.2 below)
2. Residual Receipts (Refer to 3.2.3 below)
3. Non-Critical Repairs (Refer to 3.2.4 below)
4. Sinking Fund (Refer to 3.2.5 below)
5. Mortgage Reserve/Debt Service (Refer to 3.2.6 below)
6. Initial Operating Deficit (Refer to 3.2.7 below)

B. **Escrow Accounts:** Each Escrow Account has a specific purpose, but all such accounts are intended to protect the interest of the Borrower and FHA mortgage insurance fund. Escrow Accounts are either required by Federal regulations, Regulatory Agreements, contractual agreements established during the underwriting of a project loan or contractual agreements executed subsequent to an initial loan closing. The Escrow Accounts are required to be used for specific purposes as outline in this chapter or in the escrow agreement. The disbursement process requires cooperation between ORCF, the Borrower and the Mortgagee/Servicer. This chapter sets forth the general requirements for the maintenance of Escrow Accounts and the procedures to request a withdrawal or disbursement from each of the accounts.

C. **Pending Loan in Review:** If an existing FHA-insured project has a pending application for a 223(a)(7) loan refinance or for any other FHA program, the Borrower must disclose information to the Mortgagee/Servicer and AE on a pending loan application of any request for a disbursement from an Escrow Account. Large unanticipated withdrawal requests may affect the financial information required for ORCF to process the pending loan application.

D. **Specific Escrow Requirements:** ORCF may determine that a requirement that applies to one type of Escrow Account is also applicable to another Escrow Account.

3.2.2 Reserve for Replacement (R4R) Account

A. **Introduction and Applicability.**

The Regulatory Agreement for projects financed with FHA-insured mortgages provides that the Borrower must establish and maintain an account to help defray the costs of replacing a project's capital items (the "Reserve for Replacement Account" or "R4R Account"). The R4R Account is held as a separate account with the Mortgagee/Servicer or in a safe and responsible depository designated by the Mortgagee/Servicer. Initial deposits to the account are to be made in cash at the time of the loan closing, if required. The Borrower is required to begin making monthly deposits into the R4R Account on the date that the Borrower begins making payments to amortize the principal of the FHA-insured mortgage, or on such other date as may be approved by ORCF in writing. The monthly amount to be deposited in the R4R Account is set forth in the Regulatory Agreement which provides that the account is under the control of the Mortgagee/Servicer.

Disbursements from the R4R Account, whether for the purpose of effecting replacement of structural elements or mechanical equipment of a project; to cure a mortgage default; or for any other approved purpose, may be made only with the prior written consent of ORCF (or under the provisions whereby HUD allows Mortgagee/Servicers to review R4R releases outlined in this chapter). For HUD-held mortgages, the Secretary will exercise control over the R4R Account pursuant to the authority granted under the National Housing Act. The following are some of the key requirements for a R4R Account:

1. Custodial Escrow Account. The R4R Account must be maintained as a custodial escrow account. The funds in the R4R Account may be combined or commingled with other escrow accounts; however proper disclosures must be made (form HUD-11720) and the requisite systems must be in place to properly account for each type of escrow.

2. Interest Earned on Account. ORCF encourages and in some cases requires that interest earned on the R4R Account remain in the account. Interest may never be disbursed directly to the Borrower of a project or directly to any individuals associated with the Borrower (except for approved releases pursuant to 3.2.2.H of this Chapter). All interest earned must flow through the accounts of the project and must be disclosed on the project's accounting records.

3. Mortgagee/Servicer Charges for Handling Investments of the reserve fund. If a Mortgagee/Servicer proposes to assess charges for investing the reserve fund, the fees or charges for making or accepting investments must be set forth in an agreement between the Mortgagee/Servicer and the Borrower, and may only be collected according to said agreement.

4. Type of Account. Funds may be deposited with the Mortgagee/Servicer in the form of cash. If funds in the R4R Account and all Escrow Accounts are invested, such funds must be invested in (a) an interest-bearing account insured or guaranteed by the Federal Deposit Insurance Corporation, National Credit Union Association, or any

United States of America insurance program, or (b) obligations of the Federal Government, including money market or other fund accounts limited to investments in such obligations. All funds, whether in the form of a cash deposit or invested in obligations of, or fully guaranteed as to principal by, the United States of America shall at all times be under the control of the Mortgagee/Servicer. ORCF is not establishing specific liquidity requirements for the R4R Account. The Borrower, not the Mortgagee/Servicer, is responsible for deciding the liquidity requirements of funds held in the R4R Account. The Borrower should maintain some portion of its reserves in the form of very liquid assets such as passbook savings accounts. As a guideline only, and depending on the specific project, $1,000/unit should be enough to meet minimum liquidity requirements for some projects.

NOTE: ALL MORTGAGORS SHOULD BE CAUTIONED. If any principal is lost as a result of an early or premature liquidation of an investment that is caused by an owner's requested withdrawal from the R4R Account, the lost principal must be repaid to the R4R Account. This repayment must come from non-project funds and be made by the persons who own the borrower entity, by persons with a controlling interest in the project, or by such affiliated/related parties as the project's sponsors. This caution is particularly important for non-profit mortgagors. Accordingly, the terms and durations of investments should be selected prudently and with great care.

5. Regulatory Agreement Not Modified. Nothing contained in this Section 3.2 shall be deemed to modify the terms and conditions of the Regulatory Agreement.

B. **Realty vs. Non-Realty (a.k.a. Major Movable) R4R Funds.**
ORCF no longer recommends that FHA-insured projects maintain two R4R accounts (realty and non-realty). If the project has two R4R Accounts, the Mortgagee/Servicer, with consent of the Borrower, may combine the two accounts into one account.

C. **Qualified Repair or Replacement Expenses.**
The purpose of the R4R Account is not to provide for a dollar for dollar ability to replace all building structural components and equipment as they wear out, but rather to provide a readily available source of capital to help defray the cost of replacing building structural components and equipment in the latter years of the project. The R4R Account shall not be considered as the primary source of funds for capital project repairs and replacements, but only as a supplemental source of funds. Borrowers should also maintain a repair, maintenance and/or replacement fund in the annual operating budgets of Section 232 FHA-insured projects. The R4R account is also not for routine maintenance. The following are eligible uses ("Qualified Expenses") for the R4R Account:

1. Capital items including, but not limited to:
    a. Replacement of windows in the project.
    b. Extensive replacement of kitchen and bathroom sinks and counter tops, bathroom tubs, water closets, and doors (exterior and interior).
    c. Major roof repairs, including major replacements of gutters, downspouts, and related eaves or soffits.

d. Major plumbing and sanitary system repairs.
e. Replacement or major overhaul of central air conditioning and heating systems, including cooling towers, water chilling units, furnaces, stokers, boilers, and fuel storage tanks.
f. Overhaul of elevator systems.
g. Major repaving/resurfacing/seal coating of sidewalks, parking lots, and driveways of the project.
h. Repainting of the entire building exterior. Major painting of interior spaces, such as all common areas being repainted at one time, may be considered eligible. (Re-painting of individual rooms is considered routine maintenance, and not eligible.)
i. Extensive replacement of siding.
j. Extensive replacement of exterior (lawn) sprinkler systems.
k. Major carpet replacement (e.g. multiple room replacements or entire common area of a project).

Generally, the following items are Qualified Expenses, provided that they are not a routine maintenance item: office/common area/unit equipment, appliances and furniture, nursing/patient care equipment, food service/laundry/housekeeping equipment and appliances, and maintenance equipment.

2. For certain projects, capital improvements or enhancements to the project may be considered as a Qualified Expense. For example, individual air conditioning units may be added to a project that was not air conditioned when it was built; gutters and downspouts may be added where necessary; or an initial purchase of a computer and some associated software may be purchased. However, routine repairs, maintenance and service fees, such as internet fees, web hosting, software-hardware maintenance/updates, proprietary software/vendor fees and related expenses are not Qualified Expenses.

   Some improvements may be eligible if they can be justified to:
   a. result in enhancing the mortgage security, including making the project energy efficient,
   b. upgrade the project and place the project in a more favorable competitive position in the marketplace, and/or
   c. be necessary to comply with changes in local, state or Federal laws.

D. **Non-qualified Expenses:** Items traditionally contemplated as ineligible expenses that may not be paid for with funds from the R4R Account include, but are not limited to the following maintenance items:

1. Repainting of interior areas of projects, including but not limited to, painting of residential units, hallways, community rooms, kitchens, offices, etc. A separate interior painting reserve for this kind of work may be established by mutual agreement and consent of the Borrower, Mortgagee/Servicer and ORCF.

2. Replacement or repairs of a part or a component of range burners, televisions, computers, routers, bibs, oven elements, controls, refrigerators, valves, wiring, etc.

3. Minor replacements of dwelling unit air conditioning components such as fan motors and window unit compressors.

4. Minor repairs to central air conditioning and heating systems such as valve replacements and the cleaning of boiler interiors.

5. Minor roof repairs, including minor repairs to gutters and downspouts.

6. Minor paving or repairs.

7. Minor caulking and sealing. However, caulking or sealing of the entire project to improve energy efficiency is a Qualified Expense.

8. Window and screen repairs.

9. Purchase of minor equipment, furniture, appliances or fixtures or the purchase of maintenance tools and equipment, such as lawn mowers or snow blowers.

10. Inspection/recharging/replacement of fire extinguishers.

11. Minor carpet or flooring repairs. However, carpet or flooring replacement of multiple areas/units or the entire common area of a project is a Qualified Expense.

E. **Adequacy of Reserve for Replacement Account.**
The Borrower must analyze the amounts in a project's R4R Account in the light of anticipated replacement needs (in certain cases ORCF may require that the Borrower perform an analysis of the account). A Borrower shall rely on its knowledge of the physical condition of the project, evaluations made by Operators or Management Agents, and physical inspection reports furnished by the Mortgagee/Servicer and by ORCF. If the Borrower's analysis indicates that it is necessary to increase the rate of deposits into the R4R Account, the Borrower should contact the Mortgagee/Servicer to request authorization to increase the monthly deposit requirement.

F. **Recommended Minimum Threshold.**
Borrowers should submit to maintain a minimum recommended threshold equal to at least $1000 per unit in the R4R Account. For example, the minimum R4R Account balance for a 100-unit project is $100,000. The purpose of the minimum threshold is to ensure that funds are available for an emergency, such as a major roof failure or a water or sewer main break. Failure to maintain the minimum threshold could trigger a discussion by the AE with the Mortgagee/Servicer, and the Borrower to determine whether an increase in the deposit amount is appropriate given the reliance on the fund. If the account regularly falls below the recommended minimum, ORCF may decline to approve a request to withdraw funds from the R4R Account unless in an emergency situation.

G. **Adjustments to Recommended Minimum Threshold**.
The Borrower, Mortgagee/Servicer or ORCF may increase the recommended minimum threshold of $1000 per unit under one or more of the following circumstances:

1. Physical Condition. Projects in poor physical condition, as evidenced by a recent REAC Physical Inspection Score under 60, may require larger balances.

2. Geographical Location. Exposure to severe or unusual weather conditions, as well as the widely varying costs of repairs and replacements.

3. Immediate Replacement Needs. The project is in good physical condition but an unexpected large capital need arises.

4. Changes in Replacement Items. If non-traditional items are to become eligible R4R Account items, the minimum to be held in the account may need to be increased.

H. **Withdrawals from the Reserve for Replacement Account**

1. Borrowers or Operators are to submit Reserve for Replacement (R4R) requests to ORCF through their Mortgagee/Servicer (with the exception of those that can be directly reviewed and approved by the Mortgagee/Servicer, as described in Section 3.2.2.H.5). A checklist of required exhibits to submit for R4R requests will be available on the Section 232 Program website.

2. The Mortgagee/Servicer is to receive the R4R requests, review them for completeness, accuracy and eligibility, and then forward them to ORCF with a recommendation for approval (with the exception of those that can be directly reviewed and approved by the Mortgagee/Servicer, as described in Section 3.2.2.H.5).

3. Typically, R4R releases are made for reimbursement on work that is completed. However, advances may be approved in situations where upfront or partial payments to the contractor(s) are required prior to the work being completed. At the Mortgagee/Servicer's discretion, the R4R may be used to allow for multiple draws or a single draw, depending on the scope of work. For example, draws may be established at 35 percent, 65 percent and 100 percent completion for more substantive repairs.

4. **Additional Considerations**. The following factors will be considered by ORCF in processing a request to withdraw funds from the R4R Account:
    a. Whether the expense is a Qualified Expense, as defined in Section 3.2.2.C.
    b. Adequacy of the funds in the R4R Account.
    c. If the project has an active or pending refinancing/financing application (i.e., 223(a)(7) or other loan program), the Borrower must disclose this information with the request to withdraw funds from the R4R Account.

d. If the submittal proposes remodeling, adding to, subtracting from, reconstructing, or demolishing a portion of the mortgaged project (as discussed further in Section 3.4.4 of this chapter), an environmental review as required by 24 CFR Part 50 will be conducted.
e. **Timing.** It is recommended that requests for withdrawals be made not more often than quarterly. Additionally, requests for withdrawals shall be made no more than one year after the expenditure occurred.
f. **Invoices.** Copies of invoices are not required to be submitted to ORCF if the description of the work done or items replaced is sufficiently detailed to permit an inspection and verification; however, the Borrower must keep copies of the invoices on file for at least three years and have the invoices available for ORCF staff to review

5. **Optional Mortgagee/Servicer Review and Delegated Approval of R4R Requests:** In an effort to streamline operations, decrease response times, and allow ORCF staff to focus on more complex R4R or escrow review requests, there are certain requests that may be approved by the Mortgagee/Servicer, as long as the criteria below are met. Special Requests (see Section 3.2.2.I below) must be submitted to ORCF for processing and approved only by the AE, and are not eligible for Mortgagee/Servicer approval.

   This Mortgagee/Servicer review and delegated approval is not a requirement and is optional for those who agree to administer the review and approvals within the HUD and Section 232 guidelines.

   a. **Delegated Approval Process.** A prerequisite for participation in this process is HUD approval of the Mortgagee/Servicer to participate in this delegated review. If a Mortgagee/Servicer has been approved by Multifamily Housing in accordance with their process related to delegated review of R4R requests, ORCF shall consider the Mortgagee/Servicer approved to perform delegated review of R4R requests for all residential care facility loan types (provided the specifics of the transaction meet the below criteria). If a Mortgagee/Servicer wishes to apply for approval solely to administer R4R Requests on Section 232 projects, the request must be submitted to the HUD (see procedures available on the Section 232 website) LeanThinking@hud.gov email. The request must include a revised Quality Control Plan addressing the items in 5.b-f below. ORCF will retain responsibility for review of R4R requests in all cases where there is an identity of interest between the Borrower, the Mortgagee/Servicer, or affiliates of either.
   b. **Authority.** Delegated Authority is revoked if the project is serviced by ORCF's Risk Mitigation Branch.
   c. **Reimbursements and Advances.** Typically, R4R releases are made for reimbursement on work that is completed. However, advances may be approved in situations where upfront or partial payments to the contractor(s) are required prior to the work being completed. At the Mortgagee/Servicer's discretion, the R4R may be used to allow for multiple draws or a single draw,

depending on the scope of work. For example, draws may be established at 35 percent, 65 percent and 100 percent completion for more substantive repairs.

d. **Minimum Threshold.** The R4R account balance must be at a minimum level of $1,000 per unit after the release.
e. **Modifying the Project.** If the R4R request is for a situation where there is a proposed remodeling, adding to, subtracting from, reconstructing, or demolishing of a portion of the mortgaged project (as discussed further in Section 3.4.4 of this Handbook), the R4R request is not eligible for this optional Mortgagee/Servicer review. Such proposals must be submitted to ORCF for routine processing and approval.
f. **Qualifying Expenditures.** Only qualifying expenditures, as defined in Section 3.2.2.C above, and as eligible and reported on the Funds Authorization (Form HUD-9250-ORCF) and Borrower Certification and Request Detail (Form HUD-9250A-ORCF) may be submitted for reimbursement.
g. **Delegated Approval.** Mortgagee/Servicer will review the request and determine eligibility, and may approve qualifying requests (as described above) by signing the form, noting their Name (also to include Title and Organization), Signature, City, State, and Date in the respective fields.
h. **Notification to ORCF.** Once completed, all Funds Authorizations signed by the Mortgagee/Servicer must then be submitted electronically to ORCF for record keeping. This must be received by ORCF, within seven (7) business days of Mortgagee/Servicer approval.
i. **Surchages and Penalties.** ORCF will not surcharge or penalize Mortgagee/Servicers for approved R4R releases, provided the instructions in this handbook, and on designated HUD forms were followed.

I. **Special Requests**.

1. Request to suspend or reduce monthly deposits into the R4R Account. Generally a request to suspend or reduce monthly deposits will be considered only when the project is in good financial, physical and regulatory standing. The R4R Account balance must be equal to at least sixty (60) months of deposits. Monthly deposits cannot be suspended for more than 12 months at a time. The following items are required to be submitted to ORCF in connection with a request to suspend or reduce monthly deposits into the R4R Account:
   a. Completed Funds Authorization;
   b. Completed Borrower Certification and Request Detail.

   If the request for suspension or reduction in the monthly R4R deposit is being requested because a project cannot currently fund the deposit, the Mortgagee/Servicer and AE will conduct a meeting to discuss the financial situation, cash flow problems and any other concerns leading to this request from the project.

2. Borrowing funds to cover mortgage payments or operating deficits. In extreme cases, ORCF may consider a Borrower's request for a short term loan of funds from the

R4R Account. The purpose should be related to a condition or circumstance beyond the normal control of the Borrower. A request for a loan from the R4R Account may trigger an enhanced analysis of the project. The following items are required to be submitted to ORCF in connection with a request for a short term loan of funds from the R4R Account:

a. Narrative explaining the proposed loan terms, expenses to be paid and the reason for the request (including an explanation of any outstanding ORCF and state compliance issues);
b. Completed Funds Authorization;
c. Completed Borrower Certification and Request Detail;
d. The three (3) most recent monthly financial statements for the project.

All Special Requests are to be submitted via the Mortgagee/Servicer, who must first review them for completeness, accuracy and eligibility, and then forward them to ORCF with a recommendation for approval.

3.2.3 Residual Receipts Account

A. **Definition.**
During the life of an FHA insured mortgage, Residual Receipts are an asset of the Borrower held under the control of ORCF. If a Borrower is required to establish a Residual Receipts Account for a project, the requirement will be set forth in the Regulatory Agreement which will set forth the type of assets that are included in the definition of “Residual Receipts."

B. **Calculation of Residual Receipts.**
The Borrower should use Form HUD-93486 -ORCF Computation of Surplus Cash, Distributions, and Residual Receipts either semi-annually or annually (depending on the Regulatory Agreement for the project) to calculate allowable distributions and any amounts that may be due for deposit in the Residual Receipts Account. Instructions for completing the form are shown on the back of the form and the calculation for distributions must be included in the audited annual financial statements filed with HUD.

C. **Depositing Residual Receipts.**
Residual Receipts must be deposited in a separate Residual Receipts Account, except to the extent that the Non-profit Borrower’s Regulatory Agreement may provide some limited right to retain Residual Receipts. Funds in the Residual Receipts Account may not be combined or commingled with other escrow accounts, including, but not limited to, the accounts listed in Section 3.2.1 above, without the prior written approval of ORCF. The Regulatory Agreement specifies when Residual Receipts are to be deposited into the Residual Receipts Account. The account must be maintained by the Mortgagee/Servicer.

D. **Holding and Investing Funds.**
Funds in the Residual Receipts Account for all projects with FHA-insured mortgages must be invested in, and all interest earned on the investments must be credited to, a financial vehicle that meets HUD approval. Funds in Residual Receipts Account are to be invested and safeguarded by Mortgagee/Servicers and Borrowers in the manner described in Section 3.2.2 of this chapter.

E. **Qualified Uses for the Residual Receipts Account.**
Borrowers may request disbursement of funds from the Residual Receipts Account for the following purposes:

1. To reduce operating deficits when legitimate cash flow deficits exist.

2. To make mortgage payments when a mortgage default has occurred or is imminent.

3. To make repairs or replacements to the project that are not covered by the R4R Account described in Section 3.2.2 above.

4. To provide additional project amenities such as air conditioning, a sprinkler system, fire or smoke detectors, or energy saving devices as well as office equipment such as computers and associated software.

5. For other expenses deemed necessary, and in the best interest of the project as determined by ORCF and the Mortgagee/Servicer. Generally, all expenses which qualify for reimbursement under the R4R Account may also be reimbursed from funds in the Residual Receipts Account.

F. **Withdrawals from the Residual Receipts Account.**

The Mortgagee/Servicer must submit the following (provided by the Borrower):

1. Required Documents. A checklist of required exhibits to submit to ORCF for withdrawals from the Residual Receipts Account will be available on the Section 232 Program website. Requests are to be submitted via the Mortgagee/Servicer, who must first review them for completeness, accuracy and eligibility, and then forward them to ORCF with a recommendation for approval.

2. Additional Considerations. The following issues will be considered by ORCF in processing a request to withdraw funds from the Residual Receipts Account:

    a. Whether the expenses are qualified items to be paid from the account.
    b. If the submittal proposes remodeling, adding to, subtracting from, reconstructing, or demolishing a portion of the mortgaged project (as discussed further in Section 3.4.4 of this chapter), an environmental review as required by 24 CFR Part 50 will be conducted.

3.2.4 Non-Critical Repair Escrow Account (NCRE)

A. **Applicability:** Non-Critical Repair Escrow ("NCRE") Accounts are established during the underwriting of a project and funded at Closing. The funds in the NCRE Account are intended to pay for repairs identified in the Escrow Agreement for Non-Critical Repairs (the "NCRE Agreement"). Generally, the repairs must be completed within 12 months from the date of the NCRE Agreement. The specific requirements and conditions for the completion of the repairs are set forth in the NCRE Agreement.

B. **Depositing, Holding and Investing**: Funds in the NCRE Account must also be deposited, held and invested in accordance with the requirements set forth in Section 3.2.2 of this chapter. However, since the funds are intended to be disbursed within a 12 month period, they must be deposited in an account that can be withdrawn from or immediately accessed in the full amount. Depositing NCRE Account funds in a long-term investment account is not recommended.

C. **Interim Draws and Closeout of the NCRE Account**

1. Interim Draws: At the Mortgagee/Servicer's option, the NCRE Account may be established to allow for multiple draws or a single draw, depending on the scope of work. For example, draws may be established at 35 percent, 65 percent and 100 percent completion for more substantive repairs.

2. Holdback/Retainage: HUD does not require a holdback/retainage on interim draw releases, however, the Mortgagee/Servicer may require a holdback/retainage at their discretion.

3. Advances: Typically, draws are approved for reimbursement on work that is completed. However, advances may be approved in situations where upfront or partial payments to the contractor(s) are required prior to the work being completed.

4. Review of Proposed Draws and Closeout: When determining whether to approve a proposed interim draw or final draw (closeout) of the NCRE, the Mortgagee/Servicer shall review the submission from the borrower to determine whether there is adequate documentation to evidence that the repairs/improvements associated with the requested release were completed (or there is evidence that an advance is required per Section 3.2.4.C.3. above). With the exception of NCRE accounts administered by the Mortgagee/Servicer under Section 3.2.4.H, the requests are to be submitted via the Mortgagee/Servicer, who must first review them for completeness, accuracy and eligibility, and then forward them to ORCF with a recommendation for approval (submitted electronically in accordance with the instructions on the Section 232 program website). A checklist of documents for review will be available on the Section 232 Program website.

D. **Latent Defects Deposit.** A Latent Defects Deposit is required when the total cost of the non-critical repairs is equal to or exceeds $1,000,000. The Latent Defects Deposit is calculated at 2.5% of total amount of repairs and is held by the Mortgagee/Servicer to be released to the borrower upon the later of : (i) 15 months from the completion of repair work, or (ii) at such time the latent defects have been corrected to the satisfaction of ORCF.

E. **Change of Scope of Repairs.** The Mortgagee/Servicer must request approval from ORCF for proposed revisions to the scope of the required repairs/improvements (submitted electronically by the Mortgagee/Servicer, in accordance with the instructions on the Section 232 program website). For such a request, the following must be submitted:

1. A narrative detailing why a change of scope is requested; or the reason that some or all of the non-critical (and/or Borrower elective) repairs were not completed, as applicable.

2. Copy of the original NCRE Agreement.

3. Certification from an individual determined to be qualified by the Mortgagee/Servicer (e.g. PCNA provider, lender construction analyst, architect, engineer). The certification must provide that: failure to complete the non-critical repairs will have no serious negative impact on the condition of the project; and the project, as completed, is in compliance with local building and zoning codes, and/or state regulations. Changes to Borrower elective repairs will not require a certification.

F. **Timing of Completion of Repairs and Extensions** – All repairs must be completed within the 12 month prescribed time period, unless otherwise provided in the NCRE Agreement. The Mortgagee/Servicer may provide a six-month extension at their discretion without ORCF approval where the borrower demonstrates adequate justification. Notification of the six month extension must be submitted to ORCF (see procedures available on the Section 232 website). Any extension beyond six months requires Mortgagee/Servicer review and recommendation to ORCF for approval (submitted electronically by the Mortgagee/Servicer, in accordance with the instructions on the Section 232 program website). Under no circumstances may an extension beyond 12 months be made for repairs necessary to correct accessibility deficiencies. All such repairs must be made within the time periods prescribed in the Accessibility Matrix for Section 232.

G. **Excess Funds at Closeout** - In cases where the actual cost of the repair work is less than estimated, any resulting excess funds in the escrow attributable to the Repair Estimate amount that were funded from loan proceeds may be used for the following purpose(s):

a. to pay for additional repairs approved by Mortgagee/Servicer and ORCF,
b. to reduce the outstanding Loan balance; or
c. to deposit in the R4R.

ORCF may also require that certain repairs be completed when the specified repairs are deemed necessary for the proper operation of the facility, for resident care and/or if the repairs are needed to comply with local and state regulations.

H. **Optional Process for Delegated NCRE Administration to Mortgagees/Servicers.**

1. **Purpose and Background.**
   This optional process applies only to residential care facility transactions originated under Sections 223(f) and 223(a)(7). A prerequisite for participation is HUD approval of revisions to the Mortgagee/Servicer's Quality Control Plan incorporating the requirements of this Handbook.

2. **Mortgagee/Servicer Approval Process**
   If a Mortgagee/Servicer is approved by Multifamily Housing in accordance with Notice H2013-14 for delegated NCRE administration, ORCF shall consider the Mortgagee/Servicer approved to perform delegated NCFE administration for the loan types referenced in the previous paragraph. If a Mortgagee/Servicer wishes to apply for approval solely to administer NCRE's on residential care facilities, the request must be submitted to HUD (see procedures available on the Section 232 program website).

   ORCF will retain responsibility for release of non-critical repair escrow funds in all cases where there is an identity of interest between the Borrower, the Mortgagee/Servicer, or affiliates of either.

   Delegated Authority is revoked if the project is serviced by ORCF's Risk Mitigation Branch.

3. **General Requirements.**
   Should the Mortgagee/Servicer elect to take responsibility for this task (and receive HUD approval to do so), HUD will not charge an inspection fee on Section 232, pursuant to Section 223(f), transactions. Section 223(a)(7) transactions do not require an inspection fee. ORCF has not established a minimum or maximum repair/improvement amount on which this delegated process may be used.

   This delegated authority allows the Mortgagee/Servicer to review and approve all interim draw requests and the close-out of the account. Under this delegated authority, the request to close-out the account must include a report from an individual determined to be qualified by the Mortgagee/Servicer (e.g. the PCNA provider, lender construction analyst, architect or engineer), indicating they have performed an inspection and all required repairs or improvements have been acceptably completed. No such inspection or report is required for interim draws; however, at the Mortgagee/Servicer's discretion, interim inspections may be conducted.

4. Interim Draws and Closeout of the NCRE Account, Latent Defects Deposit, and Change of Scope of Repairs shall be addressed in accordance with the provisions above in Section 3.2.4.C through G of this section.

5. The Mortgagee/Servicer is delegated to approve the final close-out of the NCRE. The request to close-out the account shall follow the same procedure as outlined above.

6. If there is a Latent Defects Deposit remaining after the close-out of the account, such Latent Defects Deposit may be reviewed and released by the Mortgagee/Servicer after the required seasoning period has passed. No further documentation on this is required to be sent to ORCF.

7. Copies of the final fully executed HUD-92464-ORCF and HUD-92117-ORCF (without attachments) and final inspection report must be submitted electronically to ORCF within seven (7) business days of the Mortgagee/Servicer's final approval.

   The Mortgagee/Servicer must keep electronic or hard copies of the documentation related to any NCRE accounts administered by the Mortgagee/Servicer under this delegated process for at least three years.

3.2.5 Sinking Fund

A. **The Sinking Fund Agreement** is the controlling document for the Sinking Fund. The Sinking Fund Account must remain in compliance with the Sinking Fund Agreement. ORCF must be promptly notified by the Mortgagee/Servicer in the event of any breach by the Borrower of the Sinking Fund Agreement and the Mortgagee/Servicer must further agree to seek specific performance or other injunctive relief for any breach.

B. **Requests for Withdrawal from the Sinking Fund Account.** Withdrawals from the Sinking Fund Account may only be made for the specific purposes stated in the Sinking Fund Account Agreement. Requests are to be submitted via the Mortgagee/Servicer, who must first review them for completeness, accuracy and eligibility, and then forward them to ORCF with a recommendation for approval. A checklist will be available on the Section 232 Program website.

C. **Requests to close a Sinking Fund Account prior to expiration.** Generally a request to close the account prior to expiration of the mortgage is submitted when the state Medicaid provider, where the project is located, no longer requires the maintenance of a Sinking Fund Account, and the project is in good physical and financial condition. Since a Sinking Fund Account is beneficial to the interests of the Borrower, Mortgagee/Servicer and HUD in the latter years of a mortgage, a state rule eliminating the Sinking Fund Account does not automatically modify or remove this requirement for FHA-insured projects. Requests are to be submitted via the Mortgagee/Servicer, who must first review them for completeness, accuracy and eligibility, and then forward them to ORCF with a recommendation for approval. A checklist will be available on the Section 232 Program website.

3.2.6 Debt Service Escrow and Long-Term Debt Service Reserve Accounts

A. **Applicability.** In specific instances, ORCF may have a Long-Term Debt Service Reserve account established at closing (See Production, Chapter 2). This account is a mortgageable item and is controlled by the terms of the Borrower Regulatory Agreement. This account is different from a Debt Service Escrow account, which is for a shorter term, is funded by the Borrower, and is governed by a separate escrow agreement. The Long-Term Debt Service Reserve Escrow Account, if required, is established during the underwriting of a project either at initial or final closing. Each of these accounts is intended to provide Borrowers with an extra "cushion" to meet debt service payments on the FHA-insured mortgage and thus, safeguard the project's financial viability. Funds in these accounts are to be used exclusively for payments of principal and interest on the Mortgage Note, or to meet project escrows such as insurance premiums, real estate taxes or special assessments.

B. **Holding and Investing Funds.** Generally, the requirements of Debt Service Escrow Account are set forth in the Escrow Agreement, and the requirements of the Long-Term Debt Service Reserve Account are set forth in the Borrower Regulatory Agreement. The funds in these accounts are to be invested and safeguarded by Mortgagee/Servicers and Borrowers in the manner described in Section 3.2.2 of this Handbook. The procedures and sanctions described in Section 3.2.2 also pertain to these accounts.

C. **Request for Withdrawal:** Requests are to be submitted via the Mortgagee/Servicer, who must first review them for completeness, accuracy and eligibility, and then forward them to ORCF with a recommendation for approval. A checklist will be available on the Section 232 Program website.

> **SPECIAL NOTE:** Any request deviating from the Mortgage Reserve/Debt Service Reserve Agreement, or any amendments and schedules thereto, shall be closely analyzed by ORCF. The approval will be conditioned with a full repayment of the funds to the account within a reasonable time frame.

D. **Additional Considerations.** The following issues will be considered by ORCF in processing Mortgage Reserve/Debt Service Reserve Account.

- Financial and Physical Condition of the Project.
- Open ORCF and State compliance Issues.
- Other relevant issues, information or documents as determined by ORCF.

3.2.7 Initial Operating Deficit (IOD) Escrow

A. **Applicability.** Initial Operating Deficit (IOD) Escrow Accounts are restricted accounts that are primarily designed to allow or assist the project in achieving sustained occupancy and adequate revenue. Disbursements from the IOD Escrow Account may be authorized monthly, commencing upon the issuance of the Certificate of Occupancy, by ORCF to meet any cash deficit in the operation of a project for the period immediately following substantial completion of construction. Requests are to be submitted via the Mortgagee/Servicer, who must first review them for completeness, accuracy and eligibility, and then forward them to ORCF with a recommendation for approval.

B. **SPECIAL NOTE**: The IOD Escrow Account is a part of the project's necessary start-up working capital. ORCF does not consider depreciation, officers' salaries, and identity of interest management fees to be reasonable operating expenses; therefore, funds in the IOD Escrow Account may not be used cover those costs.

Section 3.3
Prepayment Provisions and Prohibitions

3.3.1 Introduction

Applicability. The Residential Care Facilities Program permits Lenders to insert prepayment lockouts and penalties into the FHA-insured Note for the benefit of the source of the financing in accordance with the guidelines set out in Production, Chapter 3. Prepayment request review procedures are as follows.

3.3.2 Prepayment Procedures

HUD must receive notification in writing from the Mortgagee/Servicer, requesting to prepay a loan insured by FHA (or voluntarily terminate its mortgage insurance). The Mortgagee/Servicer is to receive the requests, review for completeness, accuracy and eligibility, and then forward to ORCF with a recommendation for approval.

The following are the steps for processing a request for prepayment of an FHA-insured mortgage or a voluntary termination of mortgage insurance:

A. Mortgagee/Servicer submits the Insurance Termination Request for Multifamily Mortgage form (Form HUD-9807) (without Block 5 completed) to the Multifamily Insurance Operations Branch in HUD Headquarters. That Office forwards a copy of the form and supporting documentation to the ORCF, which will verify that there are no prepayment restrictions for the particular project. In most cases, HUD Counsel review will not be required, but ORCF will coordinate as necessary.

B. The following must accompany the Insurance Termination Request for Multifamily Mortgage request from the Mortgagee/Servicer:

- Mortgage,
- Mortgage Note,
- Deed of Trust,
- Deed of Trust Note,
- Riders,
- Any Allonges or Amendments,
- Regulatory Agreement,
- Trust Indenture (if the Project is bond financed),

- Any secondary financing and status,
- Use restrictions, and
- Any special requests from the Mortgagee/Servicer or Borrower.

Review of the prepayment request by HUD cannot begin without the above information, along with the executed Insurance Termination Request for Multifamily Mortgage form. The complete submission of the documents is the responsibility of the Mortgagee/Servicer.

C. ORCF will ensure the following:

1. Determine if prepayment falls within any lockout period;

2. Determine status of any secondary financing and review the HUD asset management system (iREMS);

3. Determine any outstanding Departmental Enforcement Center (DEC) or Office of Inspector General (OIG) investigations, based on iREMS; if any exist, obtain input from the appropriate Division on prepayment approval.

4. Address any special requests the Mortgagee/Servicer may have prior to closing. Termination of the Borrower Regulatory Agreement would be deemed a special request, and would need to be prepared by HUD's Office of General Counsel.

D. The Office of Multifamily Insured Operation Branch will perform an audit of the loan(s) to calculate the estimation of payoff (based on projected closing date) and any refund due to the Project for overpayment of MIP, if applicable.

E. The Mortgagee/Servicer must ensure the Office of Multifamily Insured Operation Branch is notified of the closing date that is scheduled by the Project's counsel (and bond issuer, if applicable).

F. For closing and bond defeasance, the bond issuer defeases the bonds and sends HUD the complete Form 9807. Prior to closing the Mortgagee/Servicer must coordinate with the Multifamily Insured Operation Branch Chief to ensure timely processing of the Form 9807.

G. ORCF will reflect the prepayment once the Office of Multifamily Insured Operation Branch has confirmed that the payoff occurred. The AE must update iREMS to ensure the Project no longer is required to submit financial statements (if fully terminated from FHA-insurance) and document that the prepayment has occurred. Special care must be taken to ensure the Project is fully terminated from FHA-insurance prior to making updates to iREMS. For example, a refinance under Section 223(a)(7) involves a payoff of the existing loan, but the refinanced loan is still required to submit financial statements.

3.3.3 Prepayment Lock Outs and Penalties

A. Language allowing HUD to override the prepayment lockout and/or penalty provisions in the event of a default is included in the Healthcare Facility Note (Form HUD-94001 ORCF). The Mortgagee/Servicer is to receive the requests, review for completeness, accuracy and eligibility, and then forward to ORCF with a recommendation for approval.

B. Where these restrictions exist, and the Mortgagee/Servicer does not waive its optional prepayment or lockout penalty provisions, in rare circumstance HUD would consider exercising an override of a Mortgagee/Servicer's prepayment lock-out or penalty provision in order to avoid a full claim. Any override to the lockout must receive approval by the Deputy Assistant Secretary for OHP. Generally speaking, these projects will be in, or transferred to, the Risk Mitigation Branch portfolio due to the troubled nature of the project. As part of the workout necessary to avoid a claim, a background memo is prepared from the Risk Mitigation AE, explaining the circumstances justifying the request. Consideration must be given to all of the following, in providing such justification:

    1. The Borrower has defaulted and HUD has received notice of such default as required by the regulations.

    2. HUD determines that the project has been experiencing a net income deficiency that was not caused solely by management inadequacy or lack of Borrower interest and that is of such a magnitude that the Borrower is currently unable to make required debt service payments, pay all project operating expenses, and fund all required reserves.

    3. HUD finds there is a reasonable likelihood that the Borrower can arrange to refinance the defaulted loan at a lower interest rate or otherwise reduce the debt service payments through partial prepayment.

    4. HUD determines that refinancing the defaulted loan at a lower rate or partial prepayment is necessary to restore the project to a financially sound condition and to avoid an insurance claim.

C. ORFC must be satisfied that the Borrower in these circumstances did not intentionally cause a default in order to obviate prepayment penalties or lockout provisions.

Section 3.4

Request to Release or Modify Original Loan Collateral

3.4.1 Introduction

A. From time to time the collateral securing a FHA-insured mortgage needs to be modified or released. The Regulatory Agreement provides language requiring prior HUD approval of a revision to the security or collateral, including the following:

1. Reduction, Addition, or Sale of Beds (Please refer to 3.4.2 below)

2. Easements, Eminent Domain, or Sale of Land or Other Security (Please refer to 3.4.3 below)

3. Remodeling, Adding to, Subtracting From, Reconstructing, or Demolishing Portions of the Mortgaged Project (Please refer to 3.4.4 below)

B. A checklist of required exhibits to submit to HUD in each situation will be available on the Section 232 Program website.

3.4.2 Reduction, Addition, or Sale of Beds

A. **Applicability**: Licensed beds are valuable project assets securing the mortgage. Any time the number of licensed beds in the project are being reduced or increased, the value of the mortgaged project may be affected.

B. **Additional Considerations:** The following issues will be considered by ORCF in processing a Reduction or Increase of number of beds:

1. Financial and Physical Condition of the Project.

2. Open HUD and State Compliance Issues.

3. Project's PCNA (Physical Condition and Needs Assessment). If PCNA is more than 10 years old, ORCF may require a new PCNA to be performed.

4. The value of the remaining project after approval will be unaffected or the value will still be sufficient to cover the remaining balance of the mortgage.

5. Other relevant issues, information or documents as determined by ORCF.

6. ORCF will engage the services of HUD OGC (and as needed, OHP Architecture & Engineering, and/or Appraisal teams) to review all legal and technical issues.

7. In processing release of collateral requests in which funds are being received for the sale of beds, ORCF will expect to receive market value for the released collateral and the funds will be directly applied to the mortgage balance. Any deviation from this (including deposits into the R4R Account) must be expressly approved by ORCF.

C. **Processing Time.** The concurrent reviews by HUD OGC and OHP Architecture & Engineering, if required, will affect the length of processing time.

D. **Other ORCF Requirements.** It should be noted that in all increase or reduction of licensed bed requests, ORCF may require or request additional relevant documents or information. The Mortgagee/Servicer is to receive the requests, review for completeness, accuracy and eligibility, and then forward to ORCF with a recommendation for approval.

3.4.3 Easement, Eminent Domain, or Sale of Land or Other Security

A. **Applicability.** The Regulatory Agreement provides that the Borrower shall not, without the prior written approval of HUD, convey, transfer, or encumber any of the mortgaged project. Generally, there are two types of partial release of security requests. Negotiated release is when the transaction is voluntarily negotiated between the parties. Involuntary or eminent domain action is when a state, municipality or other public agent exercises its function to use a project asset for public use. In both situations, the project must be compensated for the asset appropriated or affected (Please see Section 232 Program website). The Mortgagee/Servicer is to receive the requests, review for completeness, accuracy and eligibility, and then forward to ORCF with a recommendation for approval.

B. **Negotiated or Voluntary Partial Release of Security.** This can include the sale of a portion of project land, part of a building, major assets, etc. Note: Although Easements and Right of Ways are not technically a release of security, the approval requirement in this sub-chapter will be applicable. Normally, ORCF will consider approving such requests when:

1. The quiet enjoyment of the present tenancy will not be negatively affected.

2. The amount of the reimbursement (or sale) is greater than or equal to the ORCF-determined value of the severed portion at the time of severance.

3. The value of the project will be unaffected by the partial release of security or the value will increase as a result of it.

4. The terms of the sale are cash.

5. The security to be released is not in place to mitigate an environmental condition on the site.

C. **Additional Considerations.** The following issues will be considered by ORCF in processing a Partial Release of Security request:

1. Financial and Physical Conditions of the Project.

2. Open HUD and State compliance Issues.

3. Project's PCNA (Physical Condition and Needs Assessment). If PCNA is more than 10 years old, ORCF may require a new PCNA to be performed.

4. The value of the remaining project after approval will be unaffected by the partial release of security or the value will still be sufficient to cover the remaining balance of the mortgage.

5. Other relevant issues, information or documents as determined by ORCF.

6. ORCF may also engage the services of the HUD OGC, the OHP Architecture & Engineering, and/or Appraisal teams to review all legal and technical issues.

7. If Ginnie Mae securities are involved, the Mortgagee/Servicer must ensure compliance with Ginnie Mae.

8. In processing Partial Release of Security requests in which funds are being received, ORCF will expect to receive market value for the released collateral and the funds will be directly applied to the mortgage balance. Any deviation from this (including deposits into the R4R Account) must be expressly approved by ORCF.

D. **Processing Time.** The concurrent reviews by HUD OGC and OHP Architecture and Engineering, if required, will affect the length of processing time.

E. **Involuntary or Eminent Domain Partial Release of Security**. As soon as an involuntary partial release is known, the Borrower, Operator, Management Agent and/or Mortgagee/Servicer shall immediately notify ORCF. A copy of all received notices, documents, plans, proposals, or documents related to the proceeding, shall immediately be given or forwarded to ORCF. Urgency is required, because when a portion of the mortgaged project is taken by a public authority through the use of condemnation proceedings, such taking can be without the prior approval of either the Mortgagee/Servicer or ORCF.

If ORCF's field review indicates that the proposed condemnation has the potential to cause default of the mortgage or negatively impact on the quiet enjoyment of the intended purpose, as early as possible in the process, ORCF field staff must consult with the Director, Asset Management and Lender Relations immediately.

3.4.4 Remodeling, Adding to, Subtracting from, Reconstructing, or Demolishing Portions of the Mortgaged Project

A. **Applicability.** The various forms of Borrower and/or Operator Regulatory Agreements existing on residential care facility projects require written approval from HUD prior to remodeling, adding to, subtracting from, reconstructing, or demolishing a portion of the mortgaged project. The Mortgagee/Servicer is to receive the requests, review for completeness, accuracy and eligibility, and then forward to ORCF with a recommendation for approval. "Remodeling" for purposes of this Section is defined as repairs/improvements that constitute "Substantial Rehabilitation" – as defined in the Production, Chapter 2.6.B. This chapter provides instructions on submitting a request for partial release of security from the insured mortgage. (See Section 3.4.3 of this chapter - Easement, Eminent Domain, or Sale of Land or Other Security).

B. **Prior Approval.** It is important that no major capital additions or reductions are performed without prior ORCF consent. However, in some instances when the additions or reductions were already completed without prior ORCF approval, a retroactive approval may be available. The same documents required in this section must be submitted. It should be noted although a retroactive approval is being processed, ORCF reserves the right to enforce its regulatory authority.

C. **Additional Considerations.** The following issues will be considered by ORCF in processing a request for Major Capital Additions or Reductions of the mortgage security:

1. Financial and Physical Condition of the Project.

2. Open ORCF and State Compliance Issues.

3. Project's PCNA (Physical Condition and Needs Assessment). If PCNA is more than 10 years old, ORCF may require a new PCNA to be performed.

4. The value of the remaining project after approval will be unaffected by the Major Capital Addition or Reduction, or the value will still be sufficient to cover the remaining balance of the insured mortgage.

5. Other relevant issues, information or documents as determined by ORCF.

6. ORCF may also engage the services of the HUD OGC and OHP Architecture and Engineering and/or Appraisal teams to review all legal and technical issues.

7. An environmental review as required by 24 CFR Part 50 will be conducted on any proposal for remodeling, adding to, subtracting from, reconstructing, or demolishing a portion of the mortgaged project.

D. **Processing Time.** The concurrent reviews by HUD OGC and OHP Architecture and Engineering if required, will affect the length of processing time.

3.4.5 Surplus Cash Note Request

Upon receipt of a request for a Surplus Cash Note from the Borrower, the Mortgagee/Servicer will review the request for completeness, accuracy and eligibility, determine cause for the Note, and provide any necessary supporting information to the AE, along with a recommendation for approval, modification or rejection. A checklist will be made available on the Section 232 Program website.

Section 3.5
Nursing Home Surveys and Licensure

3.5.1 Introduction

The ORCF insures mortgages for skilled nursing facilities. This type of project is licensed, highly regulated, and routinely monitored by the State in which the project is located. Maintaining ongoing compliance with the State is critical in ensuring the quality of care provided to the residents and the success of the project over the life of the mortgage.

ORCF does not intend to intervene between the State and another Federal agency. ORCF monitors the FHA-insured portfolio and when it is clear that the project is not able to come into compliance, the project will be turned over to the Risk Mitigation Branch for special servicing and work-out efforts. Since the license is collateral for the FHA-insured mortgage, it is critical that the license remains intact and the residents of FHA-insured projects receive safe, sanitary, and decent housing.

This chapter will provide an overview of the inspection process and other tools the Center for Medicare and Medicaid Services (CMS) uses to rate and rank projects in order to help consumers, their families, and caregivers compare nursing homes in a specific area.

3.5.2 State Licensing and Surveys Overview

CMS contracts with each State to provide nursing home surveys that ensure that minimum Medicare and Medicaid quality and performance standards are being met. CMS, a part of the Federal government, certifies projects to receive payments from Medicare and Medicaid. Once certified the project is then a nursing home provider for Medicare and Medicaid services. Each State government oversees the licensure process for each project with that State. There are over 150 regulatory standards that nursing homes must meet at all times in order to ensure quality and performance standards. Meeting these minimum standards allows a project to receive Medicare and Medicaid payments and remain licensed with each State. If the regulatory standards are not being met, as shown through the survey process, then CMS can impose penalties, remedies or sanctions and possibly revoke all Medicare & Medicaid funding.

3.5.3 State Inspection Process

Nursing Home State Surveys and Health Inspection are two terms that describes the nursing home State Inspection process and the terms are often used conterminously, in conjunction and/or separately from each other (e.g., State Survey, Health Inspection Survey, State Health Inspection, State Inspection, etc.). States contract with CMS to monitor nursing homes that provide care to individuals that receive Medicare and Medicaid. Health Inspections of nursing homes are conducted routinely, about every 9-15 months, by the State survey team. The State will perform more frequent survey inspections if there are complaints or the project is poorly performing. During the nursing home inspection process the State reviews many aspects of quality and performance standards. The survey is comprised of an inspection team that is normally made up of trained inspectors which include but are not limited to a registered nurse, a licensed or certified social worker and a certified life safety code inspector. Surveys are performed unannounced to the project and can be performed 24 hours a day and can fall on any of the 365 calendar days. A survey generally lasts 3-5 days which can include non-business hours and/or weekends. The survey team routinely ensures residents are safe and free from immediate jeopardy. If severe deficiencies are found which has risen to the level of harm or immediate jeopardy then the survey may be extended. The survey team follows the survey process and evaluates whether the project is meeting individual resident needs and providing quality of care as defined by CMS. The survey covers various aspects of a resident's stay within a nursing home such as resident life, quality of care, safe and sanitary food preparation processes, staff/resident interactions, environment, policy and procedures and, among numerous others, abuse and neglect.

When an inspection team finds that a project does not meet a regulatory standard they issue a deficiency/citation. The State routinely allows 45 days from the date of the survey to correct deficiencies. The State also requires the project to provide a statement of correction to prevent the deficiency from occurring in the future. The State may follow up at the project by conducting another unannounced visit to the project or completing a desk review. If the deficiency is not corrected then the State recommends appropriate enforcement actions to the State Medicaid agency for Medicaid and to the regional office for Medicare. The CMS regional office determines a project's eligibility to participate in the Medicare program based on the State's survey results and the project's compliance. If the regulatory standards are not being corrected then CMS can, depending on the severity of the violation, take action against the nursing home including imposing various remedies and possibly revoking all Medicare and Medicaid funding.

Nursing home surveys are posted on the Medicare.gov website.

3.5.4 State Inspection Process (Life Safety)

To be eligible to be a Medicare & Medicaid Nursing Home Provider the project must be in compliance with the 2000 edition of Life Safety Code (LSC). Projects that have waivers of the health occupancy provisions of the LSC or an acceptable Plan of Correction (POC) are also

considered in compliance. The LSC is a set of fire protection requirements that provides a reasonable degree of safety from fire.

The LSC only uses qualified fire safety inspectors to perform the Life Safety Survey. The nursing home must also meet the minimum Life Safety Code at all times and will receive deficiencies for non-compliance of the Life Safety Code. The LSC inspectors will make reports and recommendations to the State agency. The State routinely allows time to correct a deficiency. If the regulatory standards are not being corrected then CMS can, depending on the severity of the violation, take action against the nursing home including imposing various remedies and possibly revoke all Medicare & Medicaid funding.

The Life Safety Surveys are located on the Medicare.gov website.

3.5.5 Quality of Care Provided to the Residents

The survey process each project undergoes is an effort of CMS to oversee that quality of care is being given to each resident. CMS has established Quality Measures that are used during the survey. These Quality Measures are measurable, valid, reliable and are submitted to CMS on a routine basis. The nursing home quality measures come from actual residents that stay within each project. This data is routinely collected and measures the resident's physical and clinical conditions and abilities, as well as preference and life care wishes. This data is further converted to allow consumers to another source of information that shows how well nursing homes are caring for their resident's physical and clinical needs. This data can be viewed on the Medicare.gov website.

3.5.6 Star Rating

CMS created a Five-Star Quality Rating System. This system is intended to assist family members, consumers and care givers to compare nursing homes more easily and help identify questions that they may wish to ask. The Five-Star Quality Rating System is located on the Medicare.gov website. The website has a quality rating system that gives each of the 4 categories between 1 and 5 stars. Nursing homes with 5 stars are considered to have "much above average" quality and a nursing home with a 1 star rating is considered to have quality "much below average". Though the categories and desciptions are subject to change, and the Medicare website is the most current and accurate location to read about details, at the time of publication, the four categories of the Star Rating are Overall, Health Inspections, Staffing, and Quality Measures. The actual star rating is based on technical guidelines to establish each star rating.

Overall Star Rating: Takes into account the other categories (e.g. Health Inspections, Staffing and Quality Measures) and then gives an Overall Star Rating for the project.

Health Inspection: The health inspection rating contains information from previous years of onsite inspections, including both standard surveys and any complaint surveys. The most recent survey findings are weighted more than the prior years, based on the technical guidelines.

Staffing: The staffing rating has information about the number of hours of care on average provided to each resident each day by nursing staff. This rating considers differences in the level of need of care of residents in different nursing homes.

Quality Measures: The quality measure rating has information on different physical and clinical measures for nursing home residents. This information is collected by the nursing home for all residents. The Quality Measures offers information about how well nursing homes are caring for their residents' physical and clinical needs.

The Star Rating can be viewed on the Medicare.gov website.

3.5.7 Special Focus Designation

CMS has a Special Focus Facility Initiative that places a nursing home, with a history of serious quality issues, into a special program that is meant to stimulate the project to improve their quality of care to residents (see also, Section 3.10.4). Most of the projects placed on the Special Focus Facility Initiative Program have previously shown the following within the past three year survey history:

A. Surveys have twice the amount of deficiencies as other nursing homes.

B. More serious survey deficiencies than most other nursing homes. These deficiencies would include Harm and Injury experienced by the residents.

C. A pattern of problems that persisted over the past 3 years of surveys.

These projects are visited twice as often as regular projects (twice per year). Enforcement action becomes more stringent as more problems continue. There are three options after the project has been in the program and within the 18-24 month timeframe:

1. **Improvement and Graduation**: The project advances to an Improved Status and eventually Graduates from the program. This project would resume annual surveys and continue being a Medicare and Medicaid Provider.

2. **Termination**: This project has not met the criteria to graduate from the Special Facility Program, is not making progress and is terminated from providing services to Medicare and Medicaid recipients.

3. **Extension of Time**: An extension of time can be given to a project that is showing improved progress but not enough progress to advance to Improving/Graduated status. An extension of time could also be granted if there is a sale of the project.

Special Focus Designation can be found on the www.CMS.gov and http://www.medicare.gov/ website.

All Special Focus Facilities will be serviced by the Risk Mitigation Branch.

Section 3.6

Approval to Participate in HUD Programs - APPS and BPRS

3.6.1 Overview

A. The Office of Healthcare Programs' Section 232 Program requires participants in a proposed transaction to submit certain types of forms containing information. This information is requested in order to demonstrate to HUD their experience and the team of people who are planning to own, operate or manage a project with a Section 232 FHA-insured mortgage. Application submission requirements are contained in the application exhibits for new endorsement in accordance with the appropriate Section of the Act, including but not limited to, resumes, credit reports, and project licenses. In addition to proposed applications for a FHA-insured mortgage, a proposed change of Borrower (Transfer of Physical Assets), Change of Operator, or Change of Management Agent require approval by ORCF. These requirements can be found in Asset Management, Chapter 7 and Chapter 8.

B. Regardless of the proposed transaction or event that triggers participant approval (i.e. newly proposed FHA mortgage insurance requests or change of entity) approval as a Section 232 Program participant by ORCF is a HUD requirement. ORCF uses Active Partners Performance System (APPS) and the Business Partner Registration System (BPRS) to ensure proper clearance and up-to-date information on participants doing business with HUD. Additional information regarding participation and compliance requirements may be found in Housing Notice H 2016-15 (or successors thereto).

Section 3.7
Physical Condition

3.7.1 Introduction

The physical condition of every ORCF Section 232 FHA-insured facility is a critical factor in managing the overall risk to the FHA mortgage insurance fund to ensure the residents are residing in safe housing. ORCF strives to provide and promote the effective use of timely and reliable information to monitor and assess the condition of the ORCF Section 232 portfolio. Such assessment tools also provide valuable information to help ensure safe, decent and affordable housing is maintained throughout the ORCF Section 232 portfolio.

3.7.2 Physical Condition Monitoring Tools

A. **Real Estate Assessment Center (REAC) Physical Inspections.**

1. **General Background**. On September 1, 1998 (63 FR 35650), HUD published a final rule that established uniform physical condition stands for housing insured and or assisted under certain HUD programs. These standards are intended to ensure that this housing is decent, safe, sanitary and in good repair. The September 1, 1998 final rule also established uniform physical inspection procedures by which HUD determines compliance with the physical condition standards.

2. **REAC and ORCF Section 232 Projects**. HUD's Real Estate Assessment Center (REAC) is charged with responsibility for assessing and scoring the condition of certain projects in which HUD has an interest, including FHA-insured projects under the Section 232 Program, in accordance with the physical conditions standards and procedures of 24 CFR part 5 subpart G.
    a. **ORCF 232 Projects**. ORCF will continue to use the Real Estate Assessment Center (REAC) to schedule and physically inspect all projects in the ORCF Section 232 portfolio unless stated otherwise below.
    b. **Skilled Nursing Facilities**. This provision (24 CFR 200.855) is now applicable and it limits the inspections on skilled nursing facilities. It provides in part that REAC will no longer routinely perform physical inspections on skilled nursing facilities (though HUD can direct on a case-by-case basis that one be conducted). In applying this provision, HUD has halted the inspections on projects categorized in HUD's database as SNFs. This can include skilled nursing facilities that do have some non-skilled nursing units, but are predominantly providing skilled nursing care.

c. **Other Non-SNF Exceptions.** The provision also gives HUD the authority to determine that other (non-SNF) projects in a particular jurisdiction do not need REAC inspections if HUD finds that a particular jurisdiction provides adequate inspections with readily available results. Action, if any, with respect to that authority will be announced at a later date.

3. **Administration of REAC Inspections**. REAC inspects only a random sampling of the project to determine if the project is properly maintained. REAC conducts physical inspections through the use of contracted inspectors trained by REAC. The inspectors schedule on-site inspections with project Borrower's representatives. For assistance, questions, clarification, guidance and or questions, on procedures pertaining to REAC physical inspections, including scoring procedures and procedures and timelines to appeal an inspection report, refer to REAC's website (see Appendix 3.2).

4. **Exigent Health and Safety Items**. At the conclusion of a REAC Inspection, the inspector provides the Borrower, or designated contact, a list of all Exigent Health and Safety (EH&S) items. Once an inspection is conducted, the Borrower is responsible for mitigating all identified EH&S items within 72 hours, as verified by submission of the completed and signed certification to the assigned AE.

5. **Issuance of REAC Inspection Report**. REAC is responsible for verifying inspection data provided from the contracted inspector based on the on-site inspection. REAC scores and issues the formal REAC inspection report to the Borrower's contact, as verified at the on-site inspection.

6. **ORCF Actions and Referrals to the DEC in Response to REAC Inspection Report**. If the REAC inspection report score falls under 60 (on a scale of a possible 100 points) on two consecutive inspections, the AE will refer a Borrower to the Departmental Enforcement Center (DEC) for further review and possible enforcement action. Before referring to the Enforcement Center, the AE will review both inspections and discuss the results with the Mortgagee/Servicer to determine if the project make-up is causing improper scoring (locked doors or windows, or other characteristics unique to certain healthcare projects). ORCF will also flag the Borrower in APPS. See Housing Notice H 2016-15 (or successors thereto), for additional information on APPS flags.. All REAC Inspections receiving a score of 30 and below are automatically referred to the DEC for enforcement action.
    a. **DEC Actions**. The DEC may arrange a conference call to discuss the inspection results with the Borrower and issue a Notice of Violation (NOV) demanding correction. Requirements of a Borrower that are included in the NOV include the following:
        i. Conduct and submit a 100% survey identifying the physical deficiencies in the project;
        ii. Correct the physical deficiencies at the project including but not limited to those deficiencies identified in the REAC Inspection; and

iii. Execute and provide a certification of corrections. Refer to: http://portal.hud.gov/hudportal/documents/huddoc?id=10-04hsgnatt1.pdf

The DEC may take additional enforcement action and seek any and all available remedies including to but not limited to, acceleration of the outstanding principal indebtedness, foreclosure, or any other appropriate remedies.

b. **Follow-up and Monitoring**. In addition to mitigating EH&S items as described in A.4 of this chapter, Borrowers are responsible for correcting all deficiencies noted on physical inspection reports.

Borrowers are required to ensure a complete (100%) inspection of the project is performed. This follow up inspection shall include the site, all building exteriors, all building systems, all common areas, and all units. For clarification purposes: all areas within a building that are not residential units are considered common areas for inspection purposes. All deficiencies identified on a REAC Report must be corrected. To verify compliance, the Borrower must complete and sign the certification and provide it to their Mortgagee/Servicer and assigned - AE.

Mortgagee/Servicers play a critical role in ensuring the Borrower has met their obligation to correct deficiencies and are encouraged to monitor progress and performance. Since the REAC Inspection is just a sample of the physical condition of the project, the 100% inspection of the project is important. Mortgagee/Servicers should encourage the Borrower to, at a minimum, perform the following on an ongoing basis:

i. Review of Exigent, Health, and Safety (EH&S) problems identified in the REAC physical inspection. These items should be considered a priority and should assure that all EH&S deficiencies have been and remain corrected.
ii. Review of units and common areas to verify that significant REAC physical inspection report deficiencies (other than EH&S) such as falling retaining walls, broken sidewalks, exterior painting, etc. have been corrected

A Mortgagee/Servicer or HUD may decide to perform a site review of a project, to ensure deficiencies are addressed, should there be issues of concern with regard to the physical condition of the project.

Borrowers will be notified as subsequent REAC Inspections are scheduled by inspectors.

Any questions on REAC may be directed to the REAC Technical Assistance Center (TAC) at 1-888245-4860 or email at: REAC _TAC@hud.gov

B. **State Surveys**. As discussed in Section 3.5, part of the State inspection process includes a Life Safety Inspection. As this inspection focuses on the compliance with fire protection requirements, it may reflect concerns with the physical condition of the project as it impacts the residents. ORCF regularly reviews the Life Safety Inspection as well as the entire State Survey and Medicare Star Ratings, to determine if there may be issues pertaining to the physical condition of the project. For more information on Life Safety, State Surveys and Medicare Star Ratings, refer to Section 3.5.

3.7.3 Resources for Addressing Physical Repairs and Improvements

A. **Reserve for Replacement**. As discussed in Section 3.2.2 of this chapter, a R4R escrow exists for all FHA-insured and HUD-held mortgages, in accordance with the Regulatory Agreement. The R4R is established to help defray costs of replacing a project capital items. The R4R is a possible source of funding considered to help meet costs to maintain the physical condition of the project, in addition to the operating budget. A Borrower should work with their Mortgagee/Servicer and AE to seek approval of withdrawals from the R4R to address capital improvements and repairs. For more information on R4R, refer to Section 3.2.2 of this Chapter.

B. **Other Resource**s. As Borrowers are responsible for maintaining the project's physical condition, the Borrower may propose other resources of funding to be utilized to address needed physical repairs or proposed for capital improvements. Examples such as Borrower provided funding (not project funds); surplus cash notes, residual receipts are all potential sources to address physical repair needs. Compliance with regulatory and Section 232 Program requirements must also be ensured. .

3.7.4 Physical Condition and Regulatory Compliance

Borrowers and operators execute Regulatory Agreements under ORCF's Section 232 Programs. Part of the regulatory requirements described in the Regulatory Agreement is to keep the project in decent, safe and sanitary condition and in good repair. During any period in which HUD insures the Loan or holds a security interest on the Mortgaged Project, it is a Regulatory Violation for an Borrower or Operator, without Mortgagee/Servicer's and HUD's express written consent, to proceed to impact the physical condition of the project in any of the following ways:

A. Make physical change, or permits changes to, the Mortgaged Project, whether negligently or intentionally, in a manner that reduces its value;

B. Fail to maintain the Mortgaged Project in decent, safe, and sanitary condition and in good repair; or

C. Materially fail to comply with covenants in the Note, the Borrower's Security Instrument, the Regulatory Agreement, or any of the Mortgage Insurance Documents respecting physical care, maintenance, construction, abandonment, demolition, or insurance against casualty of the Mortgaged Project.

3.7.5 Project Capital Needs Assessment

The intent of the Project Capital Needs Assessment (PCNA) is to ensure the long term viability of the project and ensure the proper deposit to the R4R account. When required by the project's Regulatory Agreement, the existing PCNA must be updated every ten years. Updates to the PCNA must follow the Statement of Work as set forth in Production, Chapter 4, for a Limited Scope PCNA. Updated PCNAs must be submitted to the Project's AE every ten years, as required (unless required prior to that date due to other circumstances). The cost of each such PCNA may be requested for reimbursement from the R4R account.

Section 3.8
Telecommunications Towers

3.8.1 Introduction

This section provides guidance for Borrowers regarding the procedures for requesting permission from ORCF to lease an area of the FHA-insured project for communication towers and/or other telecommunications equipment. A checklist of required exhibits to submit to HUD when requesting approval for communication towers and/or other telecommunications equipment will be available on the Section 232 Program website.

3.8.2 General

ORCF supports Borrowers of FHA-insured projects leasing space for communication towers to telecommunication providers for the purpose of increasing revenue for the project. Pursuant to the Regulatory Agreement, the Borrower must submit the required documents prior to execution of the lease, as HUD approval is required for these types of commercial leases. The Mortgagee/Servicer is to receive the request and documentation, review for completeness, accuracy and eligibility, and then forward to ORCF with a recommendation for approval. A review of the documents will focus on issues regarding any effect on the project's income and expenses, the Regulatory Agreement and Security Instrument. HUD closing attorneys and HUD engineering staff may review the required documents and provisions prior to the AE making a final determination.

3.8.3 Requirements

A. **Contracts:** In the proposals for telecommunication contracts, the providers typically intend installing all necessary equipment on the project site at no cost to the project, and in return, the project receives lease payments. ORCF is supportive of these arrangements, provided that they bring a higher level of service to our communities in a more competitive atmosphere, increase project revenues, and enhance project marketability, and further provided that any associated physical, business, and legal risk involved with installation and maintenance of such towers is appropriately mitigated. Additionally, a HUD environmental review may be required before HUD approves a contract or lease for telecommunications towers.

B. **Engineered fall distance.** All structures shall be located outside the engineered fall distance of any support structure for high voltage transmission lines, radio antennae, satellite towers, cellular towers, etc., as discussed in Production, Chapter 7.5.K.2.

C. **Lease**: The following points are to be taken into consideration:

1. The lease may not be modified, extended or terminated without the prior written consent of the Mortgagee/Servicer.

2. The lease may not be modified or extended without the prior written consent of HUD.

3. The lease must be assignable by the Lessor to the Mortgagee/Servicer and/or HUD (i.e., upon foreclosure or deed-in-lieu of foreclosure).

4. The lease is subordinate to the HUD-held or FHA-insured Mortgage (Security Instrument).

5. The lease will not be automatically terminated by foreclosure or any other transfer of the mortgaged project; and, that in the case of foreclosure or deed-in-lieu of foreclosure, the Mortgagee/Servicer and/or HUD shall have the right to accept or terminate the lease.

6. The lease must contain a clause that states that the Lessee shall, upon receipt of notice of default under the Mortgage (Security Instrument), pay all rents payable under the lease to the Mortgagee/Servicer and/or HUD.

7. The lease must contain the following information:
    a. a comprehensive list of the equipment to be installed, including a list of any proposed improvements to the FHA-insured project;
    b. Lessee is responsible for the maintenance of the equipment;
    c. maintenance schedule;
    d. access information; and
    e. where the equipment is located (i.e., roof) along with a drawing of the location.

8. The lease shall contain a provision which conditions approval of the lease on the Lessee obtaining all variances, permits, license or approvals required by applicable law.

9. The lease must contain a certification from the Lessee that it has performed its own investigation of the project and has determined its suitability for use.

10. The lease may contain a provision granting the Borrower, its successors and assigns the right to relocate any equipment, wiring or cabling.

11. The lease must contain a provision permitting the Borrower, its successors and assigns the right to terminate the lease should, 1) Lessee default in payments owed under the lease, 2) Lessee's authorized use of the premises materially interfere with Borrower's use and operation of the project and building, or, 3) it be determined that the Lessee's equipment constitutes a danger to the health and safety of the project's residents or poses a danger to the structural integrity of the building.

12. The lease must contain a provision mandating that hazardous waste materials will not be stored, used, generated, etc., on or in the FHA-insured project at any time.

13. Anti-Deficiency Provision: in no event shall HUD be subject to an indemnification provision in the lease, whether in the present or future (if it becomes Lessor to the lease).

Section 3.9
Commercial Space

3.9.1 Introduction

A. **General Guidance**
This section provides guidance pertaining to ORCF's requirements related to additions or alterations to commercial space on projects currently insured under any of the programs covered by this Handbook.

B. **Categorization of Space.**
Commercial space in a Healthcare Facility can be categorized as a space within the project that has been altered or converted for use other than residential purposes from which income is derived or anticipated. In accordance with **24 CFR 200.73**, a project may include such commercial and community facilities as the Commissioner deems acceptable. Commercial space differs from community space or community facilities. The term "community facilities" refers to project amenities, such as a pool, resident parking/parking garage, business center or fitness center that are predominantly used by residential tenants, with or without charging additional fees. Community facilities generally do not produce regular income and any intermittent revenue is to be included as ancillary income.

3.9.2 Types of Commercial Space for Assisted Living, Intermediate Care, and Skilled Nursing Facilities

Commercial Space vs. Community Space. Generally speaking, due to the special nature of these types of projects, commercial space is to be limited to commercial activities that benefit the type of residents that live in the project. Unless the project has been constructed as a mixed use building, the project shall include commercial activities that are consistent with the type of project and type of residents served. Common Commercial Space areas in ALF, Intermediate Care Facilities (ICF), SNF and Board and Care Facilities include, but are not limited to: hair salons, convenience stores, specialized medical care provider spaces, ice cream parlors, coffee shops, gift shops and non-resident parking. These are deemed "commercial" instead of community spaces if they are income producing on a consistent basis and gain their revenue from residents and customers on a "pay for service" basis separate from the monthly bed charge. Residential parking, if a fee is charged to residents, is still considered community space and is recorded as ancillary income, not commercial income for the purpose of the calculations and limitations below.

3.9.3 Space and Income Limitations

This section provides guidance pertaining to when a Borrower wishes to change the intended use of part of a project to commercial space.

A. **Commercial Space and Income Limit Computations**. Commercial Space and Income is limited to 20 percent of the total gross floor area of the property and 20 percent of the Effective Gross Income of the project Commercial Space that is intended to exclusively serve the residents of the project is not counted toward the 20 percent limit.

B. **Non-Compliance and Retroactive Approval**. There may be instances in which residential space is converted to commercial use without the knowledge of HUD. ORCF shall inform the project Borrower, in writing, that such action is in violation of the Regulatory Agreement and that failure to correct this violation may result in HUD exercising its rights under the Regulatory Agreement, including denial of future participation in HUD programs. ORCF may approve the conversion retroactively, in its determination, provided all requirements are met.

C. **Parking.**

1. Parking income attributable to residential tenants is considered to be ancillary income and is not included in the limits contained in Section A, above. Commercial parking spaces reserved for use by motorists who are not project residents or are not parking to use the on-site commercial tenant's facilities, and the related non-tenant parking income, must be included in the Commercial Space and Income limitations. The income and space attributable to parking spaces reserved for non-residential or non-commercial tenants must be included in the limitations, based on applying the percentage of the total spaces that are reserved for non-tenant use. For existing projects that are to be acquired, refinanced or will undergo substantial rehabilitation, that provide parking for a monthly fee, the Mortgagee/Servicer must identify the percentage of monthly parkers who are non-tenants so as to include these in the commercial income limitations, above. The maximum occupancy factor to be applied to the parking income attributable to parkers who are not associated with either the project's residential or commercial tenants shall be the lower of:
    a. The amount indicated by the market and by the historic performance of the subject, or
    b. 50 percent.

2. If the Borrower operates a parking facility that provides parking for residential or commercial tenants of the project, the Mortgagee/Servicer must determine parking income based on an analysis of the past 3 years of operation and the trailing 12 month period prior to application.

3. If the parking facility is operated by a third-party, the Mortgagee/Servicer may use the amount of income collected under the contract if it is a fixed monthly payment.

Parking contracts that specify a percentage rent in addition to or in place of a fixed rent are not permitted without HUD approval.

3.9.4 Submission Requirements and HUD Review

A. Submission Requirements. Please see the list of exhibits provided on the checklist posted on the Section 232 Program website. The Mortgagee/Servicer is to receive any requests for additions or alterations to commercial space, review them for completeness, accuracy and eligibility, and then forward them to ORCF with a recommendation for approval.

B. **Additional Considerations**. The following issues will be considered by ORCF in processing Commercial Leased Applications:

1. Current Financial and Physical Condition of the Project.

2. Open Federal, State, and local compliance Issues.

C. **Decision on Request for Approval.** ORCF will notify the Mortgagee/Servicer, in writing.

Section 3.10

Special Circumstances Requiring the Notification of the Mortgagee/Servicer and/or AE

3.10.1 Introduction

Throughout this portion of this chapter there are indicators that require a Borrower and/or Operator either to notify the Mortgagee/Servicer and the AE concurrently, or to notify only the Mortgagee/Servicer (who would in turn elevate the matter to the AE as appropriate) of a Project's risk, of an action plan or of progress on previously reported situations. ORCF has created a sample format that Mortgagee/Servicers may use in reporting this information; the sample may be found on the Section 232 Program website.

3.10.2 Failure to Make Lease Payment

A. The Mortgagee/Servicer and AE must be immediately notified by the Borrower of a failure to make a Lease payment.

B. The Mortgagee/Servicer and AE will work with Borrower and Operator to understand the financial or business circumstances that have resulted in the non-payment, and try to facilitate an action plan that will remedy the non-payment status.

C. The Mortgagee/Servicer will continue to monitor the situation, to ensure timely payments continue in the future.

D. Borrowers and Operators are strongly encouraged to work together with the Mortgagee/Servicer to facilitate remedies to any problems with the Lease payments because the Mortgagee/Servicer can be of assistance in such scenarios. If the Mortgagee/Servicer knows of the payment status early enough, they may be able to work with the Project to create an action plan and remedies with the parties before any non-payment penalties are incurred.

E. In the event of a non-payment related to a Borrower/Operator dispute or other non-financial reason, the Mortgagee/Servicer must contact the AE to discuss the severity of the situation and whether it should be transferred to the Risk Mitigation Branch.

3.10.3 Default of Master Lease

A. Notification of Default of a master lease must be provided from Borrower to Mortgagee/Servicer and HUD within two (2) business days following the Borrower's receipt of the notification.

B. Once notified, Mortgagee/Servicer will evaluate other projects within the master lease, to determine cash flows and the ability to cover the failing project(s). The Mortgagee/Servicer will collaborate with HUD.

C. Default on a master lease will impact the Project, legal documents, and potentially a default on the mortgage. The project may also need to be serviced by the Risk Mitigation Branch.

Additional details regarding master leases may be found in Production, Chapter 13.

3.10.4 Special Focus Facility

CMS has a Special Focus Facility Initiative that places a nursing home, with a history of serious quality issues, into a special program that is meant to stimulate the project to improve their quality of care to residents (see also, Section 3.5.7).

A. Notifications to HUD and the Mortgagee/Servicer are required to be submitted within two (2) business days after the date of receipt of notice of a Special Facility Focus (SFF) designation from a state or federal regulatory agency, unless a longer time period is approved by HUD.

   Failure by the Project to notify HUD and the Mortgagee/Servicer of a SFF designation will be deemed a violation of federal regulation 24 CFR 232.1015 and may lead to the involvement of the HUD Departmental Enforcement Center (DEC).

   The Special Focus Facility list may be found at the following web address: http://www.cms.gov/Medicare/Provider-Enrollment-and-Certification/CertificationandComplianc/downloads/sfflist.pdf

B. The Mortgagee/Servicer and AE will work with the Operator (and, as applicable, the Borrower and Management Agent) to establish an action plan for being removed from the SFF list.

C. The AE will reassign the project to the Risk Mitigation Branch for ongoing servicing.

D. Each Project and situation is unique; some may show improvement and move off the SFF list faster than others. The Mortgagee/Servicer and AE (Risk Mitigation Branch member) will work with the Project to establish an action plan.

3.10.5 State Inspections

A. **Reporting Requirements.** Keeping the Mortgagee/Servicer and ORCF informed of problematic surveys and of any actions that could threaten the licensure or provider payments for a project is crucial, since such matters can threaten the viability of operations that are needed to meet operating expenses and make mortgage payments.

1. Except as limited in 3.10.5.A.2, HUD requires reporting when the Operator receives a notice, report, survey or other correspondence (regardless of form) from any governmental entity that includes any statement, finding or assertion that:
    a. Operator (or any principal, officer, director or employee of Operator), any Management Agent, the Project, or any portion of the Project is or may be in violation of or default under any of the Permits and Approvals or any governmental requirements applicable to the operation of the Project, or
    b. Any of the Permits and Approvals are to be terminated, limited in any way, or not renewed; or
    c. Any civil money penalty (other than a de minimus amount) is being imposed with respect to the Project, or
    d. Operator (or any principal, officer, director or employee of Operator), any Management Agent, the Project, or any portion of the Project is subject to any governmental investigation or inquiry involving fraud.

2. Reporting is only required with relation to Licensed Nursing Facility surveys when a survey has any findings higher than a "G" level or any repetitive "G" level or higher findings from prior surveys (pursuant to CMS State Operations Manual, Chapter 7, as may hereafter be edited or updated, or any successor guidance). Repetitive is defined as "unresolved from the two most recent consecutive surveys or a repeat violation having the same citation number".

3. **Reporting Logistics.** Unless otherwise requested by HUD or the Mortgagee/Servicer:
    a. The *initial* communication from the Operator pursuant to this Section shall be a notice by email to the Mortgagee/Servicer (not to HUD) describing the conduct cited, the scope and duration of remedy(ies) imposed, and the timelines for corrective actions (not the survey or other extensive communication itself). Such email shall be sent within two (2) business days of receipt of the notice, report, survey, or other correspondence from the governmental entity.
    b. The *next* communication from the Operator shall be email notification to the Mortgagee/Servicer that the issue(s) have been addressed to the satisfaction of the issuing regulatory agency.
    c. The Mortgagee/Servicer shall notify the AE immediately when a matter listed in Section 3.10.5.A.1 is reported by the Operator that is not expected to be readily resolved or poses an immediate threat to licensure or funding. If necessary, the Mortgagee/Servicer should work proactively with the operator to ensure the issue(s) are addressed to the satisfaction of the issuing regulatory

agency. The Mortgagee/Servicer may use an optional reporting form made available by ORCF for reporting these or other matters of concern regarding the financial or operational performance.

B. The receipt by HUD and/or Mortgagee/Servicer of notices, reports, surveys, correspondence and other information shall not in any way impose any obligation or liability on HUD, Mortgagee/Servicer or their respective agents, representatives or designees to third parties to take (or refrain from taking) any action, and HUD, Mortgagee/Servicer and their respective agents, representatives and designees shall have no liability to third parties for any failure to act thereon or as a result thereof.

C. Failure to notify the AE and the Mortgagee/Servicer of such inspection reports, Plans of Correction, approval reports or other qualifying communications, will be a violation of federal regulation 24 CFR 232.1015, as well as the operator regulatory agreement, and may lead to the involvement of the HUD Departmental Enforcement Center (DEC).

3.10.6 Legal Judgments

The Borrower and the Operator must each notify their Mortgagee/Servicer within two (2) business days of receiving a legal judgment, penalty or fine against the Project, in excess of $50,000.

A. The ability to cover a judgment/penalty/fine will vary based on the size of the project, the available cash, etc. The Mortgagee/Servicer will work with the Project to discuss reasons for the judgment and impacts on the financial status of the Project, notifying the AE of outcomes. The Operator must provide the Mortgagee/Servicer with an action plan (seeking the Mortgagee/Servicer's guidance, as necessary and appropriate), and must work with Mortgagee/Servicer to analyze the impact of the judgment, providing information to the AE of the status, until financial stability is regained.

B. Depending on the financial position of the Project and its ability to absorb the imposed judgment, it may require a change to "Potentially Troubled" status in the HUD system, by the AE.

3.10.7 Professional Liability Insurance

On an annual basis, the Mortgagee/Servicer must verify that each Project has the required Professional Liability Insurance (PLI) coverage, as approved during the Project's underwriting. This review must include a current copy of the insurance ACORD, PLI policy, certificate or memorandum of insurance or other evidence of the required insurance coverage, as well as review of the updated loss history, consistent with the underwriting review standards (Section II, Production, Appendix 14.1.VII.D)

1. If coverage is less than required, then the Mortgagee/Servicer must work directly with the Project to resolve the coverage deficiency.

2. If the coverage deficiency is not readily resolved, then the Mortgagee/Servicer must notify the AE and monitor the Project until the coverage is adequately provided.

3. . If the review of loss history indicates a negative trend in claims, the Mortgagee/Servicer must evaluate the situation, discuss with the Operator any financial or operational changes that may be warranted, and discern the Project's financial ability to absorb any ramifications imposed by the claim(s). If appropriate, the Operator must establish an action plan. The Mortgagee/Servicer will involve the AE as they deem appropriate.

3.10.8 Fidelity Bond Coverage

On an annual basis, the Mortgagee/Servicer must verify that each Project has the required Fidelity Bond/Employee Dishonest coverage, as approved during the Project's underwriting.

A. If coverage amount is less than required (at least two months annualized potential gross income receipts, as required at the time of HUD Project approval), then the Mortgagee/Servicer must work directly with the Project to resolve the coverage deficiency.

B. If the coverage deficiency is not readily resolved, then the Mortgagee/Servicer must notify the AE.

C. The Mortgagee/Servicer must monitor the Project until the coverage is adequately provided.

3.10.9 Notification of Termination of Insurance

A. A project cannot be uninsured in the Section 232 Program. The Project must notify their Mortgagee/Servicer and AE within two (2) business days of its receiving notification of any termination of insurance.

B. The Operator must provide the Mortgagee/Servicer with an action plan (seeking the Mortgagee/Servicer's guidance, as necessary and appropriate), and must work with Mortgagee/Servicer to resolve the circumstances surrounding the notification, providing information to the AE of the status, until resolution is reached.

C. Termination of insurance or the formal notification of a potential termination of insurance will immediately warrant a change to "Troubled" status in the HUD system until the issue is resolved.

Failure to notify the AE and the Mortgagee/Servicer of such notifications will be a violation of federal regulation 24 CFR 232.1015, and may lead to the involvement of the HUD Departmental Enforcement Center (DEC).

3.10.10 Threat to Abandon Project

A. The Borrower must notify their Mortgagee/Servicer within two (2) business days of any threat to abandon the Project, when initiated by the Borrower or Operator. This is separate from an inspection/ survey decertification.

B. The Mortgagee/Servicer must investigate the threat to abandon the project, and attempt to mediate a resolution. The Mortgagee/Servicer must escalate the threat to the AE if it becomes more imminent and/or cannot be resolved quickly without HUD involvement.

3.10.11 REAC Inspections

A. The Borrower must notify their Mortgagee/Servicer within two (2) business days of receiving a REAC score of 30 or below or a second REAC inspection score below 60.

1. A score of 30 and below creates an automatic REAC referral to the DEC and must be addressed immediately.

2. A second consecutive score of below 60 will warrant a referral to the DEC and must be addressed immediately.

3. The Mortgagee/Servicer must assist the Project in determining if an appeal of the inspection score is appropriate, and provide assistance in preparing the appeal to REAC.

   Appeals to REAC have extremely time-sensitive deadlines which must be met. Please reference the Physical Condition portion of this chapter for more details on the REAC appeals process.

4. The Mortgagee/Servicer must review the inspection report to ensure repetitive findings are being addressed and physical plant items are taken care of immediately.

3.10.12 Accounts Receivable Loans

As further defined in the Production, Chapter 15 and Asset Management, Chapter 10:

A. When a Project proposes to add or amend an Accounts Receivable (AR) loan, it must be reviewed with the same scrutiny that such a loan would be reviewed during the initial underwriting process. The Project must submit the required documentation to the Mortgagee/Servicer, who will review the information for completeness, accuracy and eligibility, and then forward the submission to ORCF with a recommendation for approval.

   A change in the AR loan status initiated due to extenuating circumstances that have adversely impacted the Project (rather than straightforward changes in business) should be evaluated by the Mortgagee/Servicer and brought to AE's attention for particular scrutiny. If the AR loan change is a straightforward change in the loan, there would be less of a concern than the need for a new loan due to a change in provider payments or other financial burdens.

B. The Project must notify their Mortgagee/Servicer within two (2) business days of any notification of default on its Account Receivable (AR) loan.

   1. Default on an AR loan may be an indicator of potential default on the mortgage. Therefore, once notified, the Mortgagee/Servicer must evaluate why the AR Loan has defaulted, reviewing cash flows and the ability to cover the failing loan, and work with the Project to create an action plan for moving the loan out of a default status.

   2. The Mortgagee/Servicer must collaborate with AE (and Risk Mitigation Branch, if assigned) as necessary until the remedies are put in place and the action plan has been fully implemented. The Mortgagee/Servicer must also monitor the Project closely to ensure financial and operational viability are restored.

3.10.13 Unauthorized Distributions

A. The Borrower must notify their Mortgagee/Servicer within two (2) business days of receiving a Notification of Unauthorized Distribution by the HUD Financial Assessment Subsystem (FASS).

   1. The notification also includes a designated cure period which must be adhered to.

   2. This notification is sent automatically to the email the Project registered in the system when an unauthorized distribution has been determined by FASS, as well as to the AE. The AE must also immediately notify the Mortgagee/Servicer of the violation.

   3. The Borrower and, where applicable, the Operator, must provide the Mortgagee/Servicer with an action plan (seeking the Mortgagee/Servicer's guidance, as necessary and appropriate), and must work with Mortgagee/Servicer to ensure the

cure period will be met to resolve the violation, and to further review the circumstances leading to the violation. The unauthorized distribution may be a sign of financial distress that needs to be closely monitored, and an action plan may need to be put in place to do so.

4. The Mortgagee/Servicer must notify the AE if there are extenuating circumstances that are preventing the immediate submission of the action plan, and provide the AE with the action plan expeditiously, and assure that the funds are repaid within the cure period.

B. There are times when REAC/FASS findings trigger contact from the DEC directly to the Project. Although the AE is also copied on such the notification, and must notify the Mortgagee/Servicer, the Borrower is responsible for notifying the Mortgagee/Servicer within two (2) business days of receipt of a REAC/FASS notification from the DEC.

   The Mortgagee/Servicer will then work with the Project to cure the violation or devise an action plan to cure the finding(s), including the AE as appropriate, and communicating with the DEC during the process.

3.10.14 Bankruptcy

A. The Borrower and Operator must notify their Mortgagee/Servicer within two (2) business days of any bankruptcy petition related to any of the Project participants who may file for bankruptcy (i.e. Borrower, Operator, or Management Agent).

B. The Mortgagee/Servicer must review the bankruptcy status and circumstances, and within two (2) business days of being notified by the Project, must provide the AE with the specifics of those circumstances, including, but not limited to: bankruptcy type, contact information of the participants and their respective legal counsels, the reason for petition, and whether the petition is voluntary or involuntary.

   1. A copy of the bankruptcy notice must also be provided to the AE at this time.

   2. Generally speaking, a bankruptcy status will warrant transfer to the Risk Mitigation Branch portfolio due to the troubled nature of the project..

C. The Project must notify their Mortgagee/Servicer of any imminent bankruptcy proceedings of which it is aware. The Mortgagee/Servicer must notify the AE of the imminent bankruptcy within two (2) business days of such knowledge.

   1. Until an FHA insurance claim is filed, HUD expects the Mortgagee/Servicer to fully participate in the bankruptcy proceedings. Unless, and until, HUD intervenes in the proceedings, the Mortgagee/Servicer is expected to guard HUD's interests and keep HUD fully informed as to the case's progress and major developments.

2. The AE will assign the Project to the Risk Mitigation Branch, if warranted.

3. The Mortgagee/Servicer should be reviewing the bankruptcy to ensure:
    a. The nursing home license, certificate of need, and provider agreements remain with the project
    b. Rights to the operator's account receivables ("AR") remain with the Project or are paid towards AR financing approved by HUD for the Project's benefit
    c. Lease payments are be sufficient to cover debt and R4Rrequirements
    d. Compliance with all covenant remains intact
    e. Mortgage and security instruments remain enforceable in accordance with their terms
    f. All Regulatory Agreements pertaining to the Project remain in effect and the parties to these agreements are complying with the requirements contained therein.
    g. All actions required of the Mortgagee/Servicer under Mortgagee Letter 91-17.

D. Particularly for Projects under a master lease, it will not be unusual for a Project to be involved in bankruptcy proceedings without there being a monetary default; however it is still necessary for the Mortgagee/Servicer to work closely with the troubled Project, and other projects within the master lease, to ensure that the bankruptcy has as minimal an impact as possible on the other projects, and to avoid further financial disruption in the other projects.

E. The Mortgagee/Servicer must provide routine bankruptcy status updates to the assigned AE and/or their designee. The Mortgagee/Servicer may also be responsible for working with the Risk Mitigation Branch, OGC, DEC and/or a Department of Justice (DOJ) legal team.

3.10.15 Delinquent Mortgage Payments

A. Delinquent mortgage payments are not only a violation of legal obligations by the Borrower, but are also a sign of financial distress for a Project and are to be closely monitored by the Mortgagee/Servicer. The Borrower is required to notify the Mortgagee/Servicer if the mortgage payment is delinquent as of the 16th of the month.

B. The Multifamily Delinquency and Default Reporting (MDDR) System will notify the AE of a delinquency after the 16th of the month. The AE will reach out to the Mortgagee/Servicer for a status of the delinquency and expectations of when the payment will be made.

C. Upon notification of a delinquency, the Mortgagee/Servicer must work with the Borrower (and Operator, if applicable) to ascertain the financial, operational and/or other circumstances leading to the non-payment, including, but not limited to evaluating the ability of the Borrower to pay the mortgage, any anticipation of payments to be made, the financial strength of the Borrower (and Operator), recent state survey results, extenuating circumstances and other concerns potentially leading to the delinquency.

D. The Operator must provide the Mortgagee/Servicer with an action plan (seeking the Mortgagee/Servicer's guidance, as necessary and appropriate). The Mortgagee/Servicer must then notify the AE of situation, and provide the AE with an action plan to remedy the delinquency.

E. The Mortgagee/Servicer and AE may also, at this time, request and review financial reports from the Project to determine an action plan.

F. Once notified of the delinquency, if no action from the Borrower or Mortgagee/Servicer has taken place by the end of the month, the AE will work directly with the Mortgagee/Servicer and Borrower to escalate the action plan.

G. The Mortgagee/Servicer will monitor any mortgage payment that is over 30 days delinquent until it is paid.

H. Once a non-payment has aged between 45 to 60 days, and no evidence of payment is anticipated, the Mortgagee/Servicer must again notify the AE and provide additional information regarding cash flow problems or other circumstances within the Project that have led to the delinquency.

   At this stage, the project will be evaluated to determine if a transfer to the Risk Mitigation Branch is warranted and/or to escalate the HUD involvement with the Borrower (and Operator) in an effort to avoid default of the loan. The Project will also be monitored until the financial status and mortgage payments return to a stable level.

I. For systemic late fees and delinquencies, but not beyond 30 days, the Mortgagee/Servicer may use discretion in involving the AE, but must notify HUD if this occurs more than 6 out of 12 months. These systemic delinquencies may not necessarily warrant transition to the Risk Mitigation Branch nor indicate a "Troubled" project, but further evaluation will be required.

Section III
Asset Management

Appendix 3.1
Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care

Real Estate Assessment Center website:
http://hudatwork.hud.gov/po/reac/

Form Number	Form Name
HUD-9250-ORCF	Funds Authorization
HUD-9250A-ORCF	Borrower Certification and Request Detail
HUD-93486-ORCF	Computation of Surplus Cash
HUD-92464-ORCF	Request Approval Advance of Escrow Funds
HUD-92117-ORCF	Borrower's Certification - Completion of Non-Critical Repairs
HUD-9807	Insurance Termination Request for Multifamily Mortgage
Notice H 2016-15	Processing Guide for Previous Participation Reviews of Prospective Multifamily Housing and Healthcare Programs' Participants (or successors thereto)
HEROS	HUD Environmental Review Online System (HEROS)
N/A	Pre-Operations Checklist
N/A	Template - Initial Operating Deficit Tracking Sheet
N/A	Draft Pre-Operations Agenda Letter
N/A	Condition Assessment & Proposed Replacement and Cost Schedule

Section III
Asset Management

Chapter 4
Financial Operations

4.1 Introduction

This chapter addresses loan servicing related to the financial operations of projects insured under Section 232. For the purposes of this chapter, the term "Mortgagee/Servicer" means the primary Servicer responsible for servicing the mortgage loan, whether such party is the originating Lender or third party Servicer for the originating Lender.

4.2 Financial Submission Requirements

The *Healthcare Regulatory Agreement - Borrower* (Forms HUD 92466, HUD 92466-EH and HUD 92466-ORCF) requires the submission of audited annual financial information for the Borrower. Additionally, amendments in 2012 to the Uniform Financial Reporting Requirements rule (24 CFR 5.801 et seq.), applicable to all Section 232 Operators (amendments addressed in this chapter and also delineated in the *Healthcare Regulatory Agreement – Operator,* Form HUD 92466A-ORCF) require submission of quarterly/year-to-date and annual financial statements from the Operator. This same 24 CFR 5.801 requires that financial submissions for all Section 232 related projects (both Borrower and Operator) be submitted concurrently to HUD and the Mortgagee/Servicer.

Borrowers are required to submit their annual financial statements within ninety days of their fiscal year end into the Financial Assessment Subsystem (FASS) which uploads the financial statements into the Integrated Real Estate Management System (iREMS), which ORCF uses in its routine asset management of projects. Guidelines for accounting from HUD's Real Estate Assessment Center (REAC), revised submission procedures formulated in 2004, and the guidelines for REAC submissions, can be found on the REAC website.

HUD systems perform an analysis of the financial submission of the Borrower to measure the financial condition of the project and to assess compliance with applicable laws, regulations and business documents. HUD requires Borrowers to submit audited financial statements each year to the Mortgagee/Servicer and to HUD. HUD analyzes these financial statements to assess compliance with program requirements, to evaluate the financial strength of the Borrower, and for many other purposes. Mortgagee/Servicers should conduct their examination to the extent necessary to classify asset values and make risk assessments.

A. FASS performs an initial assessment of the financial condition of the Borrower's statement, as well as a review of the project's compliance with applicable laws, regulations and business documents. Compliance deficiencies identified either by this assessment or the project's auditor may be referred to ORCF or the Departmental Enforcement Center (DEC).

B. **Borrower Submission Requirements:**
In addition to Regulatory Agreement financial submission requirements, the Uniform Financial Reporting Requirements rule (24 CFR 5.801 et seq.) requires the electronic submission to HUD and the Mortgagee/Servicer of Borrower financial information prepared in accordance with Generally Accepted Accounting Principles (GAAP).

1. For Profit Borrowers are required to electronically submit an audited Annual Financial Statement (AFS) within 90 days after the end of each fiscal year,

2. Non-profit Borrowers are required to electronically submit a Borrower-certified (unaudited) AFS within 90 days after the end of the fiscal year. An electronically submitted, audited AFS is due no later than nine months after the end of the fiscal year pursuant to 2 CFR 200. The Borrower may opt to submit the audited AFS within 90 days after the end of the fiscal year. By submitting the audited AFS within 90 days the Borrower may eliminate the additional step of submitting a Borrower-certified AFS. ORCF recommends Borrowers refer to 2 CFR 200 Subpart F for current exemption thresholds as well as how to calculate the amount of federal financial assistance received.

3. Non-profit Borrowers (receiving less than $500,000 annually in combined federal assistance) are required to electronically submit a Borrower-certified AFS within 90 days after the end of the fiscal year.

C. The HUD systems review of the Borrower's financial statement in FASS may generate an "AFS Evaluation Financial Risk" action in the HUD system. The AE will review the action and contact the project or Mortgagee/Servicer for additional details or actions necessary to comply with the FASS deficiency.

D. **Operator Submission Requirements:**

1. As set forth in 24 CFR Part 5.801, unless otherwise specified by HUD, Operator shall submit, on a quarterly and year-to-date basis (or more frequently if specified by HUD), prepared and certified by an authorized representative or agent of Operator, such financial reports relating to the operation of the Healthcare Facility in the formats and at such times as may be approved by HUD in accordance with Program Obligations.

2. Detailed requirements for Operator quarterly and year-to-date submissions will be conveyed via the Section 232 Program website.

3. Such reports must be submitted no later than sixty (60) days after the period covered by the reports, except for reports relating to the final quarter of each year, which shall be submitted no later than ninety (90) days after end of the fiscal year. Such reports are subject to the sanctions contained in 18 U.S.C. Sections 1001, 1010, and 1012.

E. **Ongoing Master Tenant Financial Requirements:**
Master Tenant shall submit, or cause to be submitted, to HUD and Mortgagee/Servicer, on a quarterly and year-to-date basis (or more frequently if specified by HUD), prepared and certified by an authorized representative or agent of Master Tenant, such financial reports relating to the Master Tenant. Such reports must be submitted no later than sixty (60) days after the period covered by the reports, except for reports relating to the final quarter of each year, which shall be submitted no later than ninety (90) days after end of the fiscal year. Such reports are subject to the sanctions contained in 18 U.S.C. Sections 1001, 1010, and 1012. Additional information regarding the Master Tenant financial submission will be provided for on the Section 232 Program website.

F. **Midsize and Large Portfolio Post Closing Quarterly Financial and Operational Review and Analysis:**
For the entity that was the subject of a corporate credit review, HUD will require ongoing submission of the same financial and operational information. The data to be collected will be similar to the initial review material, and made available on the Section 232 Program website.

4.3 Financial Assessment System (FASS) Submissions

A. The Borrower must notify their Mortgagee/Servicer within two business days of receiving a Notification of Failure to File Financials by the required deadline in Financial Assessment System (FASS).

   This notification is sent automatically to the email the project registered in the system when a deadline for submission of annual financial information is missed.

B. Once notified, the Mortgagee/Servicer must work with the Borrower to ensure submission is forthcoming, and address any delays.

   The Mortgagee/Servicer must notify the AE if there are extenuating circumstances that are preventing the immediate submission, and provide the AE with the action plan to submit the required information expeditiously.

C. Extended periods without filing FASS requirements by the deadline will warrant referral to the DEC, and additional actions may be taken by HUD to ensure compliance.

4.4 Financial Risk Metrics of Operator

A. Key Indicators

The annual and quarterly review of the project operations by the Operator, coupled with the annual Borrower financial submissions, will allow both HUD and the Mortgagee/Servicer to maintain an ongoing understanding of performance. Key indicators of the Operator financial statements will be used to monitor performance and to measure against future routine reviews. Typically, the annual and quarterly reviews are all that are necessary for monitoring the financial operations of a project; however, HUD does reserve the right to require monthly financial reports (of the Operator, the Borrower, or both) to be submitted (to HUD, the Mortgagee/Servicer or both) if financial indicators suggest this level of monitoring is needed or if noncompliance with HUD business agreements (by the Borrower, Operator or Management Agent) is suspected.

If the Borrower is the same legal entity as the Operator, then the Borrower itself will submit the Operator financial data. Detailed instructions for the submission of quarterly and annual Operator financials, using the Section 232 Healthcare Portal, may be found on the Section 232 Program website.

B. Withdrawal of Project Funds (Distributions)

As set forth in federal regulation 24 CFR 232.254, and applicable only to transactions for which a firm commitment has been issued on or after July 12, 2013, with mortgage insurance transactional documents consistent with the regulation (see in particular the ORCF *Healthcare Regulatory Agreement – Operator*,, and specifically Sections 15 and 16 thereof), a Borrower may make and take distributions of mortgaged property, to the extent and as permitted by the law of the applicable jurisdiction, provided that:

1. The calculation shall be made no less frequently than semi-annually.

2. The Borrower must demonstrate positive surplus cash. To the extent surplus cash is negative, the Borrower must repay any distributions taken during such calculation period within 30 calendar days, unless a longer time period is approved by HUD.

3. The Borrower shall be deemed to have taken distributions to the extent that surplus cash is negative, unless in conjunction with the calculations of surplus cash, the Borrower provides to HUD documentation evidencing, to HUD's reasonable satisfaction, a lesser amount of total distributions.

Note, however, that the distributions of an Operator in transactions for which a firm commitment was issued on or after July 12, 2013, are governed separately by 24 CFR 232.1013, and if a Borrower and Operator are the same legal entity then that entity's distributions are constrained by both the Borrower restrictions and the Operator restrictions.

C. Mortgagee/Servicer's Analysis of Its Overall Portfolio

To have a full and accurate picture of the financial condition of its portfolio, Mortgagee/Servicers must assess the probability that existing loans might not be repaid. Mortgagee/Servicers will need to estimate the losses that could be incurred and to establish procedures for assessing the risk inherent in each loan in their portfolios. An annual meeting between a Mortgagee/Servicer and their assigned AE(s) should be conducted to align risk mitigation efforts. The Mortgagee/Servicer shall contact the AE when the project is experiencing operational challenges which may warrant discussions amongst the parties.

Section III
Asset Management

Appendix 4.1
Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care

Real Estate Assessment Center website:
http://hudatwork.hud.gov/po/reac/

Form Number	Form Name
HUD-92337-ORCF	Healthcare Regulatory Agreement – Master Tenant
HUD-92464-ORCF	Request Approval Advance of Escrow Funds
HUD-92466-ORCF	Healthcare Regulatory Agreement – Borrower
HUD-92466A-ORCF	Healthcare Regulatory Agreement – Operator
HUD-9250-ORCF	Funds Authorization
HUD-9250A-ORCF	Borrower Certification and Request Detail
HUD-9839-ORCF	Management Certification – Residential Care Facility
N/A	Sample Format for Deposit Account Control Agreement (DACA)
N/A	Sample Format for Deposit Account Instructions and Service Agreement (DAISA)

Section III
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Chapter 5

Section 232
Risk Mitigation Branch and Asset Management Tools

5.1 Introduction

The Risk Mitigation Branch is a group of Account Executives (AE) created to service projects that are at risk of default. The AEs within the Risk Mitigation Branch work collaboratively with the AEs in Asset Management to proactively identify issues, and when appropriate, transfer the project to the Risk Mitigation Branch for enhanced servicing. The main focus of the Risk Mitigation Branch is to develop an ongoing communication schedule with all parties in an effort to proactively pursue all efforts to avoid a claim to the insurance fund. Sometimes several workout strategies are pursued concurrently. The participation in weekly or bi-weekly status meetings by *all* parties (Mortgagee/Servicer, Borrower, and Operator) to the FHA insured loan is required, when a project is assigned to Risk Mitigation Branch.

Events that would trigger the re-assignment to the Risk Mitigation Branch, if deemed appropriate by AE and Risk Mitigation Branch, would include:

1. Default of the Mortgage Payment
2. Special Focus Designation
3. Ban on Admissions
4. A serious decline in Survey or Financial Performance
5. Any other situation where all attempts to cure has been unsuccessful by the AE and more specialized and concentrated focus is needed by the Risk Mitigation team.

Upon assignment to the Risk Mitigation team, the AE will review all efforts to date and engage all participants to develop a plan to cure the default.

When the loan is assigned to the Risk Mitigation Branch, the Account Executive will initiate the reoccurring meeting with all parties and require the submission of monthly financial reports.

The agenda will include the following:

1. In collaboration with the AE, the Mortgagee/Servicer, Borrower, and Operator, must develop a plan to cure the default event and avoid an FHA insurance claim
2. Review and Discuss the Monthly Submission of Financials
3. Review and Discuss the current and historical Physical Condition of the Project
4. Review and Discuss the current and historical Survey Inspection Results

All meetings, action plans, and participants to the calls will be documented in iREMS by the Risk Mitigation Branch AE. Other participants (e.g. Program Management, ORM, and OGC) may be invited to participate in some of these calls depending on the severity of the situation and likelihood of a claim.

The items that will be discussed when developing the action plan will include, but are not limited to, the following:

1. Whether the project is currently listed or may be listed for Sale
2. Use of a consultant (when appropriate)
3. Change of Operator
4. Transfer of Assets (TPA) or Assumption of existing FHA insured loan

This chapter discusses the various risk mitigation tools and processes that may be used on existing FHA Insured Loans. These include Loan Modifications, Operating Loss Loans, and as a last resort, Partial Payment of Claim. This chapter also discusses Mortgagee/Servicer workouts/claim procedures and HUD-Held servicing and note sales on projects where an assignment has occurred.

In the event that a viable workout could not be achieved, a claim may be unavoidable. If this is to occur, it is the Mortgagee/Servicer's responsibility to ensure all assets and collateral for the FHA insured loan remain with the project (e.g. the inventory from the UCC Agreements and/or PCNA) and the Borrower/Operator understands they may not liquidate the project, and are to ensure the project and collateral remain secure. Even after the claim, ORCF will attempt to recover the highest recovery and require the full assets of the insuring loan remain intact.

5.2 Loan Modifications

A loan modification is a change to the note and/or the mortgage. The modification permanently changes the terms of the mortgage and/or note secured by the project, and as such it may need to be recorded in accordance with state and local law. The modification recasts the principal balance of the mortgage note and establishes a new amortization schedule.

HUD distinguishes between two different types of Loan Modifications – Interest Rate Reduction Only and Default.

Loan Modification - Interest Rate Reduction Only. In this type of Loan Modification, the existing insured loan is current. The only change made to the mortgage note is to reduce the interest rate and subsequently change the required principal and interest payment on the mortgage note. The term (duration) of the mortgage note must not be revised – it must equal the remaining term of the mortgage note at the time of the Loan Modification. **At the time of the Loan Modification, the loan must not be subject to a prepayment lock-out and any prepayment penalty required by the mortgage note must be satisfied.**

Default Loan Modification. In this type of Loan Modification, the existing insured loan is not current. Upon HUD's approval, the term (duration) of the mortgage note may be extended. As in the case of the Loan Modification – Interest Rate Reduction Only, the interest rate and the required principal and interest payment on the mortgage note will be decreased. Moreover, in accordance with procedures outlined in Section 5.5 below, an override of a prepayment lock-out and/or prepayment penalty may be approved by HUD.

Requirements for Review of Loan Modifications

A. **Loan Modification Applications.** Loan Modification applications must be assembled, reviewed for completeness, accuracy and eligibility, and submitted by the Mortgagee/Servicer to ORCF with a recommendation for approval. A checklist of the required application exhibits as well as the instructions for submitting the application is posted on the Section 232 Program website. Prior to submitting a Default Loan Modification application, the Mortgagee/Servicer must discuss the proposal specifics and any further required exhibits (not on the posted checklist) with the Risk Mitigation Branch AE assigned to the project.

B. **Interest Rate (Trade) Premium.** The following costs cannot be paid from trade premium: borrower counsel, organizational costs and third party reports costs (e.g. PCNA). Any portion of the interest rate (trade) premium that is not retained by the Mortgagee/Servicer or applied to Mortgagee/Servicer costs (such as Mortgagee/Servicer's Counsel fees and Government National Mortgage Association (GNMA) commitment fee) may be used to defray the prepayment premium on the existing GNMA Securities, with the balance, if any, remaining to be contributed to the project's Reserve for Replacement (R4R) account. Note: On Loan Modifications, ORCF will not object to all or a portion of title and recording costs being covered by trade premium.

C. **Prepayment Lockout Periods and Penalties**.

1. Mortgagee Letter 87-9 (Mortgage Prepayment Provisions for FHA-Insured and Coinsured Multifamily Projects) establishes Program Obligations that Mortgagee/Servicers must follow when issuing Municipal or GNMA bonds for the purpose of financing an FHA-insured loan.

2. Mortgagee Letter 87-9 clarifies HUD's position with respect to the inclusion of provisions prohibiting partial or full prepayments ("lock-outs") and prepayment

penalties in fully-insured and coinsured project mortgages, including all Healthcare Facility insured mortgages.

3. In order to include lock-outs and/or prepayment penalties in the terms of the mortgage note, the Mortgagee/Servicers must include in the mortgage note certain language prescribed in Mortgagee Letter 87-9 that specifies conditions upon which HUD may override the lock-out and/or prepayment penalty provision in the event of a default, in order to thus facilitate a refinancing or partial prepayment of the mortgage in an attempt to avoid an insurance claim.

4. Mortgagee Letter 87-9 stipulates that HUD may override the lock-out and/or prepayment penalty provision, in general, if HUD determines that prepayment will avoid a mortgage insurance claim and is therefore in the best interest of the Federal Government. Particular conditions governing the override of a prepayment lock-out and/or penalty provision are:
    a. The project Borrower has defaulted and HUD has received notice of such default, as required by 24 CFR Part 207-256 (full Insurance cases) or Part 251.810 or Part 255.808 (coinsurance cases);
    b. HUD determines that the project has been experiencing a net income deficiency, which has not been caused solely by management inadequacy or lack of Borrower interest, and which is of such a magnitude that the Borrower is currently unable to make required debt service payments, pay all project operating expenses and fund all required HUD reserves;
    c. HUD finds there is a reasonable likelihood that the Borrower can arrange to refinance the defaulted loan at a lower interest rate or otherwise reduce the debt service payments through partial prepayment; and
    d. HUD determines that refinancing the defaulted loan at a lower rate or partial prepayment is necessary to restore the project to a financially viable condition and to avoid an insurance claim.

5. Section 18-3(b) of the GNMA Mortgage-Backed Securities (MBS) Guide 5500.3 Rev. 1 ("GNMA Guide") provides the Mortgagee/Servicer authority, as the GNMA Issuer, to buy out of the MBS a loan that is ninety (90) days or more delinquent. The GNMA Guide also provides permission to re-securitize the defaulted loan into new securitizations, subject to a HUD approved modification.

5.3 Section 223(d) Operating Loss Loans (OLL)

Section 223(d) Operating Loss Loans (OLL) provide Borrowers of FHA-insured loans a vehicle for recouping their out-of-pocket expenditures to fund unforeseen operating deficits on projects during the early years of the project's operation. HUD's authority to approve a Section 223(d) Operating Loss Loan is set forth in Section 223(d) of the National Housing Act (NHA), which was later amended by Section 427 of the Housing and Community Development Act of 1987. Section 223(d) authorizes two types of OLL, both of which are available to FHA-insured Section

232 new construction and substantial rehabilitation health care projects managed by ORCF. Section 232/223(f) projects are ineligible for the OLL.

Promulgation of Section 223(d) of the NHA is an indication of HUD's awareness that a project may struggle in the early years of operations due to cash flow demands and unforeseen expenses; and that HUD is concerned about these debt service problems and net operating losses. To preserve projects and to encourage Borrowers to provide working capital to fund early financial shortfalls and avert mortgage defaults, the OLL permits Borrowers to recover their unplanned contributed equity more quickly than surplus cash notes and surplus cash distributions would otherwise allow. Thus, the OLL serves as a valuable incentive for encouraging Borrowers to remain financially committed to their projects.

OLL applications must be assembled, reviewed for completeness, accuracy and eligibility, and submitted by the Lender to ORCF with a recommendation for approval. A checklist of the required application exhibits as well as the instructions for submitting the application will be posted on the Section 232 Program website. Prior to submitting an OLL application, the Lender must discuss the proposal specifics and any further required exhibits (not on the posted checklist) with the Risk Mitigation Branch AE assigned to the project.

A. **General Requirements.** To be eligible for an operating loss loan, the following conditions apply:

1. The existing project mortgage must be insured by the Secretary under Section 232 New Construction/Substantial Rehabilitation of the National Housing Act and must include at least 20 beds (skilled nursing home or intermediate care facility); or 5 bedroom accommodations (board and care facilities).

2. An allowable loss has been experienced. The loss loan must not exceed the amount of the operating loss.

3. The operating loss must have occurred during a specific period of time.

4. The Borrower entity must have owned the project during the loss period.

5. All funds in the Initial Operating Deficit, if applicable, have been disbursed.

6. All cost certification requirements have been satisfied.

7. The Borrower, Operator, and Management Agent, as applicable, meet ORCF standards for project management.

8. The Lender on the first mortgage must consent in writing to the OLL.

9. The mortgage term must not exceed the unexpired term of the original mortgage.

10. Section 223(d) requires that the OLL must be made to, and represent an operating loss by, the Borrower entity.

B. **Financial Viability.** Implicit with the concept of an OLL, is that this supplemental loan is intended for those projects that survive early financial struggles and finally attain a self-sustaining operational state. The OLL proposal must demonstrate that the project is financially viable, i.e., that it has sufficient net operating income to meet the increased debt service obligations that come with the OLL. Self-sustaining operations is defined as follows:

1. The project must have achieved stabilized occupancy, and,

2. After achieving a stabilized occupancy, the project is solvent, i.e., revenues exceed expenses and current assets exceed current liabilities with all mortgage obligations met in a timely manner after the OLL is in place.

In certain instances, an OLL may be proposed as an essential element of a work-out strategy designed to rescue a "troubled" project and avert an FHA claim. In those infrequent instances, an OLL may be approved based on *projected* sustaining occupancy and debt service coverage. However, only actual losses (confirmed by audit) may be funded, and there must be strong indications that a self-sustaining operational state will be reached within a reasonable period of time. Refer to Production, Chapter 2 for further discussion regarding stabilized occupancy and debt service coverage requirements.

With regard only to an OLL proposed as part of a workout to avert FHA claims, the proceeds of the loan may be required to cure financial deficits. If the loan proceeds are needed to cover mortgage deficits, all or part of the loan proceeds shall be held in escrow by the Lender until the project has become self-sustaining. The funds escrowed for these purposes shall be released only with prior approval from ORCF. The requirements for the escrow will be defined as a Special Condition in the Firm Commitment.

C. **Definition of an Operating Loss.** Certain project-related costs are disallowed in calculating the operating loss for an OLL. An operating loss is defined as the amount by which the sum of the taxes, interest on the mortgage debt, mortgage insurance premiums, hazard insurance premiums, and operating expenses exceed project income. The following disbursements must not be included: payment to mortgage principal, depreciation, payments to the R4R account, payments to the sinking fund, Lender fees, officers' salaries, bad debts (rents/revenue that is deemed uncollectible) and charges incurred in connection with the application for the OLL.

D. **Section of the Act and Determination of the "Loss Period."** The original form of OLL, Section 223(d)(2), allows for Borrower recovery of defined operating losses incurred during the first two years of operation after the cost cutoff date. The later variation of OLL, Section 223(d)(3), permits a loan for operating losses during any period of consecutive months (but not exceeding 24 months) during the first ten years following the date of completion of the project as determined by the Commissioner. There may be two OLLs (one under Section

223(d)(2) and one under Section 223(d)(3)) for any individual project but no more than one per subsection. However, the OLLs must not be for the same 24-month time period.

The selected 24-month period is referred to as the "loss period" and losses claimed during that time frame must be evidenced by audited financial statements.

E. **Calculating the Potential Loan Amount.** Adhering to the definitions of allowable costs above, the determination of the maximum insurable OLL amount is made using one or more of the criteria of the Maximum Insurable Loan Calculation (Form HUD-92264A-ORCF). The operating loss loan is limited to both 100% of the operating loss *and* the amount supported by the debt service limitation. Note that ORCF current guidelines require a minimum *combined* Debt Service Coverage Ratio (DSCR) of 1.45. Additionally, for operating loss loans pursuant to Section 223(d)(3), a further limitation on the loan amount is imposed, namely 80% of the unreimbursed cash contributions. Further guidance on calculating the OLL amount is provided in Production, Chapter 3.

   The HUD underwriter may request an appraisal consulting assignment by an ORCF appraiser, and the resulting recommendations may include the requirement for an independent appraisal, market study and/or other independent consultation.

F. **Application Fees and MIP.** Application fees are required for all Section 223(d) Operating Loss Loans. Fee rates are published in the Federal Register. Since OLL's are considered higher risk loans, the MIP is set higher than for lower risk loans. Rates are published in the Federal Register annually. See Production, Chapter 1 for further guidance.

G. **Processing Procedures for OLL's.** Underwriting guidance can be found in Production, Chapter 2 and on the Section 232 Program website.

H. **Preliminary Discussions.** At the request of the Borrower, or the Lender, the AE (and/or other ORCF representatives) will conduct informal, preliminary discussions with the Borrower and/or Lender. These preliminary discussions will define the objectives that would be addressed by the OLL, and will seek to ensure that the Borrower is acquainted with ORCF guidelines relative to OLL's.

5.4 Partial Payment of Claim (PPC)

This section provides guidance regarding Partial Payment of Claim (PPC) specifically applicable to the Section 232 Program.

When a Mortgagee/Servicer of a loan on a Section 232 project becomes eligible to file an insurance claim and to assign the mortgage to the Federal Housing Administration (FHA) Commissioner ("the Commissioner") pursuant to 24 CFR Part 207.258, the Commissioner may request the Mortgagee/Servicer, in lieu of assignment, to accept a partial payment of the claim under the mortgage insurance contract and to recast the mortgage, under such terms and

conditions as the Commissioner may determine. The Commissioner may request the Mortgagee/Servicer to participate in a Partial Payment of Claim ("PPC") in lieu of assignment only after a determination that partial payment would be less costly to the Federal government than other reasonable alternatives for maintaining the project. This determination is based upon the findings of criteria indicated in this chapter and such other findings as the Commissioner deems appropriate.

In order to avoid a full insurance claim and assignment of the entire mortgage to FHA, FHA pays the Mortgagee/Servicer a portion of the principal balance and overdue accrued interest, and recasts the remaining principal balance of the mortgage under terms and conditions determined by HUD, through a PPC. Prior to processing of the PPC proposal, the Mortgagee/Servicer must voluntarily agree to accept a partial payment of the insurance claim in accordance with the terms detailed in this chapter. If applicable, the Mortgagee/Servicer must also waive any prepayment and lockout provisions in the mortgage. As the PPC is completed, the Borrower enters into a second HUD mortgage, the "PPC Note," in the amount of the PPC claim plus overdue interest on the mortgage, obligating the Borrower to pay 50 to 75% of the project's annual future surplus cash flow as repayment on for-profit entities. On non-profit entities the future surplus cash/residual receipts repayment is 75 to 100% of surplus cash or residual receipts.

The process for requesting, reviewing, approving and closing PPCs is similar to other loan modification transactions except for parts of the closing activity. Borrowers of projects in danger of defaulting must be in discussions with their project's or projects' AE(s) early on, and must provide monthly financial statements well in advance of a request. However, the formal process begins when the Borrower submits a request and plan, signed by its legally authorized agent, to the Mortgagee/Servicer, who then submits a complete application to HUD. Once ORCF obtains a complete PPC Proposal Package and undertakes a brief threshold review described in Section 5.19 below, then ORCF's Risk Mitigation Branch completes a detailed analysis, and presents to ORCF's Loan Committee a recommendation to approve or reject the proposal. The Loan Committee then presents its recommendation to the Associate Deputy Assistant Secretary (ADAS), OHP.

A. **Background on Partial Payment of Claim.** Guidance on PPCs with respect to other FHA programs has historically been contained in HUD Housing Handbook 4350.1, Chapter 14. While 24 CFR Part 232.251 and Housing Handbook 4350.1 REV-1, Chapter 14 both specify that Section 232 projects are <u>not</u> eligible for PPCs (paragraph 14-2), in 1997, 12 U.S.C. Section 1735f-19 was amended to encompass mortgages on healthcare facilities and permit PPCs on Section 232 projects.

   Mortgagee Letter 2011-15 and 24 CFR Part 232.882 implement policies with respect to PPCs for the Section 232 Program, but do not address notes for which assignment to the Secretary has already been completed and which are thus HUD-held. Mortgagee Letter 2011-15 also complements Mortgagee Letter 87-9 which allows for the waiver of prepayment penalties and lockout provisions in mortgages to avoid a mortgage insurance claim. Projects approved for a PPC are deemed to have complied with all terms of Mortgagee Letter 87-9.

B. **Applicable Policies.** Mortgagee Letter 2011-15 as well as CFR set forth the minimum conditions that must be met for a Section 232 mortgage to be eligible for a PPC. These minimum conditions are subject to the inclusion of additional conditions and/or more stringent consideration, based upon the individual circumstances of each proposed PPC, as the Commissioner deems appropriate. The minimum conditions are:

1. The Mortgagee/Servicer is entitled, after a default as defined in 24 CFR Part 207.255, to assign the mortgage in exchange for the payment of insurance benefits.

2. The relief resulting from partial payment when considered with other resources available to the project must be sufficient to restore the financial viability of the project. In evaluating financial viability, the Department will evaluate the adequacy of the debt service coverage ratio, which would generally be expected to be at or above 1.20, after allowing for the mortgage insurance payment. The Department will also consider the size of the requested PPC as a percentage of the current outstanding mortgage, keeping the PPC no larger than essential and not exceeding 50 percent.

3. The project is or can (at reasonable cost) be made physically sound.

4. The current or proposed Operator of the project is satisfactory to the Commissioner, as demonstrated by past experience in operating similar type health care projects and by state regulatory performance.

5. The default under the insured mortgage was beyond the control of the Borrower and/or Operator, or in the case of a Transfer of Physical Assets (TPA), the proposed Borrower or Operator, unless ORCF determines that any Borrower/Operator deficiencies giving rise to the default have clearly been addressed.

6. The project is serving as, or potentially could serve as, a needed nursing home, intermediate care facility, or board and care home, or assisted living facility.

7. The property covered by the mortgage is free and clear of all liens other than the insured first mortgage. The Mortgagee/Servicer has voluntarily agreed to accept a PPC under the mortgage insurance contract and to recast the remaining mortgage amount under terms and conditions prescribed by the Commissioner.

8. The Borrower has agreed to repay to the Commissioner an amount equal to the partial payment, with the obligation secured by a second mortgage on the project containing terms and conditions prescribed by the Commissioner. The terms of the second mortgage will be determined on a case-by-case basis to ensure that the estimated project income will be sufficient to cover estimated operating expenses and debt service on the recast FHA-insured mortgage.

9. For a partial payment of claim, the Borrower has made a net capital contribution equal to 5% or more of the original mortgage to fund operating shortfalls since final closing (for a non-profit, including its in-kind services acceptable to ORCF). The

consecutive timeframe for this determination commences at final closing, and then continues up to the date of initial default. This calculation period can be adjusted at HUD's sole discretion. If a TPA will be involved, then contributions to be brought to the project at closing by the acquiring Borrower can be included in this determination.

10. The Borrower has remitted all net cash (i.e., the cash remaining after the project has paid all of its operating expenses) to the Mortgagee/Servicer between the date of default and the date of closing on the PPC. If the Operator is a different entity than the Borrower, then this requirement is expanded, and the Operator must also submit to the Borrower all net cash derived from the operation between the date of default and closing of the PPC.

C. **PPC Submission Package.** The Mortgagee/Servicer's formal proposal is to be submitted to the AE servicing the particular mortgage loan. If a Transfer of Physical Assets (TPA) is anticipated, then a TPA application in accordance with ORCF requirements must be concurrently submitted. The PPC proposal must be assembled, reviewed for completeness, accuracy and eligibility, and submitted by the Mortgagee/Servicer to ORCF with a recommendation for approval. A checklist of the required proposal exhibits as well as the instructions for submitting the proposal will be posted on the Section 232 Program website. Prior to submission, the Mortgagee/Servicer must discuss the proposal specifics and any further required exhibits (not on the posted checklist) with the Risk Mitigation Branch AE assigned to the project, and must demonstrate that all of the requirements set forth above are met.

D. **Recast First Mortgage Terms.** The First Mortgage Note will be modified to reflect:

1. A reduced principal mortgage (as a result of the PPC);

2. An interest rate not to exceed 125 basis points over the 10-year Treasury rate on the day a terms letter is offered;

3. The maturity date, which is the original maturity date unless an extended date within statutory authority has been agreed upon; and

4. Modified monthly payments of principal and interest as re-amortized based on the reduced principal, new interest rate and, if applicable, new term.

If requested by the Mortgagee/Servicer, the First Mortgage Note may include a restriction on prepayment for the purpose of enhancing the marketability of the new GNMA Mortgage-Backed Security (MBS). Any prepayment restriction must be in accordance with Mortgagee Letter 87-9.

E. **PPC/Second Mortgage Note Terms.** The PPC/Second Mortgage Note, created to compensate FHA for its insurance claim loss when the first mortgage is recast in a lesser amount, has a principal amount equal to the amount of the reduction in the FHA-insured first mortgage principal plus overdue interest. Subject to any requirements for additional

Borrower cash or excess project cash, HUD will include in the PPC/Second Mortgage Note the amount of interest computed since the date of delinquency based on the actual number of days in a 365- or 366-day year. Late fees accrued since the last payment or any other costs to close cannot be included in the transaction or paid by the project in the future. The terms of the PPC/Second Mortgage Note will be as follows:

1. An interest rate equal to the applicable Federal Rate for the month of closing. This rate can be located at: http://www.irs.gov.

2. Maturity date coterminous with the First Mortgage Note.

3. A "due-on-sale, refinance, or termination" provision.

4. As long as the Second Mortgage Note is held by HUD, a service charge, calculated at 0.50 percent annually based on the unpaid principal balance of the Second Mortgage Note, must be paid to HUD monthly.

5. The minimum annual payment on the Second Mortgage Note will be 75 percent of annual surplus cash on for-profit entities and 100% of residual receipts/surplus cash (this percent can be negotiated by ORCF when the PPC is contemporaneous with a change in ownership and control of the mortgaged asset) as surplus cash or residual receipts are specified in the Regulatory Agreement between the Secretary of Housing and Urban Development and the project Borrower, together with the applicable HUD Regulations and administrative requirements. The payment of surplus cash or residual receipts to be applied to the second mortgage note payment is due within 10 days of the required filing of the Annual Financial Statement. Borrower's share shall be determined under the circumstances above. The minimum annual payment will be applied towards interest first and then principal.

6. Consistent with the Second Mortgage Note, in the event, and when, the project is operated by an entity that is legally distinct from but has an identity of interest with the Borrower, the *minimum* annual payment on the Second Mortgage Note will be 100 percent of annual surplus cash or residual receipts as defined in the Regulatory Agreement. Additionally, in that event, the Borrower must collect from the Operator a lease payment equaling or exceeding all payments required of the Purchaser for payment of all principal, interest, escrow and fees on any amortizing notes, *plus* any surplus cash or residual receipts as agreed to in negotiations for the PPC. Before calculating that rent, no payments to the Operator or any related party, beyond 4% (four percent) of gross revenue (as a management fee) will be deducted. The Borrower must accomplish any amendment to the lease necessary to effectuate this rental calculation prior to the completion of the PPC transaction.

7. Language prohibiting successors and assigns of the beneficiary of the Second Mortgage Note from imposing property insurance requirements that exceed the original principal balance contained in the First Mortgage Note or are in addition to

those required by the First Mortgage Note Holder so long as the First Mortgage Note is insured by the Secretary of Housing and Urban Development.

[NOTE: HUD has the right to sell the Second Mortgage Note. If HUD sells the Second Mortgage Note, the Borrower and Operator are required to submit annual financial statements to the Second Mortgage Note Holder in the same form as submitted to HUD or other format acceptable to the note holder.]

F. **Other Terms and Conditions of the PPC Transaction.**

1. If Identity-of-Interest expenditures have been included as a Borrower's Contribution in calculating eligibility for a PPC, then a requirement that those expenditures cannot be taken or must be re-deposited for any year in which surplus cash is negative (not to exceed the amount of the negative surplus cash). The redeposit or accrual can only be repaid from the Borrower's share of surplus cash in future years.

2. The monthly deposit to the R4R Account will resume with the first payment of the recast First Mortgage Note. Previous deposits that were not made in the past will not be required to be addressed, unless the reserve balance has been determined to be inadequate.

3. All escrows, such as tax, hazard insurance and mortgage insurance premium (MIP) shall be fully funded at closing.

4. If the insured First Mortgage Note is repaid, the Borrower must establish and maintain continued funding of all escrows required by the First Mortgage Note until the Second Mortgage Note is repaid in full.

5. Project operating income must not be used to pay financing fees, attorney fees, consultant fees, other professional fees, or any other costs of the restructuring transaction. The Borrower's share of future surplus cash may be used for these purposes only if available for distribution in accordance with HUD regulatory requirements and applicable policy guidelines.

6. Cash held in suspense by the Mortgagee/Servicer will be allowed by HUD to be used at closing to pay reasonable closing attorney fees, title and recording fees, escrow shortages and interest for the remainder of the closing month. The PPC will not be increased if project cash is insufficient to cover these costs.

7. HUD will include in the Second Mortgage Note the amount of interest computed since the date of delinquency based on the actual number of days in a 365- or 366-day year. The Mortgagee/Servicer cannot collect more interest from the project than paid by HUD.

8. The Sources and Uses of Funds Statement for the refinancing must not show disbursements of funds to the Borrowers as funds are prohibited from being disbursed to the Borrowers in a PPC transaction.

9. No funds will be paid to identity-of-interest persons or entities. The Sources and Uses of Funds Statement must also be signed by the Borrower or representative below the following statement: "Warning: It is a crime to knowingly make false statements to a Federal Agency. Penalties upon conviction can include a fine and imprisonment. For details, See Title 18, U.S. Code 1001 and 1010."

10. The first mortgage insurance documents in a PPC shall provide that the Borrower and the Mortgagee/Servicer of the first mortgage loan must provide notices and documentation to the second note holder upon the occurrence of events that could affect the value and position of the second mortgage Mortgagee/Servicer such as: full or partial payment on the first mortgage loan, events of default on the first mortgage loan, declaration of bankruptcy by the Borrower, and any documentation related to a bankruptcy or any foreclosure action.

11. In the event the First Mortgage Note is prepaid and there is no additional FHA-insured debt on the project, the Borrower will furnish HUD and the Second Mortgage Note Holder audited annual financial statements until the Second Mortgage Note is satisfied.

12. The Borrower must not incur additional collateralized debt without the prior written consent of HUD, Second Mortgage Note Holder and any separate or additional note holder.

13. The Second Mortgage Note Holder (subject to the rights of the first mortgage Lender) has the right to foreclose on the security interest in the net cash flow perfected by filing of a UCC-1 Financing Statement, in the event of a default on the Second Mortgage Note.

14. After the closing of the PPC transaction, the Borrower and Operator shall each be required to file annual financial statements (and more frequent financial statements when requested) consistent with their amended first mortgage regulatory agreements, new second mortgage regulatory agreements, and riders thereto that will be required and executed as part of the PPC transaction.

G. **Closing Documents.** The required closing documents are listed on the Closing Checklist posted on the Section 232 Program website.

Upon receipt of HUD's Preliminary Approval Letter, the Borrower and Mortgagee/Servicer must notify ORCF's Closing Coordinator (Closer) of the targeted closing date and <u>the closing date must occur within 60 days from the date of notification of ORCF's approval.</u> The Mortgagee/Servicer's requested date will be accommodated to the extent possible but the Closer, in cooperation with the OGC Reviewer, has the final authority to set the closing date.

Upon receipt of the Borrower's acceptance and notification of the target closing date, the Closer will coordinate with OGC Counsel in Headquarters and with Multifamily Claims Branch and Multifamily Note Servicing to confirm the projected closing date or suggest alternative dates if the Borrower's dates cannot be accommodated. Delays due to Borrower's, Mortgagee/Servicer's or other party's action or inaction will be deemed the Borrower's responsibility. The Borrower is strongly encouraged to meet the targeted closing dates, as delays may be costly. Once the amount of the PPC Note is determined, any increase in the funds required to close (e.g., interest) must be funded by the Borrower at closing, unless other disposition is approved by ORCF.

H. **Claims Branch Process.** Upon receipt of the Borrower's acceptance letter, the Closer will contact the Mortgagee/Servicer, Mortgagee/Servicer's Counsel, Borrower and Borrower's Counsel, and representatives of Multifamily Claims Branch and OGC to schedule a closing coordination call. The closing coordination call allows the parties to discuss closing requirements, timing, issues and logistics. It also allows OGC to coordinate submission of draft closing package with the Mortgagee/Servicer's Counsel.

The Closer will also contact the AE to obtain copies of the documents needed for inclusion in the Multifamily Claims Branch Package for PPCs.

The total amount of a PPC will be determined by the certification of mortgage balance (Certification) from the Mortgagee/Servicer after the application of remaining net cash proceeds and all unapplied funds. The Certification will include all escrow balances and must be signed by the Mortgagee/Servicer and the Borrower.

Working with ORCF, the Claims Branch will verify the current first mortgage's unpaid principal balance (UPB) and calculate the mortgage interest owing, from the date of the last payment up to, but not including, the date of closing.

The Claims Branch's calculations are based on a 365 or 366 (leap year) day year, which may cause disparities in interest calculations between HUD and the Borrower or Mortgagee/Servicer. Prior to closing, ORCF will provide to the Claims Branch a Closing Memorandum detailing the application of the claim payment to interest and principal. As part of the Closing Memorandum, a Sources and Uses Statement will be attached.

I. **Closing Process.** Upon receipt of all documents for Claims, the Closer will prepare a memorandum for Claims. This will serve as the cover letter for the submission of all the documents referenced as claims documents above. The Closer will confirm with OGC that all comments regarding the legal documents have been addressed and the transaction is ready to close.

Upon receiving notification that the transaction is ready to close the Mortgagee/Servicer's Counsel will prepare the final loan closing documents and obtain signatures. The Borrower's signature must be affixed to the documents before they are submitted to ORCF for signature. If ORCF is expected to forward the documents to a title company or other party for closing,

proper mailing media (i.e. an overnight service envelope with an addressed bill of lading) must be included with the documents submitted for signature.

On the day of closing, the Multifamily Claims Branch will not trigger the wire transfer to pay the claim before all approved documents modifying the First Deed of Trust and all approved documents establishing the Second Deed of Trust have been executed and recorded in an agreed upon order. Additionally, the Multifamily Claims Branch will not trigger the wire transfer to pay the claim before a title policy has been issued which confirms the continuing first lien priority of the First Deed of Trust and the second lien priority of the Second Deed of Trust.

All parties must be made aware that there is no guarantee that the PPC payment will be received in escrow the day the claim is triggered. Closing parties should make their plans accordingly. The Mortgagee/Servicer's attorney shall forward scans by email of final, executed, and, if applicable, recorded documents to ORCF on the day of closing.

J. **Post-Closing.** After closing, the Mortgagee/Servicer's attorney shall submit hard copies of all closing and supporting documents, including certified copies of all recorded documents, along with a copy of the final title policy to ORCF and OGC.

As long as the PPC second mortgage note is owned by HUD, ORCF's Risk Management Branch will compare the Annual Financial Statement submitted by the Borrower to the final HUD-approved base line and 20-year projections. Significant deviations will be investigated to ensure all income and expenses, reserves and accounts payable are properly accounted for and that surplus cash or residual receipts are accurate. Expenses will also be closely examined to ensure no expenses have been incurred related to the PPC as these are disallowed, except as surplus cash or residual receipts distributions per the terms and conditions of the PPC transaction. All accounting, legal, and consultant fees must be paid for by the Borrower and not out of project accounts.

After completion of the financial statement analysis, the AE is required to summarize the analysis in the Integrated Real Estate Management System (iREMS). This must be completed annually as long as HUD is the holder of the PPC.

The AE will follow established protocol to ensure filing of accurate financial statements and that required payments are made on the PPC.

5.5 Mortgagee/Servicer Workouts/Claim Procedures and Requirements

A. Alternative election by Lender.

1. Except to the extent that HUD has approved an extension of a period for an election to assign a mortgage (requests for which are required in circumstances set forth in this

Section 4.10 and in 24 CFR 207.258), when the Lender becomes eligible to receive mortgage insurance benefits pursuant to 24 CFR § 207.255(a)(3) or (b)(3), the Lender must, within 45 calendar days after the date of eligibility (such period is referred to as the ''Eligibility Notice Period'' for purposes of this section), give the Commissioner notice of its intention to file an insurance claim and of its election either to assign the mortgage to the Commissioner, as provided in paragraph (b) of this section, or to acquire and convey title to the Commissioner, as provided in paragraph (c) of this section. Notice of this election must be provided to the Commissioner in the manner prescribed in 24 CFR part 200, subpart B. HUD may extend the Eligibility Notice Period at the request of the Lender under the following conditions:

a. The request must be made to and approved by HUD prior to the 45th day after the date of eligibility; and
b. The approval of an extension shall in no way prejudice the Lender's right to file its notice of its intention to file an insurance claim and of its election either to assign the mortgage to the Commissioner or to acquire and convey title to the Commissioner within the 45-day period or any extension prescribed by the Commissioner.

2. For any mortgage insured under Section 232 of the Act, the Lender must:
    a. Request up to a 90-day extension of the deadline for filing the notice of the Lender's intention to file an insurance claim and the Lender's election to assign the mortgage or acquire and convey title in accordance with the Lender certificate, which HUD may further extend at the written request of the Lender;
    b. Assist the Borrower in arranging refinancing to cure the default and avert an insurance claim, if the Commissioner grants the requested (or a shorter) extension of notice filing deadline;
    c. Report to the Commissioner at least monthly on any progress in arranging refinancing;
    d. Cooperate with the Commissioner in taking reasonable steps in accordance with prudent business practices to avoid an insurance claim;
    e. Require successors or assigns to certify in writing that they agree to be bound by these conditions for the remainder of the term of the prepayment lock-out or prepayment premium; and
    f. After commencement of amortization of the refinanced mortgage, notify HUD of a delinquency when a payment is not received by the 10th day after the date the payment is due.

3. *Acknowledgment of election.* For mortgages insured pursuant to Section 232 of the Act, if the Servicer provides notice to the Commissioner of its election either to assign the mortgage to the Commissioner or to acquire and convey title to the Commissioner, the Commissioner shall, not later than 90 calendar days after the expiration of the Eligibility Notice Period, as defined in paragraph (a)(1) of this section, as the same may have been extended, acknowledge and accept, or reject for cause, pursuant to program requirements, the Servicer's election, provided that the Commissioner may, in the Commissioner's discretion, extend such 90-day period by

no more than an additional 90 calendar days if the Commissioner determines that such an extension is in HUD's interest.

B. Assignment of mortgage to Commissioner.

1. Timeframe; request for extension.
    a. If the Lender elects to assign the mortgage to the Commissioner, the Lender shall, at any time within 30 calendar days after the date HUD acknowledges the notice of election, file its application for insurance benefits and assign to the Commissioner, in such manner as the Commissioner may require, any applicable credit instrument and the realty and chattel security instruments.
    b. The Commissioner may extend this 30-day period by written notice that a partial payment of insurance claim under § 207.258b is being considered. A Lender may consider failure to receive a notice of an extension approval by the end of the 30-day time period a denial of the request for an extension.
    c. The extension shall be for such term, not to exceed 60 days, as the Commissioner prescribes; however, the Commissioner's consideration of a partial payment of claim, or the Commissioner's request that a Lender accept partial payment of a claim in accordance with § 207.258b, shall in no way prejudice the Lender's right to file its application for full insurance benefits within either the 30-day period or any extension prescribed by the Commissioner.
    d. The requirements of paragraphs B.2 and B.3 of this section shall also be met by the Lender.

2. Notice of assignment. On the date the assignment of the mortgage is filed for record, the Lender must notify the Commissioner, in the manner prescribed in 24 CFR part 200, subpart B, of such assignment, and must also notify the FHA Comptroller by telegram of such recordation.

3. The Servicer must also proceed consistently with all other applicable provisions set forth in the federal regulation 24 CFR 207.258.

Default Dates and Related Deadlines

Unpaid Installment Due On:	Must be Paid By:	Lender Eligible for Insurance On:	Notify HUD by C.O.B.:	Make Election to Assign Mortgage:
Jan 1	Jan 31	Feb 1	Mar 2	Mar 17
Feb 1	Mar 3	Mar 4	Apr 2	Apr 17
Mar 1	Mar 31	Apr 1	Apr 30	May 15
Apr 1	May 1	May 2	May 31	June 15
May 1	May 31	June 1	June 30	July 15
June1	July 1	July 2	July 31	Aug 15
July1	July 31	Aug 1	Aug 30	Sept 14
Aug 1	Aug 31	Sept 1	Sept 30	Oct 15
Sept1	Oct 1	Oct 2	Oct 31	Nov 15
Oct 1	Oct 31	Nov 1	Nov 30	Dec 15
Nov 1	Dec 1	Dec 2	Dec 31	Jan 15
Dec 1	Dec 31	Jan 1	Jan 30	Feb 14

1. These dates assume 28 days in February; adjust for leap years.
2. For deadlines falling on Sat., Sun., or federal holiday, use next business day.

5.6 HUD-Held Servicing and Note Sales

Upon assignment of a Section 232 Program mortgage under the provisions of the National Housing Act the note is deemed a HUD-held note which simply means that HUD paid a claim on the note, now owns the note and is responsible for servicing the note completely.

A. **HUD-Held Servicing.** Consistent with HUD's policies of providing access to affordable residential healthcare facilities as well as limiting losses to the Federal Housing Administration ("FHA') insurance fund, one of ORCF's goals is the prevention of mortgage assignments. Cooperation among ORCF, Mortgagee/Servicers and Borrowers is of paramount importance in accomplishing this goal. However, when an assignment takes place, ORCF Risk Mitigation staff will have already been involved with the project and have a plan on the most appropriate course of action to work with the project as well as determine the ultimate settlement of the project for HUD. ORCF's options after assignment generally include holding the mortgage in default to try to resolve the delinquency, placing the mortgage under a workout agreement to bring the project back into a financially viable status, placing the mortgage with the Property Disposition ("PD") Center for a foreclosure action, or selling the note in a note sale through the FHA Office of Asset Sales (OAS) at HUD. The ultimate decision as to which of these routes to pursue will depend upon the unique circumstances of each such Project.

Once a note is assigned, a claim is filed with the subsequent claim settlement on that note administered by the Multifamily Claims Branch. Note servicing-related activities are no longer performed by the Mortgagee/Servicer but are instead overseen by HUD's Multifamily Notes Servicing Branch, which currently contracts out these administrative functions to a third party provider for Section 232 Program notes. These administrative functions include preparation of monthly billing statements and the application of collected payments; overseeing deposits to and withdraws from escrow accounts maintained for taxes, insurance and R4R; investing reserve funds, as applicable; and filing UCCs, as applicable.

It should be noted that reserve accounts continue to need to be maintained in accordance with mortgage insurance documents and project funds must not be used to pay legal or consulting fees related to foreclosure or bankruptcy-related actions. Additionally, Monthly Accounting Reports and Annual Audited Financial Statements continue to need to be submitted to HUD as required.

ORCF's Risk Mitigation Branch administers HUD-held notes and manages the day-to-day issues as they arise with the Borrower and with the Operator if the Project is still in operation. The same levels of care and service provided to residents prior to the assignment are expected to be continued to be provided after the assignment. The Risk Management Branch will continue to explore practical options that preserve the value of the collateral securing the note to allow for maximizing the recovery on the claim paid from the FHA insurance fund.

B. **Note Sales.** Sales of Section 232 Program notes are managed by ORCF with the OAS, which coordinate the disposition of FHA-held single family, multifamily and healthcare mortgage notes. The OAS Loan Sale program is intended to minimize claim costs and maximize recoveries to the FHA insurance fund on performing and non-performing notes that were assigned to HUD under provisions of the National Housing Act. Notes sales are completed in compliance with the Debt Collection Improvement Act of 1996 which requires credit agencies with over $100 million in loan assets to sell delinquent loan assets that meet certain criteria and with OMB Circular Number A-11, Part 5, Section 185. It is noted that the mortgage note on the project is offered for sale, and it is not the project itself that is being offered for sale.

OAS contracts with a third party to oversee certain administrative functions and a Transaction Specialist to administer bidding-related aspects of note sales. The mortgage notes are secured by first liens on the project and are sold servicing-released and without FHA insurance. The sales of Section 232 notes may take place in conjunction with the sale of other multifamily notes, or as a stand-alone sale of multiple healthcare notes. Details of upcoming of sales are announced in a Sales Announcement which can be viewed at the Asset Sales section of the Section 232 Program website. Information on upcoming note sales is also published in the Federal Register and via a print advertising campaign. The notes are offered individually and in pools, by collateral type, loan type, and geography. The notes are typically sold in a sealed-bid auction format periodically. However, notes have also been offered via online bidding conducted in real-time as an "English", or "Outcry," auction by OAS as an alternative sales process.

Parties interested in becoming a bidder must submit a Confidentiality Agreement and Qualification Statement which are provided by the Transaction Specialist. Among other things, it is noted that to become a Qualified Bidder, a party must not be in default on any FHA-insured or HUD-held loans and must not be in violation of any regulatory or business agreements on any projects insured by HUD. Borrowers with a performing loan(s) may bid on other loan(s) provided they are a Qualified Bidder but they cannot bid on their own loans in a sale. Qualified Bidders have access to a Bidder Information Package which has information about the loans, including Payment Histories, Asset Summary Reports, and Selected Attributes Loan Data. Qualified Bidders are eligible to submit questions in writing during a designated due diligence period. HUD will make every attempt to answer such questions within forty-eight hours whenever possible. OAS periodically informs the ORCF Risk Management Branch of Section 232 Program notes that have been assigned and whose related FHA claims have gone through full settlement and are thus eligible for a note sale. Notes that have been assigned, but whose claim has not yet been settled are not eligible for sale. ORCF's Risk Management Branch will review the notes, and, after factoring in market conditions, timing, project-specific issues, feedback from OAS staff, and other qualitative factors, will then make a determination as to whether or not to include eligible notes on a case by case basis. In the pursuit of continuous improvement, ORCF statistically analyzes historical recovery rates of the notes sales under various parameters. In order to help further limit losses to the FHA insurance fund, historical recovery rates are factored into ORCF's decision-making process when assessing the most appropriate course of action on a HUD-held note. Once ORCF's Risk Management Branch has selected specific notes for an upcoming note sale, it is actively involved in assisting OAS in preparation for such sales. ORCF's involvement includes compiling project-specific legal documents from the loan files, databases and other information to be used in the sales process by Qualified Bidders, participation in weekly OAS sale-specific working group meetings, and answering questions received from Qualified Bidders during the due diligence period.

The Borrower is also notified of the upcoming note sale and is reminded of its Regulatory Agreement compliance requirements and its payment obligations to HUD until notified that the note has been sold and closed. The Borrower may also be required to provide access to the project securing the loan for purposes of an environmental assessment, physical needs/site inspection, and/or market rent study. Additional documents that may be requested include recent rent rolls, financial statements, and copies of applicable licenses and certifications.

Notices are also sent to the Unit of Local Government (ULG) where the project is located to advise that HUD has acquired the mortgage for a healthcare development in their jurisdiction and is requesting input on disposition strategies which could benefit the city and its citizens. The ULG is also notified that as part of the disposition process, HUD has the statutory authority to allow a ULG to purchase the mortgage note outside of the auction process.

The marketing and due diligence period typically begins four weeks prior to when bids are due. Winning bids are then awarded and closings are scheduled to take place shortly thereafter. HUD does not provide any financing for these sales and purchasers must provide

the full purchase price in cash. In some situations, upon review of the bids received and the level of bidder interest generated, a note may be removed from the auction and not sold if ORCF determines that a recovery may be greater if the note is instead offered at a subsequent note sale or if a new avenue of disposition is identified that would allow for a larger recovery. The decision to transfer funds from any reserve escrows to the winning bidder, or to apply those funds to enhance the recovery on the claim paid is assessed on a case by case basis by ORCF.

Additional information regarding current offerings and prior HUD note sales (including brochures, advertisements, results reports and successful bidder contact information) is available at the HUD OAS on the Section 232 Program website and via email at assetsales@hud.gov**.**

Section III
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Appendix 5.1
Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care

Link to GNMA Mortgage-Backed Securities (MBS) Guide 5500.3 Rev. 1:
http://www.ginniemae.gov/pages/default.aspx

Link to HUD Mortgagee Letter 87-9 (Mortgage Prepayment Provisions for HUD-Insured and Coinsured Multifamily Projects):
http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/1987ml.cfm

Link to HUD Mortgagee Letter 2011-15 (Revision to Procedures for Partial Payment of Claims of Section 232 Mortgages):
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/letters/mortgagee/2011ml

Form Number	Form Name
HUD-92264A-ORCF	Maximum Insurable Loan Calculation
HUD-92466-ORCF	Healthcare Regulatory Agreement – Borrower
HUD-92466A-ORCF	Healthcare Regulatory Agreement – Operator
N/A	Interest Rate Reduction Loan Modification Checklist
N/A	Sample Format for Lender Analysis and Recommendations Section 232 Note Modification

Section III
Asset Management

Chapter 6
Departmental Enforcement Center

6.1 Introduction

The Departmental Enforcement Center (DEC) is an office within HUD's Office of General Counsel (OGC) that, amongst other responsibilities, ensures regulatory and statutory compliance with the business agreements and regulations pertinent to the Office of Residential Care Facilities (ORCF) Section 232 Program. In order to accomplish this mission, the DEC relies upon both financial and physical condition information that is submitted to, processed by and disseminated from the Real Estate Assessment Center (REAC).

The DEC receives referrals for such enforcement review and action either through "automatic" referrals from REAC or through "elective referrals" from ORCF. ORCF "elective referrals are made when ORCF determines that DEC involvement would be helpful in addressing Section 232 Program participant compliance with HUD Regulations and business agreements. By doing so, ORCF aims to help restore a project to operational and financial long-term viability.

6.2 DEC-REAC-ORCF Enforcement Protocol Overview

In summary review, after receiving financial or physical information, REAC has automated algorithms that identify potential compliance deficiencies (findings), that are then subject to review by REAC Analysts. The REAC Analysts, after further review, determine what compliance findings need to be referred to either ORCF or the DEC. For financial compliance findings, the REAC review will either downgrade a compliance finding to "none," or determine whether to refer the compliance finding to ORCF or the DEC, based upon the type and magnitude of the finding. For physical compliance findings, the REAC Physical Score drives the direction of the referral to either ORCF or the DEC with consideration of both the value of the most recent score and the occurrence of substandard scores being the determining factors. Complete information regarding this referral

methodology is discussed with physical operations and financial operations in Asset Management, Chapter 3 and Asset Management, Chapter 4.

The DEC can bring expertise and experience to bear in addressing performance issues that are inseparably intertwined with compliance issues. There are numerous circumstances in which DEC involvement (via an elective DEC referral) could be extremely helpful either in effectuating *changes in Borrower/Operator practices* to stabilize the asset or, alternatively, in bringing about a *change of Borrower and/or Operator themselves* when essential to bring the asset into stabilized performance.

6.3 DEC and Physical Referrals

In accordance with current governing protocols (www.hud.gov/reac), REAC will automatically refer Section 232 projects receiving a defined Physical Assessment Sub-system (PASS) score to the DEC, and will also automatically refer any projects receiving a third consecutive score low score (as defined in current protocols) to the DEC. Although ORCF will have the lead responsibility for compliance assessment and enforcement of projects having passing PASS inspection scores, ORCF may make an elective referral to the DEC of any projects it deems necessary for enforcement actions. ORCF will make such elective referrals once it has determined that the score is not a result of scoring irregularities related to the nature of the project. Before making the elective referral, ORCF will coordinate the referral with the DEC.

Upon receipt of a physical referral, the DEC will analyze the REAC physical inspection report(s). The DEC will issue legally sufficient notices (sometimes in collaboration with the Lender) to the project participants to correct compliance deficiencies that are supported by the administrative record. Upon closing the referral, the DEC will recommend a course of action it deems appropriate to address any uncorrected compliance deficiencies.

The DEC may visit the project, if necessary:

A. To validate the REAC inspection report(s), and

B. To obtain photographic evidence for the administrative record. Should the DEC determine that a site visit is necessary, the DEC will coordinate the visit with ORCF.

6.4 DEC and Financial Referrals

REAC agrees to review the financial referrals that are currently automatically generated. REAC will manually direct such automatic referrals to the DEC or ORCF for action based on the agreed upon thresholds. Although the ORCF will have the lead responsibility for compliance assessment and enforcement of projects not automatically referred to the DEC (see the financial operations sections of Asset Management, Chapter4), the ORCF may

make an elective referral to the DEC of any projects that it deems necessary for enforcement actions (e. g., if quarterly interim Operator financial statements received by the Lenders suggest financial failings or compliance issues). Before doing so, ORCF will coordinate the referral with the DEC.

Upon receipt of a referral, the DEC will analyze the administrative record and the pertinent financial statements. If necessary, the DEC will request information and/or documentation from the Borrower to determine if a compliance violation occurred. Should the Borrower refuse to comply with the request for information, fail to resolve a compliance deficiency after having received a corrective action request from the DEC, or commit repeated violations of any of its business agreements with HUD, HUD will initiate appropriate administrative and/or enforcement action.

6.5 DEC and Non-Filer or Late-Filer Referrals

The Regulatory Agreements for Section 232 FHA-insured projects require Borrowers (with some exceptions as noted in Asset Management, Chapter4) to submit audited annual financial statements (AFS). HUD now requires the electronic submission of such statements to REAC. ORCF and REAC will work together to produce an e-mail reminder that will be issued to each Borrower who has not filed a required AFS within eleven days of the statement's due date. If the AFS is not received within 30 days from the date of the e-mail to the Borrower, REAC will then automatically refer all first-time non-filers to ORCF. REAC will refer to the DEC those Borrowers who are overdue in filing an AFS for a second or subsequent time.

For all first-time non-filers, ORCF will review the administrative record to ensure that an AFS is required and if so, contact the Borrower concerning any overdue AFS. If the Borrower fails to respond to the ORCF's request for compliance, then the ORCF may make an elective referral to the DEC.

6.6 DEC and Other Referral Types

Upon the DEC's own initiative, or at ORCF's request, the DEC may conduct a portfolio review, which is a review of projects based on a compliance issue that is common to one particular Management Agent, Operator, or Borrowers entity. The ORCF or DEC Satellite Office will confer with the DEC Operations Division Director concerning all potential portfolio reviews. The Operations Division Director will coordinate with the requestor to determine whether the DEC will accept the portfolio review, and if so, which DEC office will handle it. The DEC Director or their designee will approve all requests for portfolio reviews.

Should ORCF encounter violations of statutory, regulatory, or contractual issues that it considers to be significant in nature, but are not otherwise covered under this protocol,

ORCF may request the enforcement assistance of the DEC by seeking an elective referral. The DEC Operations Division Director will coordinate with ORCF to decide whether to accept the referral, and if so, which DEC office will handle it. The DEC Director or their designee will approve all requests for "other" elective reviews.

6.7 DEC and Suspension or Debarment Referrals

Suspension and debarment actions are taken to protect the public interest, not for punitive purposes. The ORCF may opt to refer cases to the DEC for suspension or debarment where serious program violations are detected or there is evidence of improper conduct based on an investigation, inspection, audit or review. Such requests are directed to the DEC's Compliance Division Director for consideration and possible assignment. However, program counsel may review the case prior to submission to the DEC to ensure that the administrative record supports the proposed sanction.

6.8 DEC, ORCF and Lender Successful Collaboration

While a project is assigned to the DEC, ORCF will coordinate with the DEC on any significant servicing actions. The DEC will coordinate any significant enforcement activities with ORCF and the Lender.

DEC, ORCF and the Lender cooperate with each other towards the common goal of attaining compliance with HUD's requirements while preserving residential care facilities for those served by the Section 232 Program.

Section III
Asset Management

Appendix 6.1
Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care

Real Estate Assessment Center website:
http://hudatwork.hud.gov/po/reac/

Section III
Asset Management

Chapter 7
Change in Ownership: Transfer of Physical Assets

7.1 Introduction

A full Transfer of Physical Assets ("TPA") is a sale or conveyance by deed of a property that has a mortgage insured or held by HUD. A modified TPA is a conveyance of certain interests in entities owning an FHA-insured project. This chapter applies to all transactions involving the transfer of all or part of an interest in the ownership of such properties.

This chapter lays out the procedures that all parties will follow to ensure that new participants are appropriately vetted and obligated to perform the duties and responsibilities required by HUD. The chapter will also outline the applicability requirements to HUD's programs and outline the delegation of responsibilities for HUD's staff. The criteria to determine a project's and Borrower's eligibility for a transfer of assets is outlined in detail and directions are provided for certain relationships involving multiple commitments.

Submissions herein must be assembled, reviewed for completeness, accuracy and eligibility, and submitted by the Mortgagee/Servicer to ORCF with a recommendation for approval. A checklist of the required application exhibits as well as the instructions for submitting the application is posted on the Section 232 Program website.

7.2 Applicability

A. Transactions requiring HUD's **full review** of a project, its current Borrower, and the qualifications of the new controlling entity include, but are not limited to, projects demonstrating the following characteristics:

1. Transfer of title from the Borrower entity to a buyer, including conveyance by installment sales contract, land contract, or wrap-around mortgage;

2. Transfer of any interest in a partnership Borrower that causes a dissolution of the partnership under applicable state law;

3. Transfer of the beneficial interest in a passive trust that results in a change in control and management of the asset, although legal title remains in the trustee.

B. HUD requires a **modified review** of certain transactions involving transfers of interests in entities owning properties with the following characteristics:

1. Any transfer of partnership interests in excess of 50% that do not cause a dissolution of the existing partnership under applicable law, as certified by an attorney who has no identity-of-interest with the partnership and is licensed to practice law in the state where the partnership is organized;

2. Addition or substitution of a managing or controlling member in a Limited Liability Company (LLC);

3. The substitution of one or more of the general partner(s) of a limited partnership Borrower that does not cause a dissolution of the existing partnership under applicable law, as certified by an attorney who has no identity-of-interest with the partnership and is licensed to practice law in the state where the project is located;

4. A transfer of stock of a corporate general partner of a partnership where such transfer results in one person or entity controlling in excess of 50% of the stock of a publicly traded entity or closely held corporation, where such transfer results in a change of control of the corporate general partner;

5. A transfer of stock of a corporate Borrower where such transfer results in one person or entity, other than the original controlling entity, controlling stock in excess of 50%, or an amount less than 50% where such a transfer results in a change of control of the corporate Borrower; and

6. Transfer of a beneficial interest in a passive trust that does not result in a change in control of the property.

7. Other entities not falling into categories above, where the managing control is changing (for example, a change to a corporate officer or voting board member of a non-profit corporation).

C. **TPA Light Reviews** include, but are not limited to, transactions with the following characteristic:

Change of Internal Revenue Services (IRS) Reporting Structure, i.e. when a Borrower(s) changes from Limited Partner (LP) to LLC but all principals remain the same and the Tax Identification Number is not changing.

D. When faced with a transaction that does not fall clearly into the definition of a TPA, but ORCF believes warrants HUD review, a TPA Application may be required. After addressing

the following questions, ORCF will determine whether or not a modified review or full review will be performed.

1. Will there be a change in the control of the project ownership?

2. Will a significant sum of money (any amount that exceeds 10% of the original insured loan amount), change hands in conjunction with the transaction?

Note that a change to ownership entities/structure can be done in conjunction with a Section 232 refinance under Section 223(a)(7) of the National Housing Act. In this situation, the required exhibits for the processing of this change are listed on the Section 223(a)(7) Firm Application Checklist posted on the Section 232 Program website.

E. A change to ownership entities/structure is also possible prior to the final closing of an insured Note for new FHA mortgage insurance. Such situations should be discussed with the ORCF Closer; ORCF may choose to re-process the application for Mortgage Insurance or require a TPA (depending upon the extent of the change).

F. On occasion, there will be changes within the second, third or even higher levels of an FHA project owner; these various levels of ownership are referred to as "tiers." These changes need to be reviewed with the Account Executive (AE) to determine if the transaction is considered a TPA and falls into one of the categories above or if another form of review is required. Any changes in the higher levels of ownership (tiers) must be reported to HUD, along with a summary of the transaction and organizational charts (please reference Housing Notice H 2016-15 or successors thereto). HUD will determine what will be required in these situations, as well as the type of review.

7.3 Transfer Fees

The Department imposes a fee of $0.50 per $1,000 of the original face amount of the mortgage to cover the costs of administrative, legal, and fiscal actions that a review entails. Substitution of principals that result in a change in control of the project (regardless of whether a change in ownership will occur (i.e., the single asset entity Borrower remains the same)) will be subject to the application fee. Applications received for a full review that are not accompanied by the proper fee will be returned without review. For applications that are reviewed by HUD and subsequently withdrawn, the fee paid to HUD will be considered earned and non-refundable.

A. Transactions Not Requiring a Transfer Fee:

1. Substitution of principals, if the assignment <u>does not</u> result in a change in the control of the project;

2. Transactions where both parties to the transfer are non-profit purchasers;

3. Assignment of the beneficial interest in a trust that holds title to the project if the assignment does not result in a change in the control of the project; and

4. A TPA Application Fee is not required when the new owner is obtaining a new FHA-insured mortgage at the time of the transfer.

B. Certain complex transactions involving multiple transfers may be subject to more than one TPA fee:

1. With transactions involving two transfers of title by deed, the Director of Asset Management will determine whether a second fee is required after consulting with Field Counsel.

2. If the Director of Asset Management determines that a transaction or series of transactions have been structured to avoid paying the application fee, the TPA application will be rejected and new application(s) will not be accepted until the required application fee(s) have been paid.

C. The same application fee is required for a transfer of interest requiring a modified review if the proposed transaction involves: (a) a transfer of more than fifty percent (50%) of the partnership (or limited partnership) interests of a Borrower; (b) a transfer of more than fifty percent (50%) of the corporate stock (or shares) of a Borrower; or (c) a transfer of the corporate stock (or shares) of a Borrower that constitutes a change in control of such entity.

7.4 Approval Authority

A full TPA includes an initial (sometimes referred to as preliminary) and a final approval stage. The initial approval of a full TPA provides the assignee with all HUD approvals needed for the deed to be transferred and the transaction to be completed. ORCF will not grant approvals that are conditioned upon commitments being issued from other sources. In limited circumstances, HUD has the discretion to issue a letter that acknowledges (if required by a third party) that once all TPA requirements have been satisfied, a preliminary approval letter will be issued.

7.5 Initial and Final Approval Actions

A. Initial and final approval authority rests with the ORCF.

B. ORCF will review the Application for Transfer of Physical Assets (TPA) (Form HUD-92266-ORCF) and all accompanying documentation. At the end of the review process, if the attached instruments are found to be in order, and the transfer proposal is acceptable, HUD will issue a letter granting initial approval of the application. This approval may be conditioned upon any ORCF requirement plus necessary changes in the submitted documents, if any, and will authorize the execution of all remaining required instruments. It

is at this point that the parties to the transaction are authorized to transfer possession of and beneficial interest in the project. The purchaser is not authorized to transfer any interest in, take possession of, or assume the burdens and benefits of ownership without the written approval of ORCF.

C. After the initial approval letter is issued, the real estate transaction can close and all of the documents approved by HUD can be executed and recorded along with any additional items included in the initial approval letter. The TPA transaction may be completed based upon a certification by the applicant's attorney that the documents to be executed and recorded are exactly as approved by HUD. The form of the required certification is "Attorney's Certification on Execution and Recordation" (See Appendix 7.1).

D. For final approval, certified copies of all executed and/or recorded documents, along with any additional items required in the initial approval letter, together with the final documents that were reviewed by HUD prior to initial approval, must be provided to the AE within 45 working days from the date of the letter of initial approval, unless additional time is granted by ORCF in writing.

E. ORCF may grant final approval of the TPA after it has approved the final documents and determined that any additional requirements included in the initial approval letter have been met.

F. Records in HUD's database associated with the Property ID will stay the same. There will also be no change in the FHA loan number.

G. The Financial Assessment System (FASS) date is the date of legal ownership change (which is either the date the deed is signed or recorded, as dictated by state law). This date must be entered into FASS as soon as HUD is aware of the legal transfer. FASS will automatically calculate the reporting periods for old and new Borrowers. However, at the time of filing of the first financial return for the new Borrower, the auditor may need to call FASS Technical Assistance and request help with changing the reporting period in the filing template that they use. Please refer to iREMS User Guide for complete details for transferring the property. After the transfer the HUD database is required to be updated with the new Borrower information, Operator, or management information depending upon the transaction.

H. It should be noted that the previous Borrower is not relieved of the obligation to file a final financial statement from the start of their fiscal year to the day of legal ownership change. The recording of new documents shall not release sellers of liability for pre-transfer violations of their Regulatory Agreements or for (1) funds or property coming into their hands which, by the provisions thereof, they are not entitled to retain; and (2) for their own acts and deeds or acts and deeds of others that they have authorized in violation of the provisions thereof.

7.6 Procedures for Processing a Full TPA Review

After submission of the initial TPA application, as described above, the Mortgagee/Servicer shall contact HUD to schedule a conference call between the assigned AE, the prospective Borrower, and the Mortgagee/Servicer. The AE will perform a completeness review prior to the call and, provide the results of such review. The AE may return the package to the applicant without further processing if the application is deficient. Please see the TPA checklist on the Section 232 Program website.

A. The following items need to be discussed in the initial conference call:

1. Nature of the transaction,
2. Organizational charts that describe the transaction (highly important),
3. Identification of the type of TPA transaction,
4. The applicable checklists and appendices to this chapter,
5. Application requirements,
6. The project's current physical and financial condition,
7. Special considerations, such as accounts receivable financing and/or master lease requirements, and
8. Experience of the new Borrower and its principals.

Based on project data and history, the AE will assess each of the items in this section to determine the extent of review necessary to achieve a thorough understanding of the Borrower's proposed transaction. All project files must be reviewed to evaluate the Borrower and proposed Lessee/Management Agent's previous performance and acceptability, the Lessee/Management Agent operations, financial compliance and performance and physical condition of the project using available data, such as Center for Medicare & Medicaid Services (CMS) star rating, and survey performance data. If necessary, new or additional data must be gathered, being mindful that Lessee/Management Agent, physical plant and financial operations are interrelated. If problems exist, they must be identified in the application, along with proposals to adequately address the problems through the TPA process.

Processing a review entails communications with buyers, sellers, counsel for buyers and sellers, and the AE. It is imperative that replies are made as quickly as possible.

B. Project Records

The review and analysis begins with a thorough examination of the project records and database information, including Center for Medicare & Medicaid Services (CMS) and Nursing Survey Risk Reports, as applicable. If the physical condition data is outdated, the star rating is less than two stars, the Survey Risk Reports rating is high, or there is serious recurring or unresolved compliance or performance problems, a risk management plan must be provided as an exhibit in the TPA application.

1. The physical, financial and management operations must be fully acceptable, or immediate corrections are proposed and funded that are acceptable to the Department.

2. Capital improvement needs will be evaluated and conditions imposed by the ORCF to ensure all capital repairs, upgrades, and replacements are made. A Borrower Certification addressing when such work will be accomplished must be provided.

3. All known noncompliance and operating performance issues will be shared with the Borrower as soon as possible after the AE receives the transfer application. The Borrower must clearly understand that addressing each item to the satisfaction of the Department will be required for initial approval.

NOTE: If the TPA includes a change in the Operator, then the process will require the implementation of a new Healthcare Regulatory Agreement – Operator (Form HUD-92466A-ORCF). This form includes requirements for a Risk Management Program in Paragraph 7, and is applicable to all new Operators, irrespective of compliance or performance risks detailed above.

C. Proposed Owner/Operator/Management Agent

1. Previous Participation Review. Controlling Participants, as defined in Housing Notice H 2016-15 (or successors thereto), must file a Previous Participation Certification either via the Active Partners Performance System (APPS) or via the Consolidated Certification. Detailed information on the Previous Participation Review process is found in the above CFR Subpart, and the associated Processing Guide.

2. Requisite Experience. Prospective owners must satisfy ORCF that they bring sufficient experience and lessee/management expertise to successfully operate the project. HUD requires that a minimum of three years of owning, and/or operating similar or relevant projects be demonstrated for each of these entities. For a troubled project, ORCF will require an experienced Owner/Operator who has demonstrated the ability to successfully own and manage troubled projects. In cases where there will be significant repairs and/or upgrades, the prospective owner/managing entity must have sufficient experience, capability and capacity to timely complete the rehabilitation requirements.

3. All organization documents that affect the transfer, including but not limited to the establishment of the new purchasing entity, alterations to existing ownership documents, lessee/management agreements, etc., must be reviewed to assure that none of the provisions of those documents conflict with HUD contracts, regulations or statutes.

D. Procedures and Requirements for:

1. Accounts Receivable Financing, see Production, Chapter 15 and Asset Management, Chapter 10;

2. Master Lease, see Production, Chapter 13 and Asset Management, Chapter 9.

3. Operating Lease and/or Management Agreement, see Asset Management, Chapter 8; and

4. Project Capital Needs Assessment (PCNA), see Asset Management, Chapter 3.

E. Legal Review of TPA Proposals by Office of General Counsel (OGC). The AE and the HUD Attorney shall simultaneously review the application based on the criteria set forth in this handbook. If the proposed transaction is deemed acceptable by HUD, a preliminary approval letter shall be transmitted to the applicant. If the proposed transaction is unacceptable, the applicant shall be notified accordingly and provided the reasons for such rejection.

   [NOTE: The Purchaser is not authorized to transfer any interest in, take possession of, or assume the burdens and benefits of ownership of the project without the prior written approval of HUD. If this requirement is violated, HUD reserves the right to pursue all available administrative, legal, civil, and criminal remedies.]

F. Opportunity for Update to Affirmative Fair Housing Marketing Plan (AFHMP). HUD requires a Borrower to review a project's AFHMP (where AFHMP was required during the firm application process of the existing loan) every five years. The TPA application review process provides the Office of Healthcare Programs an opportunity to inquire of the proposed Purchaser whether such reviews were performed and the results of such reviews. Any updated AFHMPs should be obtained for HUD's records. HUD may recommend that the AFHMP be updated to reflect changes in demographics or other relevant changes in the project's marketing area.

7.7 Procedures for Processing a Modified Review TPA

A. Routine minimum documentation that must be submitted by the Borrower to the ORCF when a modified review is required may be found on the Submission Checklist – Section 232, Transfer of Physical Assets (TPA) Checklist for Full or Modified TPA (see Section 232 Program website).

B. Opportunity for Update to Affirmative Fair Housing Marketing Plan (AFHMP). HUD requires a Borrower to review a project's AFHMP every five years. The TPA application review process provides the Office of Healthcare Programs and the Office of Fair Housing

and Equal Opportunity an opportunity to inquire of the Borrower whether such reviews were performed and the results of such reviews. HUD may recommend that the AFHMP be updated to reflect changes in demographics or other relevant changes in the project's marketing area.

7.8 Procedures for Processing a Light Review

Types of transfer requiring a Light Review include, but are not limited to, transactions with the following characteristics:

A. Change of Internal Revenue Services (IRS) Reporting Structure (i.e., when a Borrower converts from a limited partnership to a limited liability company, but all principals remain the same and the Tax Identification Number is not changing).

B. Opportunity for Update to Affirmative Fair Housing Marketing Plan. HUD requires a Borrower to review a project's AFHMP every five years. The TPA application review process provides the Office of Healthcare Programs and the Office of Fair Housing and Equal Opportunity an opportunity to inquire of the Borrower whether such reviews were performed and the results of such reviews. HUD may recommend that the AFHMP be updated to reflect changes in demographics or other relevant changes in the project's marketing area.

7.9 Special Consideration

A. **Secondary Financing**. Any portion of the purchase price that is not paid in cash at the time of purchase is considered to be secondary financing. Secondary financing must be junior (subordinate) to the FHA-insured mortgage or deed of trust and can be recorded or unrecorded. Secondary financing includes all deferred financing: financing secured by the project, financing secured by collateral other than the project, or unsecured financing.

   ORCF must make certain specific determinations when secondary financing is an element of the TPA.

   1. HUD policy permits the use of secondary financing in connection with transfers of projects in those situations that the ORCF determines that the proposal does not jeopardize HUD's security, does not conflict with HUD's legal or programmatic interests, and will not unduly burden the project with financial debt.

   2. If FHA-insured secondary financing is proposed as part of the TPA or Section 232/223(a)(7) refinance, it must meet the underwriting criteria of the applicable Section of the Act. The proposed documents must not conflict with a HUD-held or FHA-insured first mortgage or the Regulatory Agreement, or the language of any

subsidy agreement. ORCF will approve the use of secondary financing in a TPA only when the following conditions are met:

a. ORCF will not approve any transfer that includes a lien against the project without the written approval of the first Lender;
b. Where the consent of the first Lender to allow secondary financing is obtained, the original signed consent document must be transmitted immediately to the Office of Asset Management at HUD Headquarters for inclusion in the project's safe instruments file;
c. Approval of the secondary financing will not increase HUD's exposure to financial risk or loss; and
d. Approval of the proposal would not violate the Department's obligation to provide housing at the least cost to the Federal government.

3. **Subordination of Secondary Financing**. The second mortgage or security agreement must be subordinate to any HUD-held or FHA-insured mortgage, and comply with Production, Chapter 3.15. The following language, as appropriate, must be included:
    a. **Security Agreement**. Secured Party, for itself and its successors and assigns, covenants and agrees that all of its rights and powers under this security agreement are subordinate and subject to the rights of [identify mortgagee] under that certain [mortgage or deed of trust] dated [date] and recorded [date], office of recordation, and under that certain Security Agreement dated [closing date], and the rights of the Secretary of Housing and Urban Development under that certain Regulatory Agreement dated [original closing date] and incorporated by reference in the above described mortgage.
    b. **Second or Wrap-Around Mortgages**. Mortgagee, for itself and its successors and assigns, covenants and agrees that all of its rights and powers under this mortgage are subordinate and subject to the rights of [identify first mortgagee] under that certain [mortgage or deed of trust] dated [original closing date] and recorded [date], [office of recordation] and under that certain Security Agreement dated [original closing date], and the rights of the Secretary of Housing and Urban Development under that certain Regulatory Agreement dated [original closing date] and incorporated by reference in the above described mortgage.

Payment Only from Surplus Cash. Notes evidencing secondary financing subordinate to FHA-insured or HUD-held financing must provide that any payments from project income can only be made from permissible distributions from surplus cash.

7.10 Monitoring

ORCF must ensure that each project is monitored after initial approval or final approval where applicable, to ensure that the conditions of approval are satisfied.

Monitoring should begin at the point when initial approval is issued and continue until such time as all of the terms and conditions of the transfer have been satisfied. All required documents, including the Regulatory Agreements, Riders, and/or Assumption/Assignment documents, if any, must be executed in the form as reviewed and approved and conform to the terms and conditions of initial approval.

7.11 Non-Compliance with Transfer

HUD will use the TPA process as an opportunity to enforce compliance with regulatory agreement requirements that are not being followed and will not grant final approval of the transfer until all financial, physical, and legal requirements are met.

A. If a scheduled payment, repair, or other requirement of the TPA, is not made as agreed under the terms of the transfer, the AE assigned to monitor the transfer must provide the Borrower with written notice of non-compliance and direct that appropriate corrective action be taken within the reasonable period of time specified in the written notice of non-compliance.

B. If the deficiency is not corrected within the period of time specified in the written notice of non-compliance, the situation should be reported to the Workload Manager. The Workload Manager should immediately consider all available options to enforce compliance. Field and Regional Counsel may be consulted and, if necessary, OGC and/or the Departmental Enforcement Center (DEC) may be requested to participate in developing a plan of enforcement. The available remedies and Administrative Sanctions include: Civil Money Penalty (as expressly authorized by 12 U.S.C. Sections 1735f-15(b)(1)), Limited Denial of Participation (LDP), suspension, debarment, etc., as well as suit for specific performance to enforce the conditions of the TPA.

7.12 Project Capital Needs Assessment (PCNA)

A PCNA (in accordance with the Statement of Work as set forth in the Section 232 Handbook, Production, Chapter 4, for a Limited Scope PCNA) and Reserve for Replacement (R4R) Analysis are required with a TPA in the following situations:

- A PCNA or comparable reserve analysis has not been submitted to HUD in the previous 10 years; or
- If the Borrower wishes to halt R4R Deposits

7.13 Financial Statement Requirements

When a Full Transfer of Physical Assets occurs, the old Borrower **is not relieved** of filing a final financial statement from the beginning of their fiscal year until the legal ownership change. A

final financial statement must be filed within 90 days from the date of the actual Transfer of Physical Assets, and if not timely filed, will be subject to Civil Money penalties of $42,500 (or the amount in effect at the time of the failure to file) for each return not filed.

Section III
Asset Management

Appendix 7.1
Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care

Link to HUD Handbook 4065.1 REV-1 website (Previous Participation (HUD-2530) Handbook):
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/handbooks/hsgh/4065.1

Link to CMS' Nursing Home Compare website:
http://www.medicare.gov/nursinghomecompare/?bhcp=1

Form Number	Form Name
HUD-92266-ORCF	Application for Transfer of Physical Assets (TPA)
Notice H 2016-15	Processing Guide for Previous Participation Reviews of Prospective Multifamily Housing and Healthcare Programs' Participants (or successors thereto)
N/A	Attorney's Certification on Execution and Recordation
N/A	Submission Checklist – Section 232, Transfer of Physical Assets (TPA) & Lessee/Operator/Management Agent Change

Section III
Asset Management

Chapter 8
Operators and Management Agents

8.1 Introduction

Production, Chapter 8, Operator and Management Agent Analysis, deals at length with the necessary qualifications for Operators and Management Agents of newly insured projects, and it also addresses required elements of the relevant contractual documents. The purpose of this Chapter is to describe the Office of Residential Care Facilities' (ORCF) ongoing expectations and monitoring of such Operators and Management Agents and also to describe the procedures ORCF will follow in approving a *change in* an Operator or Management Agent of a currently insured or HUD-held project. The criteria and considerations set forth in Production, Chapter 8 apply with equal force when a Borrower on a currently FHA-insured or HUD-held project is seeking a change of Operator or Management Agent.

It is the responsibility of the Borrower to determine how to best organize the project and establish an effective means to oversee the operation of an insured project. In those instances, where the Borrower decides to engage an Operator and/or Management Agent, the establishment of an effective relationship among the Borrower, the Operator and/or Management Agent, and ORCF, is critical to the success of the project over the life of the mortgage. ORCF's principles with respect to Borrower/Operator/Management Agent relationships are:

A. While ORCF will work with Operators and/or Management Agents and monitor their performance, the Borrower shall remain responsible for a project's compliance with HUD regulations and requirements. Such responsibility shall apply regardless of whether ORCF also requires Operators and/or Management Agents to enter into regulatory or other agreements that place responsibilities on those parties. ORCF expects that Borrowers will oversee the performance of their Operators and/or Management Agents and take steps to correct deficiencies as they occur, consistent with the controlling documents.

B. ORCF will not intercede in the relationship between Borrowers and their Operators and/or Management Agents, except:

    1. to review the qualifications of proposed Operator and Management Agent candidates,

    2. to review the proposed contractual agreements between Borrowers and Operators and/or Management Agents, and

3. to assure compliance with applicable program requirements.

To this end, ORCF requires that detailed Management Agent and Operator documents be submitted (through the Mortgagee/Servicer) for ORCF approval prior to any proposed material amendment or termination of a project's Operator and/or Management Agent. For these purposes, an amendment is deemed material when it would substantially alter the scope of responsibility of an Operator or Management Agent, whether that change in scope is an increase or decrease in responsibility. In such circumstances, the Borrower shall submit the request and supporting information to the Mortgagee/Servicer. The Mortgagee/Servicer must review the request for completeness, accuracy and eligibility, and submit to ORCF with a recommendation for approval. In analyzing the request, the Mortgagee/Servicer shall adapt and tailor the approach and analysis used in recommending an Operator or Agent as part of a firm application (as set forth in Production, Chapter 8.8,).

It is the owner's responsibility to verify that the proposed Operator and/or Management Agent demonstrates the qualifications and experience necessary to assure that the project will be operated in a legal, prudent, efficient, and cost-effective manner prior to submitting a request for approval of such Operator and/or Management Agent. Appropriate qualifications and experience are addressed more fully in Production, Chapter 8, Sections 8.4 and 8.8. If the Borrower determines that the proposed Operator and/or Management Agent satisfies these criteria, the appropriate application shall be submitted to the Mortgagee/Servicer by the Borrower and, upon Mortgagee/Servicer review, ORCF's written approval must be obtained prior to entering into any binding agreements and/or providing services related to the applicable Section 232 project.

** Note if an application is to be submitted for a Change of Operator and/or Management Agent, the proposed entity should work with its attorney in the submission of the application.*

8.2 Ongoing Expectations for Operator Performance

All HUD approved Operators (defined at length in Production, Chapter 8.2) shall conduct all project affairs in a complete and professional manner and comply with the following requirements:

A. Be approved by ORCF prior to participation.

B. Comply with all regulatory and program requirements, including without limitation:

1. execution of a Healthcare Regulatory Agreement-Operator (Form HUD-92466A-ORCF);

2. execution of a lease or other contractual agreement that is acceptable to ORCF; and

3. execution of other documents in a format as required by HUD, and as may be determined by the nature of the transaction and the structure of the organization.

C. Respond timely to any requests from HUD for project operating data.

D. Provide evidence of insurance coverage in accordance with HUD requirements.

    1. Professional Liability Insurance coverage consistent with Production, Chapter 14, Insurance Requirements

    2. Property insurance as required and as agreed in the lease or other operating agreement

E. Satisfy HUD requirements regarding financial accounting and reporting, including without limitation:

    1. properly maintaining books and accounts in accordance with Program Requirements and as to allow for audit of the project;

    2. maintaining the HUD-required operating account;

    3. submitting to Mortgagee/Servicer (and also to ORCF directly if requested) quarterly and year-to-date certified financial reports, consistent with Program Requirements and as addressed in Asset Management, Chapter 4;

    4. providing answers to specific questions posed by ORCF, and

    5. adhering to all other financial guidelines of HUD.

F. In accordance with Program Requirements, including without limitation the Operator Regulatory Agreement and Asset Management, Chapter 3 of this Handbook, electronically notify the Mortgagee/Servicer and ORCF of survey or other matters placing the project's licensure or funding at risk.

G. Maintain the project in accordance with the lease (or other Borrower-Operator contractual agreement, as applicable) and program requirements.

H. Comply with all applicable fair housing and civil rights laws and requirements.

I. Maintain in full force and effect at all times, each of the permits and approvals of the healthcare project, including the state-issued operating license and any other authorizations, consents, approvals, permits, actions, filings and/or certifications necessary to operate the project. (Refer to Healthcare Regulatory Agreement-Operator)

J. Engage the services of an independent consultant, if required by ORCF, at its expense, to alleviate project operating deficiencies that have been identified by ORCF. All such consultants must be approved by ORCF prior to such engagement.

K. Implement and maintain a risk management program meeting ORCF requirements, in accordance with Program Obligations. (See Production, Chapter 2)

L. Maintain regular communications with the assigned ORCF representative and provide prompt notification for all urgent financial, operational and/or regulatory compliance issues.

8.3 Ongoing Expectations for Management Agent Performance

"Management Agent" is a term defined in Production, Chapter 8.3. A Management Certification – Residential Care Facility (Form HUD-9839-ORCF) shall be required for any entity that is directing the day-to-day functions of a healthcare project with respect to a management agreement, and is not required to execute the Operator Regulatory Agreement under the criteria of Production, Chapter8.2. If, however, that entity *is* required to execute the Healthcare Regulatory Agreement-Operator), pursuant to any of the criteria in Production, Chapter 8.2, then the Management Agreement that entity executes must incorporate subordination language approved by HUD. The requirements and responsibilities of Management Agents are described in detail in the Management Certification – Residential Care Facility. The typical duties of Management Agents, which shall be described in detail in the management agreement, may include, but are not limited to the following:

- Personnel Administration
- Resident Admissions
- Supervision of resident care/patient services
- Marketing
- Direction of project operations and maintenance services
- Administration of contracts and commercial leases
- Billing
- Collections
- Accounting services
- Enforcement of employment policies and internal financial controls
- Food services
- Banking services
- Maintenance of business licenses, permits, and other certifications from governmental authorities
- Coordination of State licensure functions
- Coordination of HUD Real Estate Assessment Center (REAC) inspections, if applicable
- Representation of the project at official meetings
- Performance of any other activities necessary for the function and management of the health care project as further described in the management agreement.

The Management Certification is applicable to the Borrower (or Operator, depending on the particular contractual structure) and Management Agent. The separate parties together certify

that they will comply with HUD requirements and contract obligations, execute an acceptable Management Agent agreement, and further that no payments have been made to the owner in return for awarding the management contract to the Management Agent and that such payments will not be made in the future. Management Agents must also comply with all applicable fair housing and civil rights laws and requirements.

8.4 Expectations for Consultant and Contractor Performance

Borrowers, Operators and/or Management Agents may, without ORCF's consent, (but as limited by Program Obligations, the operating lease and the management agreement, as applicable), engage consultants or contractors to provide assistance and/or guidance in specialized areas. Certain engagements of consultant services, such as the hiring of legal counsel, are for services clearly beyond the traditional scope of managerial expertise. Other such engagements may be for consultants that offer a highly specialized skill in a narrow area of project operations, such as pharmacy, psychiatry, rehabilitation management and case coding, and are generally advisory in scope and for a negotiated fee over a limited period of time.

Consultants are distinguished from Management Agents as follows:

1. Consultants make recommendations and have no contractual or other authority to commit or exact resolutions of their own
2. Consultants advise on matters within specific areas of expertise for a specific time frame

If an entity, which was presented by the Borrower or Operator to be a consultant, is found by HUD to have project commitment authorities or to be providing a wide scope of managerial services over an extended time period, ORCF may deem the consultant to be a Management Agent and may require that the entity be reviewed and approved as a Management Agent.

8.5 Procedure for Change of Operator and/or Management Agent

The Borrower shall be independently responsible for the initial screening and selection of an Operator and/or Management Agent for the project; however, as described in this Chapter, such selection shall be subject to Mortgagee/Servicer review and to final review and approval of ORCF.

All requests for the approval of an Operator and/or Management Agent shall be initiated by the Borrower. Such request shall be submitted to the Mortgagee/Servicer at least sixty (60) days prior to the date such Operator and/or Management Agent is proposed to commence its duties under the operating lease or management agreement, and shall include the required documentation described in detail in the appropriate change request Checklist (available on the

Section 232 Program website) for proposed Operators and/or Management Agents. Submissions should be sent electronically.

In certain limited circumstances, it may prove necessary for the Borrower (or Master Tenant or Operator, if applicable) to approve an emergency replacement Operator or Management Agent. In such circumstances, the Borrower shall be required to immediately notify ORCF and the Mortgagee/Servicer of such exigent circumstances, and within five (5) business days of such emergency replacement, shall submit all the documents required by this Chapter for the review and approval of the new Operator and/or Management Agent as set forth herein.

When a change of Operator or Management Agent is requested, evidence of an Operator's (or Management Agent's) experience, as delineated in Production, Chapter 8.4, shall be provided in a format that includes specific examples, including the applicable healthcare project's name, type of care, location, and unit and bed count. For projects that added units to a market, evidence shall also include the year the project opened, key operating metrics (fill pace, occupancy, net operating income margins, etc.), and the specific responsibilities required for the management and operation of such health care project. The requirements of this Section are intended to better ensure that HUD will approve Operators and Management Agents that are committed to the long-term success of the project and have the requisite experience to operate and manage the project.

An application for the change of an Operator or Management Agent must be assembled, reviewed for completeness, accuracy and eligibility, and submitted by the Mortgagee/Servicer to ORCF with a recommendation for approval. A checklist of the required application exhibits as well as the instructions for submitting the application is posted on the Section 232 Program website. Factors for the Mortgagee/Servicer's analysis and recommendation are set forth in Production, Chapter 8.8

Operating Lease requirements and Management Agreement requirements are detailed in Production, Chapter 8, Sections 8.6 and 8.7, respectively, of the Production portion of this Handbook.

The AE shall review the request, and the Mortgagee/Servicer's analysis and recommendation of that request, consistent with Production, Chapter 8.9.

The Management Agent may begin performing their duties and or responsibilities upon receipt of a written final approval from ORCF, in addition to the executed Management Agent Certification. There is no preliminary approval for a Management Agent.

It is ORCF's practice that if upon examination of the application and the attached instruments by the appropriate HUD staff and OGC, the submission is found to be in order, then a preliminary approval may be given to a proposed Operator. The Operator may be authorized to assume responsibilities once preliminary approval is granted. Preliminary approval may be based on conditions of documents in need of correction and or revision as well as a preliminary approval pending ORCF's receipt of all recorded documents. If the terms of the preliminary approval are not met within 45 working days from the date of the issuance of the preliminary approval,

(unless further time is granted by the Commissioner in writing), the preliminary approval shall be terminated.

Until ORCF gives a preliminary and or final approval of an Operator and or Management Agent in writing, the transaction may not take place. HUD will prosecute to the fullest extent possible, any unapproved unauthorized transactions.

Section III
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Appendix 8.1
Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care

Active Partners Performance System (APPS) website:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/mfh/apps/appsmfhm

Form Number	Form Name
HUD-91116-ORCF	Addendum to Operating Lease, Section 232
HUD-91117-ORCF	Operator Estoppel Certificate
	Closing Document Requirements for Operators and Management Agents (chart)
HUD-91725-INST-ORCF	Instructions to Guide for Opinion of Borrower's and Operator's Counsel
HUD-92323-ORCF	Operator Security Agreement
HUD-92325-ORCF	Guide for Opinion of Operator's Counsel and Certification
HUD-92466A-ORCF	Healthcare Regulatory Agreement-Operator
HUD-9839-ORCF	Management Certification – Residential Care Facility
Notice H 2016-15	Processing Guide for Previous Participation Reviews of Prospective Multifamily Housing and Healthcare Programs' Participants (or successors thereto)
N/A	Risk Notification Form – Servicer (Sample)
N/A	Section II, Production, Chapter 14, Appendix 14.1 Professional Liability Insurance
N/A	TPA Checklist (Full and Modified Transfer of Physical Assets & Lessee/Operator/Management Agent Change)

Section III
Asset Management

Chapter 9
New or Modification of Master Lease Structure

9.1 Introduction

As indicated in Production, Chapter 13, HUD has worked diligently to ensure that its insurance fund remains stable by addressing the concentration of credit within the same ownership and/or operating structures. In 2001, HUD issued new processing procedures for multiple-facility applications. Although each facility is still evaluated individually, borrowers and operators face increased scrutiny when they seek financing for multiple facilities within an 18-month timeframe. Additional guidance was also provided in Mortgage Letter 2014-06 regarding Master Lease and Portfolio transactions.

Criteria for a master lease and/or an addendum to a master lease are set forth in Production, Chapter 13.4.

The master lease structure allows for any rental deficiencies at one facility to be supported by income from other facilities included in the master lease. A master lease does not, however, pool the assets of all facilities for underwriting a single mortgage loan for multiple facilities. Each individual loan must meet HUD's underwriting standards on its own merit.

This Chapter is applicable to all applications to modify an existing Master Lease structure or any requests for a new Master Lease structure for existing FHA-insured facilities. Production, Chapter 13 is applicable to Master Leases in connection with FHA-insured loan applications.

The Mortgagee/Servicer must notify HUD anytime one or more properties which are part of a Master Lease are encountering rental deficiencies. The Mortgagee/Servicer must inform HUD of how the situation will be handled when the remaining facilities are unable to make up the rental deficiencies of the failing facilities.

9.2 Program Considerations

In addition to the key provisions identified in Production, Chapter 13.3, ORCF will review the following conditions for approval of an application with a Master Lease structure:

A. Each loan will have a separate note for each borrower and each note will be secured by its own security instrument. The Master Tenant and Operators shall not engage in any other businesses or activity, including the operation of any other rental project, or incur any liability or obligation except as may be permitted by HUD in connection with the project.

B. The Master Tenant and Operators shall execute the applicable HUD Regulatory Agreements, to address various ownership and operational responsibilities with respect to the mortgaged property.

C. The Master Lease and all subleases (sometimes collectively referred to herein as "Leases") shall be subordinate to the FHA-Insured Security Instrument/Mortgage/Deed of Trust (Form HUD-94000-ORCF) ("Security Instrument") and must be approved by HUD prior to execution. The Leases may not be modified or amended without the prior written consent of HUD and, unless there is a qualified non-disturbance agreement in place, they may be terminated by HUD, at HUD's election once HUD takes title to the project. If requested timely by Borrower/Lessor and included in the documentation for the transaction, HUD will agree to allow an amendment to the Security Instrument providing that notice of such default be given to the Master Tenant contemporaneously with the giving of notice to the Borrower/Lessor.

D. HUD will also consider the financial and physical condition of the facilities, and whether the facilities are in compliance with State and HUD requirements.

9.3 Documents for Submission and Review

A. **New Application.** For new Master Lease structure applications submitted by existing FHA-insured facilities, see the submission requirements in Production, Chapter 13.

B. **Modification Applications.** For modifications to an existing HUD-approved Master Lease, the Modified Master Lease Checklist (available on the Section 232 Program website) should be followed.

C. **Requests for Release.** For the release of individual projects from an existing HUD-approved Master Lease, the required procedures and documentation must be provided, and approved by ORCF. Guidance will be made available on the Section 232 Program website.

An application for a new master lease structure or the modification to (or release from) an existing master lease structure must be assembled, reviewed for completeness, accuracy and eligibility, and submitted by the Mortgagee/Servicer to ORCF with a recommendation for approval. A checklist of the required application exhibits as well as the instructions for submitting the application will be posted on the Section 232 Program website.

9.4 Pre-Application Conference

It is recommended that all parties participate in a pre-application conference prior to the submission of a formal application for modification of an existing Master Lease. The following information or issues should be discussed during this meeting or conference:

- The details of the application;
- The requirements on the Submission Checklist - Section 232 New or Modification of Master Lease;
- The existing Master Lease Structure and the proposed modification thereof;
- The layers of financing and necessary documentation related thereto; and
- The names and financial interest of all principals, as defined in 24 CFR Part 200, including, but not limited to the Borrower(s), Master Tenant and operators.

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Appendix 9.1
Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/section_232/lean_processing_page

Link to Notice H 01-03 (HUD) (Review of Health Care Facility Portfolios and Changes to the Section 232 Program): http://www.hud.gov/offices/adm/hudclips/notices/hsg/01hsgnotices.cfm

Form Number	Form Name
HUD-92070-ORCF	Lease Addendum
HUD-92322-ORCF	Intercreditor Agreement (for AR Financed Projects)
HUD-92323-ORCF	Operator Security Agreement
HUD-92337-ORCF	Healthcare Regulatory Agreement – Master Tenant
HUD-92466-ORCF	Healthcare Regulatory Agreement – Borrower
HUD-92466A-ORCF	Healthcare Regulatory Agreement – Operator
HUD-94000-ORCF	Security Instrument/Mortgage/Deed of Trust
N/A	Submission Checklist – Section 232 New or Modification of Master Lease
N/A	Section II, Production, Chapter 18, Appendix 18.3 Sample Cash Flow Chart
N/A	Section II, Production, Chapter 18, Appendix 18.4 Sample Cash Flow Chart

Section III
Asset Management

Chapter 10
Accounts Receivable Financing and Cash Flow Structures

10.1 Introduction

Please refer to Production, Chapter 15 for guidance related to Accounts Receivable Financing as it relates to Asset Management concerns, except as outlined below.

**In November 2008, HUD issued H08-09 Accounts Receivable Financing. The guidance in this chapter supersedes this Notice.*

10.2 Applicable Programs

The Office of Residential Healthcare Facilities ("ORCF") will evaluate AR Financing loan requests utilizing the guidance provided in this chapter and Production, Chapters 15 (Accounts Receivable Financing) and 16 (Cash Flow Structures/DACAs and DAISAs) for the following programs:

1. Section 232 for new construction or substantial rehabilitation
2. Section 232 pursuant to Section 223(f)[1] for purchase or refinance
3. Section 232 pursuant to Section 223(a)(7) and Section 232 pursuant to Section 223(f) pursuant to Section 223(a)(7) for refinancing
4. Section 241(a) for supplemental loans in connection with a Section 232 insured mortgage under one of the categories described above
5. Section 223(d) operating loss loans in connection with a Section 232 insured mortgage loan under one of the categories described above

Generally, HUD approval must be obtained for any AR Loan or any material modification of an existing AR Loan, and the AR Lender must execute an Intercreditor Agreement with the FHA Lender, the Operator and the Borrower. A proposed cash flow chart must be included with all

[1] Negative working capital (accounts payable exceeding accounts receivable) may not be included as existing indebtedness in proposed Section 232 refinance transactions.

submissions. (See Production, Chapter 16 Cash Flow Structures, DACAs and DAISAs for guidance on cash flow charts).

A. Review of Accounts Receivable Financing: An AR loan request may be submitted at any time during the life of an FHA-insured mortgage. For example, an AR loan request may be submitted: along with a Transfer of Physical Assets (TPA); included in a submission for a new and/or change of Operator; or with a request to approve a new AR loan or modification of an existing AR loan. If the AR loan is being put in place in conjunction with an FHA-insured loan closing (or with a TPA that is being processed concurrently with an FHA-insured loan closing), review of the AR approval request takes place as part of the firm commitment process and loan closing. Otherwise, requests to approve AR financing are directed to the ORCF Account Executive (AE) assigned to the project. In all instances, including post-closing requests, the submission must be by the FHA Lender, and Lender's Counsel, not the Operator or Borrower.

B. In all of the above instances, it will be determined if a portfolio review acceptance letter applies and whether the proposed AR financing is consistent with such letter and any flow charts or documents approved in connection therewith. See Production, Chapter 16.2 (Cash Flow Structures, DACA's and DAISA's), and Production, Chapter 17 (Portfolios).

C. The parties may propose as part of the AR loan review request that HUD pre-approve certain future modifications or that HUD permit certain additional types of obligations to be secured by Operator project collateral.

D. All existing HUD loans entering into a new accounts receivable line of credit must comply with current policies pertaining to Accounts Receivable Financing.

E. Projects being added to existing HUD-approved accounts receivable lines of credit must comply with the current ORCF mortgage insurance documents.

10.3 Accounts Receivable Financing Application Considerations

Please refer to Production, Chapter 15.3.

10.4 Document Requirements and Reviews

Please see Production, Chapter 15.4 for a list of the key documents that ORCF reviews when considering a request for AR Financing, except as included below.

If the AR financing is proposed as part of an FHA-insured loan closing, the appropriate HUD form of Lender Narrative must be submitted. If proposed post-closing, the AR portion of the

same template shall be submitted.

The particular terms that must be included depend on an evaluation of the proposed transaction as a whole. However, for existing FHA-insured mortgages, ORCF will consider not only the important safeguards and conditions outlined in Production, Chapter 15.5, but also whether the Borrower and Operator are in compliance with all business agreements with the Department (i.e., not in default on those business agreements, current on financial statement submissions, passing scores on physical inspections and the like).

10.5 Accounts Receivable Financing Work Outs

An AE is aware that the AR Financing is a tool to ensure that an Operator continues to have cash advances for operations. If applicable, the AE will partner with the assigned field counsel when dealing with the AR Lender and the FHA Lender to restructure the AR loan to encourage the AR Lender to continue making advances while issues with the Operator are being worked out between the FHA Lender and the AR Lender. If the AE becomes aware that an Operator is having significant difficulties, including but not be limited to the occurrence of a Triggering Event (as defined in the applicable agreement), an AE shall:

1. Review financials
2. Review state surveys
3. Discuss and assess with the Turnaround Team (Risk Mitigation Branch).
4. Seek assistance of the Office of General Counsel (OGC)
5. Discuss the possibilities of bringing in a consultant
6. Hold a meeting with all parties involved
7. Discuss an action plan by Operator (if applicable)
8. Update iREMS

A. Lender Servicing

Please see Asset Management, Chapter 3 (General Loan Servicing) for a discussion of HUD's expectations regarding the FHA Lender's servicing of loans as it pertains to Accounts Receivable Financing generally. The FHA Lender is a party to the Intercreditor Agreement and charged with its administration, as well as the administration of any deposit account control agreements (and other security documents, such as assigned cross-guaranties in a master lease structure, etc.).

B. Portfolios and Account Receivable Financing.

1. Releasing a project from the AR Line of Credit – In the event that the AE receives a request from the Borrower to release a property from the AR Line of Credit collateral base the AE must receive a detailed analysis from the FHA Lender outlining the terms and conditions of said release. The details must include (and are not limited to) the following; the payoff date of the property mortgage balance, the AR Lender's concurrence and agreement with said release, any changes to the terms and conditions

of the AR line of credit, and an analysis of the impact of the release on the borrowing base going forward. The AE must consult with OGC on any such release.

2. Adding a project to the AR Line of Credit – When a new project is being added to an existing AR Line of Credit, the same process that is used in underwriting a new project must be utilized. See Production, Chapter 6 Participant Credit and Financial Review.

C. HUD Asset Management

1. Occurrence of a Triggering Event – When there occurs a payment default or event of default under the Security Instrument or Regulatory Agreement which are determined to be a "Triggering Event" pursuant to the Intercreditor Agreement, the AE will work with the FHA Lender to issue a Triggering Event Notice to the AR Lender and work with the parties involved to put in place an action plan to resolve the default.

2. Cut Off Notice – If an action plan in place fails and/or concerns as stated above cannot be corrected, the AE shall have a call with the assigned OGC; it may also be necessary and appropriate for the AE to include an assigned AE of the Turnaround Team (Risk Mitigation Branch). Please see Asset Management, Chapter 3 (General Loan Servicing).

10.6 Cash Flow Charts, DACAs and DAISAs

Please refer to Production, Chapter 16 Cash Flow Structures, DACAs and DAISAs for guidance related to these issues as they relate to FHA-insured projects that have closed and are serviced by the AE, except as outlined below.

10.7 Submission and Review of Cash Flow Charts, DACAs and DAISAs

The ORCF will evaluate cash flow structures, DACAs and DAISAs pursuant to the guidance provided in this chapter for the following programs:

1. Section 232 for new construction or substantial rehabilitation
2. Section 232 pursuant to Section 223(f)[2] for purchase or refinance
3. Section 232 pursuant to Section 223(a)(7) or Section 232 pursuant to Section 223(f) pursuant to Section 223(a)(7) for refinancing

[2] The amount by which accounts payable exceed accounts receivable is *not* a sum that may be included as existing indebtedness in proposed Section 232 refinance transactions.

4. Section 241(a) for supplemental loans in connection with a Section 232 insured mortgage loan under one of the categories described above
5. Section 223(d) operating loss loans in connection with a Section 232 insured mortgage loan under one of the categories described

HUD Review of cash flow structures, DACAs and DAISAs may take place at various times:

A. Post-closing. Unless stated otherwise, post-closing submissions are to be directed to the AE assigned to the project.

    1. **Accounts Receivable – New line or modification of an existing line** – Reviews are required any time a request for approval of a new AR line is submitted, or any request to approve a modification of an existing AR line that will result in a change in the previously approved cash flow chart.

    2. **Change to approved cash flow chart** – Reviews are required when a change to the approved flow chart (opening new accounts, changing depositories, replacing or closing an existing DACA or DAISA account) is proposed.

    3. **Transfers of Physical Assets or Change in Operator involving AR Financing –** Reviews are required in connection with a transfer of physical assets (TPA) or change in Operator that involves AR financing. TPAs not occurring in conjunction with an FHA-insured loan closing shall be directed to the AE assigned to the project.

    4. **After a Cut-Off Time has occurred –** Once a Cut-Off Time occurs, FHA Lender can require the establishment of separate deposit accounts into which payments with respect to Accounts arising after the Cut-Off Time are to be deposited.

B. In all the above instances, it will be determined if a portfolio acceptance letter applies and whether an overall cash flow chart was approved during portfolio review, so that it can be determined:

    1. If the proposed structure is consistent therewith; and

    2. If a DACA and/or DAISA form has been previously approved in conjunction with the portfolio.

C. In all of the above instances, if an existing AR Lender is being replaced, the parties must make arrangements acceptable to HUD for termination of any existing DAISAs or DACAs in favor of such Lender.

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Appendix 10.1
Resources

HUD Forms Library:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/

Section 232 Program website:
http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care

Form Number	Form Name
HUD-9001i-ORCF	Lender Narrative 223a7.223d.232i – Addendum – AR Financing
HUD-9002-ORCF	Lender Narrative 223f
HUD-90020-ORCF	A/R Financing Certification
HUD-91110-ORCF	Subordination, Non-Disturbance and Attornment Agreement of Operating Lease (SNDA)
HUD-92070-ORCF	Lease Addendum
HUD-92322-ORCF	Intercreditor Agreement (for AR Financed Projects)
HUD-92323-ORCF	Operator Security Agreement
HUD-92325-ORCF	Guide for Opinion of Operator's Counsel and Certification
HUD-92337-ORCF	Healthcare Regulatory Agreement – Master Tenant
HUD-92420-ORCF	Subordination Agreement – Financing
HUD-92466-ORCF	Healthcare Regulatory Agreement – Borrower
HUD-92466A-ORCF	Healthcare Regulatory Agreement – Operator
HUD-94000-ORCF	Security Instrument/Mortgage/Deed of Trust
N/A	Asset Management Submission Checklist – Section 232, Accounts Receivable Financing
N/A	Sample Format for Deposit Account Control Agreement (DACA)
N/A	Sample Format for Deposit Account Instructions and Service Agreement (DAISA)
N/A	Production, Chapter 16, Appendix 16.1 Sample Cash Flow Chart
N/A	Production, Chapter 16, Appendix 16.2 Sample Cash Flow Chart
N/A	Production, Chapter 16, Appendix 16.3 Sample Cash Flow Chart
N/A	Production, Chapter 16, Appendix 16.4 Sample Cash Flow Chart

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Chapter 11
Presidentially Declared Disaster Guidance

11.1 Introduction

This chapter addresses details of how the Office of Residential Care Facilities (ORCF) responds to natural or man-made disasters impacting projects insured under the Section 232 Program. As most Section 232 projects are licensed by a state agency, ORCF's first point of contact will be the state agency and/or its disaster operations center. As state requirements regarding the relocation of residents vary, HUD will attempt to align efforts with local agencies to ensure there is not a duplicate reporting effort to state and federal agencies.

11.2 Presidentially Declared Disasters

A Presidentially Declared Disaster (PDD) is defined as a "major disaster or emergency declared under the Robert T. Stafford Disaster Relief and Emergency Assistance Act, as amended (42 U.S.C. 5121 et seq.). FEMA recommends that the President declare a major disaster or emergency and coordinates all relief efforts." In the event of a disaster, not all HUD-related projects in a PDD area may be impacted, but all potentially affected projects will be monitored. Projects that require special disaster assistance due to a PDD will receive support from HUD in addition to the normal servicing of the portfolio.

When a disaster reaches the level of becoming a PDD, ORCF works immediately to coordinate with the appropriate authorities in each state included in the PDD. ORCF staff provide requested support and information to state agencies, as directed, and in situations where those agencies may not be able to reach projects impacted by the PDD that are involved in the Section 232 program, ORCF will reach out to the projects. In instances where other federal agencies have been activated due to a disaster, ORCF will cooperate as directed in a coordinated federal response.

If it is necessary to have direct contact with the projects, in the time of a PDD, ORCF works to minimize its impact the project, and will only seek to ensure they are safe and secure from the disaster, inquire about any needs they may have that ORCF can assist with or find additional

information about, and whether they may be able to assist other affected healthcare projects within the surrounding area.

11.3 Other Disasters

There are times when a local disaster may occur, yet not be designated as a PDD. ORCF may be made aware of these disasters through notification directly by an impacted Section 232 project, through news or social media, or other means. In these instances, ORCF will react and initiate activities to quickly determine the geographic area covered by the disaster, and will identify all Section 232 projects within that area.

Once the PDD is declared, ORCF staff will then reach out to all Section 232 projects in the disaster area. This outreach will include ascertaining project damages, their operating status, and ensuring that staff and residents are safe and secure from the disaster.

ORCF will track and report all information gathered during this process, and provide requested information to the appropriate HUD divisions, as well as any state agencies that may be involved. The Office will work diligently to coordinate efforts with other Federal (HHS/CMS) and state licensing agencies that regularly survey and inspect these projects and approve evacuation and relocation plans for the residents.