



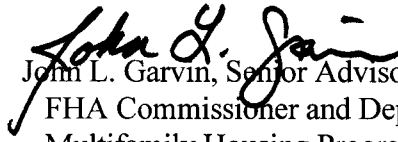
U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

MAR 3 2008

MEMORANDUM FOR: All Multifamily Hub Directors
All Multifamily Program Center Directors
All Multifamily Operations Officers
All Directors of Project Management
All Field Counsel

FROM:


John L. Garvin, Senior Advisor to Assistant Secretary for Housing-
FHA Commissioner and Deputy Assistant Secretary for
Multifamily Housing Programs, HT

SUBJECT:

Draft Policy and Procedures on Multifamily Mortgage Insurance
Applications Involving Master Lease Ownership Structures

Purpose

The Department is considering a unified policy and set of procedures with respect to FHA insured transactions utilizing a Master Lease, also referred to as a “sandwich lease” structure. This policy will only apply to tax credit transaction in which a “pass-through” election has been made for the benefit of a Master Lessee. This memorandum sets forth the Department’s current guidance and proposed policy for such transactions, anticipated to be used under Section 221(d)(4), 220 and 231 mortgage insurance programs, on a case by case basis. This guidance presents the Department’s current formulation of good practices to follow generally in such transactions. The Department will evaluate its experience under this guidance in developing a more permanent framework to use for applications involving Master Lease ownership structures. Master Leases are used to maximize the benefits of the following tax credit sources: Federal Historic Tax Credits, Federal New Market Tax Credits, State Historic Tax Credits, State New Market Tax Credits, Federal Low Income Housing Tax Credits. Master Leases are advantageous to investors and developers participating in these programs by providing maximum leverage for project financing and premium pricing for equity while reducing the need for additional debt.

The Hub and applicable Program Center will be responsible for reviewing requests to utilize master lease ownership structures. The Hub will provide a recommendation on the request to Headquarters (HQ) to approve, or to approve with conditions. HQ will issue a final approval or disapproval of the request. Hubs and PCs will be able to reject requests without seeking HQ’s concurrence.

Background

A Master Lease, also known as a Sandwich Lease or Credit Pass Through, is used by developers of multifamily projects to maximize tax credits and distribute benefits among various investors. Typically, these leases permit a combination of investment by one or more investors under one or more tax credit programs. A typical Master Lease organizational structure is enclosed as Attachment 1. As the organizational chart demonstrates, these transactions create a tiered ownership structure with a Master Tenant leasing the entire project from the Mortgage/Lessor, and then entering into sub-leases, which are sometimes master subleases, with commercial and/or residential tenants. The Master Lease structure differs from the more traditional ownership structure in that project assets and revenues under a Master Lease structure pass through a number of tiers and, in doing so, come under the control of entities other than the Mortgage. HUD's concern is that these tiers of control not have a negative impact on the result HUD seeks to achieve, that the Master Tenant pays the Mortgage/Lessor rent that equals or exceeds the amount necessary to satisfy all financial obligations required by the HUD Insured Mortgage. To mitigate such a negative impact, it is contemplated that the Mortgage/Lessor, the Master Tenant and all Master Sub-lessees (not individual residential and commercial tenants) will execute HUD Regulatory Agreements and submit financial reports to HUD.

Applicable Programs

It appears that the utilization of a master lease structure will provide significant additional leveraging of funds and otherwise facilitate the development of affordable housing. As such, a Department-wide policy and procedures to permit this type of ownership structure needs to be developed. We anticipate limiting these transactions to the following programs:

Section 221 (d)(4) Mortgage Insurance for Multifamily Housing
 Section 220, Mortgage Insurance for Rehabilitation and Neighborhood Conservation
 Section 231, Mortgage Insurance for Rental Housing for the Elderly

Due to programmatic complexities, during the formative stages of the policy, these Master Lease ownership structures should not be used for projects assisted by a Section 8 contract or in conjunction with a Section 236 de-coupling.

Section A. Programmatic Requirements

Each of the following provisions should be considered as a condition for approval of a Master Lease proposal:

1. The Master Tenant and Master Sub-lessees will be single purpose entities. The Master Tenant and Master Sub-lessees may not engage in any other businesses or activity including the operation of any other rental project or incur any liability or obligation not in connection with the project.

2. The Master Tenant and Master Sub-lessees will execute the standard HUD regulatory agreement with a special rider attached to address the various ownership and operational responsibilities with respect to the mortgaged property. Riders used in a previous sandwich lease transaction are attached as Attachment 2.
3. The management agents at the various levels will execute HUD's management certifications. The Master Tenant and Master Sub-lessees will file management certifications and management profiles. HUD will be able to terminate a management agreement if warranted, without Lender consent, to protect its mortgage insurance interests. The management agreements will include the standard termination language required in Section 9 (a) of the Regulatory Agreement.
4. Net rentable commercial area as a percentage of gross floor area and income will be determined in accordance with section 3-4 of the MAP Guide or for TAP applications paragraph 3-7 of the Basic Underwriting Handbook, 4425.1 Rev-2.
4. All Master and Sub-leases shall be subordinate to the HUD Insured Mortgage; will be subject to approval by HUD prior to execution and may not be modified or amended without the prior written consent of HUD; may be terminated by HUD, at HUD's election, in the event that the HUD Insured Mortgage loan is assigned to HUD; will incorporate by reference the applicable regulatory agreement, HUD rules, regulations and directives and contain an agreement to perform the undertakings, obligations and requirements contained therein, and will include an obligation to pay all rent due under the respective lease to HUD or to the mortgagee of the HUD Insured Mortgage, as directed by HUD, in the event of a default under a document that evidences, secures or otherwise is executed in connection with the HUD Insured Mortgage. If requested timely by Mortgagor/Lessor and included in the documentation for the transaction, the HUD Insured Mortgage may have a rider attached to it that contains additional parties to receive notice(s) of default under the HUD Insured Mortgage contemporaneously with the giving of notice to the Mortgagor/Lessor, and a cure of such default will be accepted during such notice period from the Master Tenant on behalf of the Mortgagor/Lessor, provided such cure occurs prior to the assignment to HUD of the HUD Insured Mortgage.
5. Project revenues or earnings (at the Mortgagor/Lessor, Master Tenant and all Master Sub-lessees levels) may not be distributed without a declaration of surplus cash per the regulatory agreements. Surplus cash determinations (including, without limitation, net operating income) will be made as if the entire project is owned and operated by one single purpose entity.
6. All financial operations and reporting are governed by HUD requirements.
7. The rent paid by the Master Tenant equals or exceeds the monthly principal and interest payments due on the insured first mortgage and all required escrows and reserves.

8. All business agreements are to be disclosed to and are subject to approval by HUD during loan underwriting (including, for example, inter-company and intra-company loans and advances, investor or outsider loans other than the insured mortgage, investor controls over operations including controls or rights to control activities, actions and deliverables that affect or are linked to regulatory or contractual compliance or performance, etc.). The firm commitment will incorporate any conditions imposed by HUD with respect to such agreements.
9. Any payments (fees, income, etc.) to the Mortgagor, Master Tenant, Master Sub-lessees, syndicator and developer are disclosed to HUD on the annual financial statement filings and on any required monthly reporting to HUD, and must be disclosed to and be subject to approval by HUD at the time of loan underwriting. The payment of the developer's fee(s), or any portion thereof, may be restricted pending the achievement of certain performance benchmarks established by HUD (the "Sustaining Performance"). The firm commitment will incorporate any conditions imposed by HUD with respect to such agreements.
10. Any cost for oversight by the tax credit allocating agency will be paid from non-project funds.
11. Consistent with the parties obligations under the regulatory agreements, all Master and Master Sub-leases need to include a provision prohibiting assignments or subleases (except to the end-users of the commercial spaces and apartment residents).
13. The regulatory agreement riders contain provisions that suspend the initial surplus cash distribution until Sustaining Performance is achieved, as more particularly described in Section E below.

Section B. Firm Commitment Exhibits and Processing

The Hub/Program Center Director should conduct a pre-application meeting prior to the submission of a formal application for mortgage insurance. In addition to the exhibits required by MAP or TAP, the following information should be submitted with the firm commitment application to facilitate a review of each transaction:

1. All layers of financing are identified and applicable loan/financing documents are provided.
2. Full disclosure of the name and financial interest of:
 - a. All principals, as defined in 24 CFR Part 200, of the Mortgagor, Master Tenant and Master Sub-lessees;
 - b. The general contracting firm

3. Certifications are provided from the following entities, disclosing all relationships between parties to the transaction:
 - a. All principals of the sponsor/mortgagor
 - b. Mortgagee
 - c. General Contractor
 - d. Management Agent
 - e. Syndicator
 - f. Developer
 - g. Master Tenant
 - h. Master Residential Tenant
 - i. Master Commercial Tenant
 - j. Party making bridge loan, if any
4. If the Mortgagor/Lessor obtains bridge loan financing which is secured by future Syndication proceeds, a letter from the lending institution is submitted which:
 - a. Details all conditions under which the loan will be made.
 - b. Certifies that the loan is not secured by the project and that the lending institution has no claim, and will not later assert any claim, against the mortgaged property, mortgage proceeds, any reserve or deposit made with the mortgage transaction, or against the rents or other income from the mortgaged property for payment of any part of the loan transaction.
 - c. Includes the criminal certification.
5. A Sources and Uses statement of total development costs and Form HUD-2880, Applicant/Recipient Disclosure/Update Report.
6. An executed copy of the developer's fee agreement.
7. Certifications from Mortgagor/Lessor, Master Tenant, Master Sub-lessees and investor(s) that HUD has been given full disclosure of all details of the transaction structure, including the information required in Section A above with respect to business agreements and payments.
8. A narrative describing the lease agreements between the Mortgagor/Lessor and Master Tenant, and the Master Tenant and Master sub-lessees, detailing the collection and flow of funds from the Master Sub-lessee to the Master Tenant and from the Master Tenant to the Mortgagor/Lessor.
9. A market study establishing demand for any proposed commercial space.

10. A subsidy layering review, in accordance with the October 16, 2007 memorandum titled Interim Guidance for Subsidy Layering Reviews, shall be performed once all layers of funding have been identified to determine that no more Federal funding has been provided than is needed to develop the housing.
11. Previous Participation Clearance, HUD Form 2530, for the Principals of the Mortgagor/Lessor, Master Tenant and all Master Sub-Lessees.
12. The Mortgagor/Lessor, Master Tenant, and Master Sub-Lessees are all subject to the standard underwriting requirements found in Chapter 8 of the MAP Guide or in the Underwriting Handbook 4470.1, REV-2, Mortgage Credit Analysis for Project Mortgage Insurance.
13. HUD will determine the amount of any Initial Operating Deficit Escrow and Working Capital Escrow required to fund project operations during initial occupancy and rent-up.
14. Attachment 3 is a preliminary list of Special Conditions that should be included in all Firm Commitment for Insurance of Advances, Form HUD-92432 with Master Lease ownership structures.

Section C. Actions Prior to Initial Endorsement

Prior to closing, HUD's Office of General Counsel should review and approve all proposed closing documents to ensure compliance with all special commitment and other transaction specific conditions. See Attachment 3. In addition, the following documents will be reviewed by the Hub/PC:

1. A final Sources and Uses statement of total development costs, reflecting any revisions to hard and soft costs as reflected on the firm commitment, HUD-92264. If any funding sources have changed, a revised HUD-2880 is also required.
2. A final subsidy layering review is performed once all layers of funding have been identified to determine that no more Federal funding has been provided than is needed to develop housing.
3. The following Forms will be revised to more clearly reflect the lease structure and HUD requirements:

Form FHA-2433, Mortgagor's Certificate- To include language that clearly states that the Master Tenant and sub-lessees report lease payments during the construction period as rental income.

Form FHA-3305, Agreement and Certification- To include language that clarifies that the Mortgagor reports all receipts and disbursements from the date of first occupancy, and that all receipts and disbursements are reported during the rehabilitation period for substantial rehabilitation cases. The Agreement and Certification will also require cost certification reporting requirements for The Master Tenant and all Sub-lessees.

4. Evidence that the insured mortgage loan is in first lien position with respect to all project collateral
5. All documents should include conflict language giving the HUD documents supremacy over other documents. Documents may not include indemnification provisions (except provisions permitted in Chapter 12 of the MAP guide), waivers of jury trials or arbitration provisions.
6. At and as of closing, the Mortgagor, Master Tenant, Master Sub-lessees and investor(s) will reaffirm and certify that the information required in Section A above with respect to business agreements and payments remains true and correct.

Section D. Cost Certification and Final Endorsement

1. The Mortgagor/Lessor, the Master Tenant and all Master Sub-lessees will be required to cost certify. The cost certification contains a certification signed by an authorized agent of the each entity that the following information, audited by a CPA or IPA contains a Schedule of Tax Credit/Syndication Proceeds including the following:
 - a. The amount of syndication proceeds received from the investing partner to date.
 - b. Purposes for which syndication proceeds received as of the cut-off date were used.
 - c. Dates, terms, and conditions under which future investor contributions are to be made.
 - d. The above certifications must include the criminal certification.
2. Total income of the Mortgagor/Lessor, including lease payments, is recognized during the construction /rehabilitation period. In accordance with HUD Cost Certification requirements, any income received by the Mortgagor/Lessor, Master Tenant and Master Sub-lessees must be applied to reduce the insured mortgage amount. The Mortgagor/Lessor, Master Tenant and Master Sub-lessees are required to submit a certified operating statement which reflects the income collected and expenses incurred in accordance with the lease agreements and all other documents provided to HUD.
3. A final Sources and Uses Statement is included in the cost certification report as a supplemental information. The final statement shall be reviewed to determine actual sources and uses. If the statement indicates that funding sources have exceeded actual uses, a mortgage reduction shall be applied accordingly.

Section E. Sustaining Performance

The anticipated standards to achieve Sustaining Performance should be described in the Riders. The Riders will state that Sustaining Performance has been achieved when (a) construction of the project is complete and HUD has reviewed and reconciled, to its reasonable satisfaction, the cost certification audit with an audit of the project's sources and uses of all funds, including the proceeds from the FHA-Insured Loan, (b) the project has received a score of 85 on the most recent HUD REAC inspection, (c) the FHA-Insured Loan is in good standing, and (d) for a period of two consecutive annual operating periods:

- No delinquencies may occur for the entire period;
- No defaults may occur for the entire period;
- Monthly Accounting Reports are filed with the Hub or Program Center in accordance with HUD requirements;
- Annual financial reports are filed in accordance with HUD requirements;
- The property achieves the following performance benchmarks as computed by Multifamily's Financial Accounting SubSystem (FASS): Occupancy Rate of 95%; Reserves per Unit of \$800; Debt Service Coverage Ratio of 1.10; Quick Ratio of 1.6. The local Hub or PC will be responsible for determining whether these benchmarks are achieved. The Hub or PC must inform the Mortgagor/Lessor whether these benchmarks have been achieved within 30 days of the accepted annual financial statement submission for the Mortgagor/Lessor, Master Tenant and Master Sub-lessees. Please note that the benchmark determinations for the Master Tenant and Master Sub-lessees may need to be computed manually by the Hub or PC since FASS is currently unable to accept these financial statements.

Section F. Multifamily Housing Hub/Program Center (PC) Responsibilities

Once the final policy is issued, the Hub/PC will have the responsibility to review the submission to ensure that all applicable conditions have been satisfied. The Hub Director must prepare a memorandum confirming compliance to the Director of the Office of Multifamily Housing Development in Headquarters, summarizing the transaction with a recommendation to approve and any additional conditions for such approval. HQ will issue a final approval or rejection of the proposed transaction. The Hub/PC may reject requests to utilize master lease ownership structures without seeking HQ's concurrence.

Attachments:

Attachment 1-Sample Master Lease Ownership Structure

Attachment 2- HUD Regulatory Agreement Riders

Attachment 3-Firm Commitment Special Conditions