

CHAPTER 9. DEFAULTS

Section 1: Definitions and Reporting Requirements

- 9-1. INTRODUCTION. Chapters 2 through 8 provide guidance on routine servicing and oversight functions. If owners and lenders adhere to the procedures discussed in those chapters, both parties should be able to keep abreast of project conditions, identify developing problems, implement corrective actions, and thereby minimize the incidence of defaults and insurance claims. Since not all defaults can be avoided, this Chapter discusses the lender's and HUD's rights and the lender's responsibilities in the event of default.
- 9-2. DEFINITION OF DEFAULT. There are two types of defaults: fiscal and covenant.
- a. A monetary default exists when the owner fails to make any payment due under the mortgage.
 - b. A covenant default exists when the owner fails to perform any other covenant under the provisions of the mortgage or of the regulatory agreement, which is incorporated into the mortgage. A lender becomes eligible for insurance benefits on the basis of a covenant default only after the lender has accelerated the debt and the owner has failed to pay the full amount due, thus converting the covenant default to a monetary default. Lenders should note that both the regulatory agreement and mortgage require them to obtain HUD's approval before accelerating the debt because of a regulatory agreement violation.
- 9-3. LENDER'S AND HUD'S RIGHTS IN THE EVENT OF DEFAULT. The mortgage and the regulatory agreement set forth the lender's rights in the event the owner defaults. While the regulatory agreement also gives HUD the right to act on owner defaults, HUD generally will not initiate the enforcement actions. HUD expects that lenders will monitor owners compliance and implement regulatory agreement and mortgage enforcement actions when owners either cannot reinstate a mortgage or refuse to correct serious covenant defaults. HUD will enforce its regulatory agreement rights only if the lender fails to take appropriate enforcement actions.
- 9-4. NOTIFYING HUD. The lender must notify the HUD Field Office in writing of the following occurrences.
- a. Significant Regulator Agreement Violations. Significant violations include, but are not limited to, unauthorized distribution of project assets; unauthorized transfers of ownership or management responsibility; failure to properly maintain the project; charging rents in excess of the amounts permitted under HUD requirements; and encumbering the project without prior lender approval. While lenders need not report all owners who are delinquent in submitting required financial reports or responses to the lender's reviews or

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- inquiries, lenders should inform HUD when owners are 60 or more days delinquent in submitting required information. HUD will consider owners' and agents' compliance records when evaluating those parties' requests for additional participation in the coinsurance or other HUD programs.
- b. Late Payments. If the lender does not receive the owner's payment by the 16th day of the month in which the payment is due, the lender must notify HUD of the delinquency. Procedures for reporting delinquent payments are set forth in Paragraph 2-3 of this Handbook.
 - c. Notice of Default. If a default continues for a period of 30 days, the lender must notify HUD within 30 days thereafter, unless the default is cured. For example, if the mortgage payment is due March 1, HUD must receive the lender's notice by the close of business on April 30. The lender's notice must be submitted on Form HUD-92426, Multifamily Default Status Report. This Form is shown in Appendix 28. Lenders must follow the instructions in Appendix 28 in preparing this Form. The lender must send three copies of this Notice to the HUD Field Office having jurisdiction over the project. The lender must submit this Notice monthly until the default has been cured, the lender has acquired title to the property or the insurance contract is terminated as provided by Paragraph 11-21. HUD must receive the Notice by the last calendar day of each month. NOTE: The lender must submit monthly Default Status Reports even if the owner has made all payments required by a temporary payment plan. The lender's notice must report on whether the owner has complied with the terms of any mortgage relief.

9-5. DATE OF DEFAULT. The date of default is:

- a. The date of the first uncorrected failure to perform a mortgage covenant or obligation; or
- b. The date of the first failure to make a monthly payment which is not covered by subsequent payments, when such payments are applied to the overdue payments in the order in which they were due. For example, if an owner did not make the May and June payments but did make one monthly payment on July 15th, the date of default would be June 1. The July 15 payment would be applied to the amount due May 1, and June 1 is the due date of the first unpaid payment.

9-6. REINSTATEMENT. If the owner cures a default (i.e., pays all amounts due under the mortgage and cures any covenant defaults) prior to completion of foreclosure proceedings, the lender must reinstate the loan. "Amounts due under the mortgage" include reasonable legal, audit or foreclosure

expenses which the lender incurred and which the regulatory agreement and/or mortgage authorize the lender to collect from the owner. If the default is cured, the coinsurance contract continues in force as if the default had not occurred. When a mortgage default is cured, the lender must report the reinstatement on Form

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HUD-92426, Multifamily Default Status Report. The lender must send three copies of this Form to the HUD Field Office having jurisdiction over the mortgaged property within five days after the mortgage is reinstated.

Section 2: Analysis of Reinstatement Prospects

- 9-7. CONDITIONS FOR MORTGAGE RELIEF. While the lender should be willing to temporarily or permanently restructure the mortgage payment terms, the lender may do so only if the following conditions are met.
- a. The mortgage relief will: (1) resolve the project's problems, reinstate the mortgage and ensure the long-term financial health of the project; or (2) give the owner time to raise additional capital by selling the project or restructuring the mortgagor entity.
 - b. The owner agrees to implement all of the management initiatives the lender deems necessary (e.g., change occupancy procedures, hire a new management agent, implement budget and cash controls, etc.) and make any cash contributions needed to stabilize the project's operations.
- 9-8. ANALYSIS OF PROJECT CONDITIONS. When a fiscal default occurs, the lender must determine the cause of the default and whether the owner is willing and able to reinstate the mortgage and restore the financial and physical condition of the property. To make this analysis, the lender will need to review the project file, meet with the owner and, possibly, visit the project site.
- a. Identify the Project's Problems and their Causes. Working with the owner, the lender should identify what problems contributed to the default and the causes of those problems.
 - b. Analyze the Project's Needs and Abilities. Will a rent increase be marketable? Can the project pay the delinquency by making additional payments for several months? Can the project pay any increased debt service that would be required under a modification? Do deferred maintenance or delinquent accounts payable exist? If so, are there funds to correct or pay these items? Is current management acceptable?

- c. Assess the Owner's Willingness and Ability to Resolve the Project's Problems. Is the owner willing to make a cash contribution? forego payment or accrual of distributions? raise additional capital through syndication? make necessary changes in project operating procedures? hire a new management agent, if needed? implement any necessary rent increases?

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9-9. TYPES OF FINANCIAL RELIEF.

- a. Temporary Adjustments of Mortgage Payments. The lender may agree to temporarily hold the mortgage in default and adjust the owner's payments if doing so will enable the owner to reinstate the mortgage and stabilize the project's operations. Any such agreement must be written and the lender must send a copy of the agreement to the HUD Field Office. The lender may approve temporary payment plans, without obtaining HUD's approval, only if all of the conditions listed below are met. Lenders may approve payment plans which do not meet these conditions only after obtaining the HUD Field Office's approval.
 - (1) The temporary payment plan will last no longer than 18 months.
 - (2) Payments will be set at less than the debt service and escrows required by the mortgage for no more than 6 months.
 - (3) The plan requires the owner to pay a specific dollar amount each month but also gives the lender the right to require that the owner also apply any net operating income to the mortgage delinquency.
 - (4) The owner agrees that, even if the project is current under the terms of a temporary payment plan, no distributions will be paid until: (a) the mortgage itself has been brought current; and (b) the owner has complied with all terms of the temporary payment plan and any broader reinstatement plan, including completion of any maintenance work or management initiatives. Reinstatement plans are discussed in Section 3.
- b. Withdrawal from the Reserve for Replacements. If the mortgage is more than 25 days delinquent, without HUD approval the lender may withdraw reserve funds to pay up to one month's debt service and mortgage escrows. Each time the lender uses the reserve to cover mortgage obligations, the lender must give the HUD Field Office written notice of that fact. The lender must obtain the local HUD Field Office's approval for withdrawals which individually or

cumulatively over 12 months would exceed one month's mortgage payment. All withdrawals must be documented as required by Paragraph 5-6 of this Handbook.

- c. Suspension of Deposits to the Reserve for Replacements. Without HUD approval, the lender may suspend reserve deposits for up to six months during any 36 month period. The lender must give the HUD Field Office written notice of the suspension and must send the HUD Field Office a copy of the approval letter. Suspension in excess of six months during any 36 month period can be made only with approval of the local HUD Field Office. Since suspension of Reserve deposits seldom provides the amount of relief needed and can frustrate the project's ability to make repairs needed in the future, lenders should only rarely approve suspensions.

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- d. Recasting the Mortgage. Lenders may permanently modify the mortgage by recasting delinquent principal and interest over the remaining mortgage term so long as the conditions listed below are met. The lender must send the HUD Field Office a summary of how the mortgage was recast and copies of the Modification Agreement and of the new amortization schedule.

- (1) the sum of the principal outstanding at the time of the Modification Agreement plus any delinquency to be added to such principal and recast does not exceed the original mortgage amount; and
- (2) the lender obtains HUD's approval before executing a Modification Agreement.

NOTE: If the mortgage backs GNMA securities, the lender-issuer must continue to pay the securities holders all amounts due under the securities even if the lender does not collect the full amount from the owner.

9-10. DETERMINING WHETHER TO ACQUIRE OR OFFER MORTGAGE RELIEF. If the lender determines that Paragraph 9-7's conditions for mortgage relief are met and that relief will enable the project owner to reinstate the mortgage and thereafter remain financially viable, the lender and owner must immediately formalize a reinstatement plan. If the conditions for mortgage relief are not met, the lender must take the following steps:

- a. Determine whether to seek mortgagee-in-possession status or the appointment of a receiver. If the lender determines that either of these actions is needed to protect project assets, the lender must diligently pursue the appropriate action in accordance with State law and the terms of the mortgage or deed-of-trust.
- b. Initiate acquisition and notify HUD as required in Chapter

10 of this Handbook.

Section 3: Reinstatement Plans

9-11.FORMALIZING THE REINSTATEMENT PLAN. A reinstatement plan is a list of all actions that will be used to reinstate the mortgage and stabilize project operations. The lender and the owner must execute a written reinstatement plan when the lender plans to hold the mortgage in default for more than three months or when the lender determines that significant corrective actions (e.g., owner contributions, repairs or management improvements) are needed to stabilize the project. If the plan involves any financial relief for which HUD approval is required pursuant to Paragraph 9-9, the lender must obtain HUD's approval of the reinstatement plan. All reinstatement plans must:

- a. explicitly state that the mortgage is in default;

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- b. list all actions (e.g., cash contributions and management improvements) required of the owner and specific schedules for completing these actions;
 - c. reiterate the regulatory agreement requirement that the owner may not pay distributions while the mortgage is in default;
 - d. require the owner to submit monthly financial reports on project income, cash, payables and occupancy as prescribed by Paragraph 3-5 of this Handbook.
 - e. give the lender and HUD the right to cancel the reinstatement plan if the owner violates its terms.

9-12.MONITORING A REINSTATEMENT PLAN. The lender must closely monitor the owner's compliance with the terms of the reinstatement plan.

- a. Review Monthly Accounting Reports. The lender must review the owner's monthly accounting reports to determine:
 - (1) the adequacy of occupancy and rent collection efforts;
 - (2) whether the owner is complying with Chapter 3's rules on the use of project operating funds;
 - (3) if the owner has made cash contributions in the amounts and by the dates required by the lender; and
 - (4) whether funds are being spent for required management and/or physical improvements.
- b. Conduct On-Site Visits. The lender must conduct physical

inspections, management reviews and other on-site visits as needed to ensure that the owner is implementing required corrective actions and management initiatives.

- c. Notify HUD. When preparing the monthly Notice of Default required by Paragraph 9-4.c., the lender must report on the owner's compliance with the terms of the reinstatement plan.

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