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How to Cover Multiple Facilities with a Single Loan under HUD's Lean Program

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The Multifamilly and Healthcare Facility divisions of HUD are a bit like two different dialects of the same language; both offer mortgage insurance under the Federal Housing Administration, but each has its own distinct rules and conventions on underwriting, closing and asset management. Being conversant in one dialect doesn't necessarily equip you to get by in the other.

Notwithstanding the numerous differences, HUD-insured multifamily and health care facility (Lean) loans do have certain common denominators, including the rule that borrowers must be single-asset entities. What all can be included in a "single asset"? As Dinsmore recently experienced when representing a HUD-insured lender on a Section 232/223(f) Lean deal, HUD's Office of Residential Care Facilities (ORCF) is willing to take an expansive view of what the single asset serving as collateral for a HUD-insured loan can be. In fact, multiple facilities were combined on that deal and served as a single asset securing the loan. The discussion below describes the documentation challenges the parties faced and the solutions on which they agreed.

The Setup

Prior to applying to HUD for refinancing, the borrower's principal was the controlling participant of entities that owned four separate facilities (two assisted living and two skilled nursing). Two of those facilities were leased to a single operator, while each of the other two had its own operator (all three operators were affiliated with the borrower). To further complicate matters, two of the facilities were on a single site in one county and two were on a single site in a non-contiguous county.

As part of the HUD-insured transaction, ownership of the four facilities was consolidated into a single newly created entity that served as the borrower. The operators, by contrast, continued in their respective, separate roles post-closing (thus alleviating a potential change-of-operations trigger). In summary, the deal involved one borrower obtaining one loan secured by four facilities operated by three operators on two sites in two different counties.

The Challenge

An inherent risk of covering multiple facilities with a single loan is that financial issues at any individual facility can trigger a loan default that negatively impacts all facilities. This is the same concentration of risk that HUD's Section 232 Handbook refers to in connection with portfolios. However, in a traditional Lean portfolio, HUD requires a master lease and cross-default guaranty among the operators that purport to mitigate the concentrated risk and may require the strong facilities to bail out the weaker ones. Furthermore, if a bailout is not possible in the master lease context and one facility is beyond saving, that weak facility, which has its own loan separate from the rest of the facilities in the master lease, will not bring down the entire portfolio. The challenge in the deal at hand was to import risk-mitigation tools from the master lease concept into a deal where a single mortgage encumbered a small portfolio of related facilities.

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The Solution

For better or for worse, the HUD firm commitment did not prescribe a particular approach to drafting documents for a mortgage loan covering multiple facilities. After discussing the unique circumstances with HUD counsel, the parties agreed that the closing documents would differ from a typical Lean deal in the following ways:

First, each operator would sign its own set of loan documents. The parties initially considered a single set of operator loan documents, with all three operators serving as the collective "Operator," but on closer review, the HUD documents did not lend themselves to this approach, as significant tailoring would have been necessary. Drafting three sets of operator loan documents added to the bulk of the closing binder (the final docket was anything but Lean) but ultimately simplified matters by staying within the parameters of standardized HUD templates.

Second, the three operators would sign a Cross-Default Guaranty. The Guaranty, normally used in connection with master lease deals, required the operators to cure each other's lease violations. Moderate tailoring of the Cross-Default Guaranty of Subtenants was required, but HUD was willing to approve the tailoring as a means of mitigating the concentrated risk of four facilities being covered by a single loan. The "safety in numbers" achieved through the Guaranty trumped the need to adhere to standardized forms.

Finally, a special rider would be attached to the three Operator Regulatory Agreements. The rider had two primary functions. First, it required each operator to submit not only quarterly and year-to-date financial statements to HUD and the lender for its own operations, but also quarterly and year-to-date calculations of the working capital (assets minus liabilities) for all four facilities combined. In this way, HUD and the lender are assured a holistic view of the single asset's finances on a regular basis. Second, the rider contained a provision prohibiting each operator from making distributions if the aggregate working capital of all four facilities is negative. That provision worked hand in hand with the Cross Default Guaranty, putting each operator on notice that, so long as the overall working capital of the four facilities is negative, the healthy operators must bail out their challenged sibling(s) in the portfolio before taking profits.

The Takeaway

ORCF's willingness to broadly interpret "single-asset entity Borrower" ultimately allowed this deal to move from concept to closing. In the absence of guidance in HUD's Section 232 Handbook on the mechanics of closing a loan secured by multiple facilities, the parties had to improvise solutions and work with HUD to deviate from the standardized loan documents in several instances. While borrowers and lenders should not view the deal as a signal that ORCF is open to insuring multiple-facility loans in the regular course of business, Dinsmore's experience does shed light on how to address documentation challenges posed by such loans.

If you have any questions please contact your Dinsmore attorney.

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