

## 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

37 entity(ies) comprise each Borrower and/or operator. Affiliated residential care facilities and/or  
38 healthcare operating entities will be grouped into a portfolio if they share common control as  
39 defined here. The type of corporate credit review will depend in part on the size of the combined  
40 mortgage amount of the portfolio

41  
42 **Single Asset Entity:** For each individual project, the mortgaged property shall be the only asset  
43 of the Borrower and Operator- [\(please see Production, Chapter 2.5.B and 2.5.C for SAE](#)  
44 [requirements\).](#)

45  
46 **Affiliates/Affiliated:** Any person or business concern that directly or indirectly controls the  
47 policy of a principal or has the power to do so.  
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## 13.3

## Policies and Guidance

### 49 50 A. Purpose of Master Lease

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

#### 57 58 **The purpose of utilizing a master lease structure is twofold:**

- 59
- 60 1. To provide a mechanism for a master tenant to access available profit from any of the  
61 other facilities that are a party to the master lease in order to assist an individual  
62 property that may be experiencing inadequate cash flow to meet its financial  
63 obligations.
  - 64 2. The master lease is also a tool to ensure that in the event of a bankruptcy that all  
65 project obligations are utilized to maximize HUD's recovery.  
66

67 A master lease is not a traditional cross collateralization of all project collateral (which would  
68 be an accepted practice for a bank loan, a Commercial Mortgage Backed Securities (CMBS)  
69 or a bond financed facility). For FHA-insured projects, the master lease is a cross default of  
70 only the individual subtenants. A master lease reduces the risk of “cherry picking” – a  
71 practice in which the subtenants of multiple FHA-insured facilities maintain the lease in  
72 financially successful projects while rejecting the leases of poorly performing projects. A  
73 master lease can prevent “cherry picking” in that the master lease is an indivisible lease  
74 which requires a debtor in bankruptcy to accept all leases or reject all leases included within  
75 a master lease.  
76

### 77 B. Description of the Master Lease

78 A master lease is a primary lease that controls subsequent leases. The master tenant will

79 sublease its interest to a subtenant operator. All subtenant operators are bound by the master  
80 lease. A master lease essentially ties together multiple facilities with the same ownership.  
81

82 Under each sublease, the operator will be obligated to pay to the master tenant a minimum of  
83 base rent plus reserves and escrows owed by the borrower on the FHA-insured loan. Each  
84 operator will sign a Cross-Default Guaranty of Subtenants, pursuant to which each operator  
85 guarantees to the master tenant the performance of the obligations of the other subtenants  
86 under their collective subleases. If any subtenant defaults on any single sublease, that default  
87 would trigger a default on the master lease and all subtenants.  
88

89 It is not in FHA's interest for a default to occur for all subtenants, so it has provided a  
90 mechanism to provide a reasonable timeframe for the master tenant and the parent operator  
91 to correct any deficiencies and or cure a default to the project as long as there is not a  
92 substantial and imminent risk of a revocation or termination of the license or other  
93 necessary permits or approvals.  
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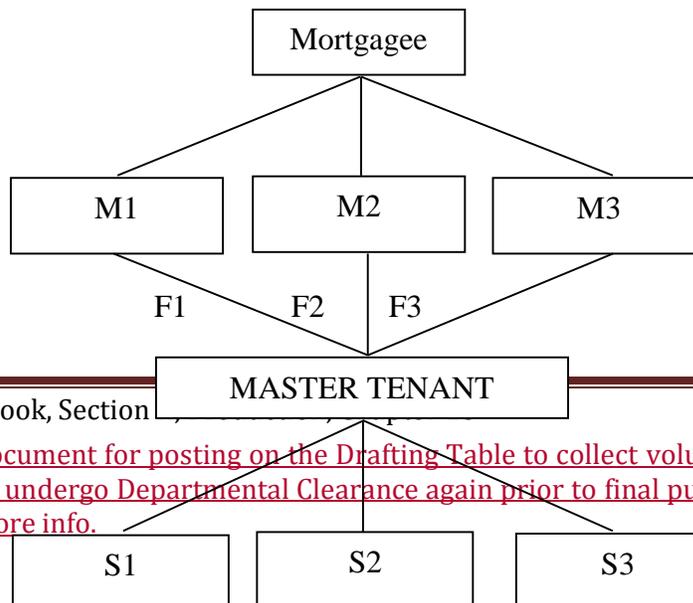
95 **C. Underwriting of Projects included in a Master Lease**

96 Each mortgage insurance application must meet FHA's underwriting standards on its own  
97 merit. HUD does not permit a master lease structure to be used to justify the approval of  
98 applications for mortgage insurance for fundamentally weak projects, and HUD will not  
99 accept the premise that "the strong projects will take care of the weak projects." As with all  
100 FHA projects, each loan will have a separate note for each borrower and each note will be  
101 secured by its own security instrument. FHA does not cross collateralize the real estate of  
102 projects included in a master lease structure.  
103

104 **D. Master Lease Structure**

105 Under the master lease arrangement, the Borrower for each property included in the master  
106 lease is collectively known as the landlord. The landlord enters into a master lease with the  
107 master tenant. The master tenant will enter into a separate operating sublease with each  
108 healthcare project operator entity. Each sublease will be included in the master lease. Each  
109 subtenant operator therefore enters into a separate lease agreement with the entity that owns  
110 the facility (i.e. the landlord).  
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112 Master Lease Structural Map



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F1            F2            F3

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

168 ownership position is determined to be. Any related party to the minority party after  
169 the buyout shall be considered the common majority owner.

170  
171 HUD understands that the ownership interests of multiple facilities can vary due to  
172 the inclusion of minority interests in differing ownership entities. ORCF has  
173 structured master lease transactions with unique and atypical circumstances. HUD  
174 has been able to achieve creative solutions in consultation with lenders and OGC to  
175 structure master lease documents that protect HUD's interest while not interfering in  
176 the legal rights of or fairness to minority ownership interests.

177  
178 **See the Pledge of Cash Flow Model in Appendix 13.1 for a sample diagram.**

179  
180 **2. Multiple Operators**

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

191  
192 **See the Master Landlord Structure in the Appendix 13.2 for a sample diagram.**

193  
194 **3. Multiple Lenders**

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

203  
204 In such situations, a master lease for each lender with subordinate cross default  
205 guarantee agreements may be a suitable alternative.

206  
207 **See Multiple Lender Master Lease Alternative diagram in Appendix 13.3.**

208  
209 Also, the master leases from different lenders may contain a provision that a default  
210 under one master lease may constitute a default under all master leases if HUD, in  
211 consultation with all lenders, determines that a cross default provision should be

212 exercised.

213

214 **4. Legal Restrictions**

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

219

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

231

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

237

238 **5. Contractual Restrictions**

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

244

245 **F. Alternatives to Master Lease.** The master lease requirement applies to projects that are  
246 utilizing, or will utilize, a lessee-operator "PropCo/OpCo" structure. For organizational  
247 structures with no operating lease, however, HUD looks to an alternative means of mitigating  
248 the concentration of risk inherent in the common ownership (e.g., a Limited Guaranty and  
249 Security Agreement).

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## 13.4

## Master Lease Criteria

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253 The master lease procedures that are applicable to for-profit and non-profit owners and operators

254 of residential care facilities are stated below.

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256 A master lease will be required where there is:

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- 258 1. An application for mortgage insurance for purchase or refinance of an existing facility
- 259 pursuant to Section 223(f);
- 260 2. An application for mortgage insurance involving new construction or substantial
- 261 rehabilitation pursuant to Section 232 NC/SR;
- 262 3. An application for mortgage insurance for refinance of an existing FHA-insured facility
- 263 pursuant to Section 223(a)(7);
- 264 4. A transfer of physical assets (TPA); or
- 265 5. A change in control of facility operator. This will generally be a change in the lessee of a
- 266 facility, a change in the operating license holder, or a change in the operating entity that
- 267 provides patient care to residents (a management agent in some circumstances).
- 268

268

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

270

- 271 1. A transaction includes three or more properties and/or \$15 million or more in aggregate
- 272 mortgage amount (meeting either threshold is sufficient);
- 273 2. The borrowers will either be under same ownership or a majority ownership individual or
- 274 group will control the properties;
- 275 3. The operators of each property will be a lessee with the same ownership;
- 276 4. Subsequent application received within 18 months from the last project with the same
- 277 ownership and operating structure as an existing FHA-insured portfolio with a master
- 278 lease in place, that property must be added to the existing master lease. In cases where
- 279 there are different minority owners, different operators or different lenders, refer to the
- 280 guidance in Section 13.3.E. above - Alternative Forms of Project Structures and
- 281 Variations in Master Lease Structures; and
- 282 5. The applications for mortgage insurance are submitted within any rolling 18-month
- 283 timeframe that begins when the first application is assigned to an ORCF underwriter.
- 284 The submission of an application creates an open window for a master lease. The
- 285 window remains open for 18 months following the start of processing of the most recent
- 286 application. Thus for multiple submissions, the cumulative open window may be longer
- 287 than 18 months from the first application to the last.
- 288

288

289 This 18-month timeframe may be expanded, at the discretion of ORCF where necessary,

290 to accomplish the intent of a master lease and to fully evaluate the risk to the General

291 Insurance Fund.

292

292

293 The master lease must be in place at closing for all projects that meet any of the above criteria.

294 The master lease is required regardless of whether the borrower and operator are either identity-

295 of-interest or independent or third party entities.

296

296

297 The master lease requirement applies to newly insured facilities and TPAs. HUD will not reach

298 back and require that existing FHA-insured facilities be placed in a new master lease except  
299 when they are within a portfolio of properties submitted for financing or refinancing within the  
300 open window, or if credit considerations on a new transaction would otherwise warrant a master  
301 lease requirement being imposed as a risk mitigant.  
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## 13.5

### Term of Master Lease and Subleases

304  
305 The master lease is meant to mitigate the concentration of risk for the term of the mortgages to  
306 which the master lease applies. Accordingly, it is expected that the master lease shall run at least  
307 as long as the mortgage having the longest remaining term.  
308

309 HUD recognizes that in some situations such an initial term may not be feasible, such as where,  
310 for example, the operator entities and ownership entities are unrelated parties, or where state law  
311 would prohibit or impose substantial negative financial consequences on such a long-term lease.  
312

313 In such situations, the lender must provide the basis for that determination and propose an  
314 alternative terms that addresses HUD's long-term intent. Any proposed alternative structure  
315 shall, at a minimum, specify that:  
316

- 317
- 318 1. Unless HUD approves otherwise, the subleases shall each be, and remain,  
319 coterminous with one another, and
  - 320 2. Each borrower's Regulatory Agreement will include an addendum to be approved by  
321 HUD requiring that in the event the master lease will terminate prior to the maturity  
322 date of the FHA-insured mortgage, the borrower shall enter into a new master lease  
323 with another party acceptable to HUD covering all subject properties prior to the  
324 expiration of the existing master lease.  
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326 The master lease shall only include facilities insured by FHA under the Section 232 program.  
327 Projects with affiliated ownership that are not insured under Section 232 shall not be included in  
328 a HUD master lease.  
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## 13.6

### Master Lease Review

331  
332 HUD has developed a series of approved legal documents that are required to be utilized for  
333 master lease transactions.  
334

335 The legal documents are as follows and are available on the Section 232 Program website:  
336

- 337
1. Cross-Default Guaranty of Subtenants,

- 338 2. Guide for Opinion of Master Tenant’s Counsel,  
339 3. Healthcare Regulatory Agreement - Master Tenant,  
340 4. Master Lease SNDA,  
341 5. Master Lease Addendum,  
342 6. Master Lease Estoppel Agreement, and  
343 7. Master Tenant Security Agreement.  
344

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

350  
351 For small portfolios, prior to the ORCF Loan Committee and the issuance of a Firm  
352 Commitment, both the OGC closing attorney and ORCF underwriter will review the information  
353 to ensure that it meets HUD’s requirements.  
354

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

360  
361  
362 A. Lender shall provide a narrative which describes the following:  
363

- 364 1. The terms and conditions of the master lease;  
365 2. Any waiver or other requests for modifications to the master lease regime that deviate  
366 from the standard requirements specified in the HUD forms, policies or practices for  
367 master leases;  
368 3. Any proposed payments (fees, income, etc.) to or from the master tenant;  
369 4. The lease agreements between borrower and the master tenant, and the lease  
370 agreements between the master tenant and the subtenants;  
371 5. The collection and flow of funds from the subtenants to the master tenant and from  
372 the master tenant to the borrower. Include the involvement of funds flow with the AR  
373 lender if an AR lender is providing AR loans to the project; and  
374 6. A diagram or other visual depiction of the flow of funds from each Operator to the  
375 master tenant to the Borrower. Specify the depositories for each individual project  
376 funds, as well as for the master tenant as applicable.  
377

378 B. Lender shall provide a spreadsheet with the following:  
379

- 380 1. The names of the facilities to be included under the master lease;  
381 2. The proposed mortgage amount for each facility;

- 382 3. The recommended appraised value of each facility;  
383 4. The proposed debt service coverage ratio for each facility including the mortgage  
384 insurance payment;  
385 5. The number of beds at each facility;  
386 6. The CMS Star Rating at each facility, if applicable;  
387 7. The current balance of each facility's replacement reserve account; and  
388 8. Any other reserve funds that will be available to the owner/operator to fund project  
389 costs.

390  
391 C. Description of the Legal Structure: A narrative shall be provided describing the legal  
392 structure of the borrower or master landlord entity, the master tenant, and the operating  
393 entity/subtenant. The legal structure must disclose all tiers of ownership. If the Borrower or  
394 Operator has multiple tiers of ownership, the narrative shall include a diagram or chart  
395 identifying all parties and their relationship to one another and any conflicts of interest  
396 between the parties.

397  
398 D. ORCF Review: ORCF, in cooperation with OGC, will review the following items to ensure  
399 agreement with the contents of the lender's application:

- 400  
401 1. Master Lease and Subleases;  
402 2. Base rent amount;  
403 3. Escrow amounts (for example, taxes, MIP, property insurance, etc.);  
404 4. Term of the master lease;  
405 5. HUD mandated immediate and/or critical repairs;  
406 6. HUD required replacement reserves; and  
407 7. Any other required reserves.