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

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

Special Attention of
All Multifamily Hub Directors
All Multifamily Program Center Directors
All Multifamily Operations Officers
All Directors of Project Management
All Field Counsel
All Multifamily Owners

Notice H 2011-31
Issued: November 10, 2011

Expires: November 30, 2012

Cross References:

Subject: Policy for Treatment of Proceeds Resulting from the Sale of FHA-insured or Secretary-held formerly insured Multifamily Projects by Nonprofit Owners

I. Purpose

This Notice provides guidance and clarifications on the Department's policy regarding the use of sale proceeds from a multifamily project sold by a Nonprofit Owner that has an FHA-insured or Secretary-held formerly FHA-insured mortgage. Many Nonprofit Owners of projects that have FHA-insured or Secretary-held, formerly FHA-insured mortgages are selling their properties to purchasers who will maintain the long-term affordability of the project. This Notice clarifies the circumstances under which Nonprofit Owners may retain the proceeds from the sale of a project, and the processing oversight that will be provided by HUD.

II. Background

During the 1960s and 1970s, HUD worked with Nonprofit organizations, including housing organizations, faith based institutions and community groups, to finance thousands of properties under mortgage insurance programs including, but not limited to, Section 221(d)(3), Section 231 and Section 236 of the National Housing Act. These properties were financed nearly 40 years ago and are approaching their mortgage maturity dates and are in need of repair and recapitalization. The majority of these insured properties have Section 236 and Section 221(d) (3) mortgages.

Nonprofit organizations own 39 percent of all Section 236 and 221(d) (3) properties with maturing mortgages. Currently, more than 700 Nonprofit-owned Section 236, Section 231 and Section 221(d)(3) properties have mortgages that will mature within the next 10 years, representing roughly 80,000 affordable units, including 42,000 units with project-based rental assistance.

As the mortgages mature on these properties, the underlying use and affordability restrictions also expire, placing the long-term affordability of the properties at risk. In addition, the physical viability of these properties is also at risk as many of the properties will need significant capital improvements to continue operating competitively in the marketplace, and to continue offering safe and decent affordable housing to residents of the project.

HUD offers Nonprofit Owners a number of tools to accomplish the refinancing and recapitalization of their properties. Nonprofit Owners with properties subject to Section 250(a) of the National Housing Act may prepay their mortgages with HUD approval, provided that all conditions of Section 250 are met. Nonprofit Owners of Section 236 properties with Interest Reduction Payments (IRPs) may complete the IRP Decoupling process to receive ongoing operating resources. Other Nonprofit Owners may elect to syndicate Low-Income Housing Tax Credits (LIHTC) and form new partnerships following the process outlined in HUD's Transfer of Physical Assets policies. These tools have proven to be extremely useful options for those Nonprofit Owners wishing to retain ownership of the properties.

Historically, the Department has restricted Nonprofit Owners from receiving the proceeds from the sale of an FHA-insured or Secretary-held property. [1] Proceeds are defined as the difference between the sales price of a project and the mortgage payoff amount. This restriction has created a disincentive for Nonprofit Owners to sell properties to purchasers seeking to preserve properties and maintain their long-term affordability.

HUD seeks to facilitate the sale and preservation of these properties as affordable housing, prior to their mortgage maturity dates. This Notice provides the parameters under which a Nonprofit Owner may retain proceeds from the sale of a property to complete a preservation transaction prior to mortgage maturity.

III. <u>Applicability</u>

This Notice applies to eligible transactions. Eligible transactions are those that involve the sale of a Nonprofit-Owned property with an FHA-insured or Secretary-held formerly FHA-insured mortgage, and that meet the terms of this Notice. Requirements of this Notice also apply to entities that purchase the properties.

This Notice does not apply to properties with Section 202 Direct Loans.[2]

This Notice supersedes the existing requirements in Chapter 13, Section 19 of HUD Handbook 4350.1, *Multifamily Project Servicing*, involving the sale of a property by a Nonprofit Owner to another entity.

This Notice clarifies and supersedes existing guidance for Nonprofit Owners seeking prepayment approval of Section 250 mortgages and/or approval of Section 236 Interest Reduction Payment (IRP) Decoupling Applications[3] <u>only</u> with regard to treatment of sales proceeds and the length of required Use Agreements. Nonprofit

[1] The regulations at 24 CFR Part 265.4 restricted Nonprofit Owners of FHA-insured or Secretary-held property. While in effect, the regulation allowed Headquarters to approve waivers on a case-by-case basis. 24 CFR Part 265 was removed in its entirety in 1996 as part of the Reinventing Government initiative. This regulation was implemented through HUD Handbook 4350.1, Chapter 13.

[2] See Housing Notice 04-21 for guidance on sales proceeds following a Section 202 prepayment.

[3] See Housing Notice 00-8 for guidance on continuation of Interest Reduction Payments after refinancing of Section 236 properties (IRP "Decoupling").

Owners seeking to receive sales proceeds must comply with all applicable Section 250 prepayment approval requirements and/or IRP Decoupling requirements and the requirements of this Notice regarding treatment of sales proceeds and Use Agreement duration. The form of Use Agreement required under Section 250 and Section 236 Decouplings will remain the same; only the term will be extended to comply with the requirements of this Notice.

This Notice will take effect on the date of publication and will apply to all prepayment requests where HUD approval has not yet been granted.

IV. Requirements for Release of Proceeds

A Nonprofit Owner may retain the proceeds from the sale of a project, provided that the transaction meets the following six (6) requirements and the transaction is approved by HUD:

1. Execution of Use Agreement

The Nonprofit Owner (seller) must ensure that the project will continue to be maintained by the purchaser as an affordable rental housing project by the execution and recordation of a Section 250 Use Agreement that extends the affordability restrictions of the project for a term of at least 20 years beyond the original mortgage maturity date of the FHA-insured or Secretary-held formerly FHA-insured mortgage; with the same affordability and rental restrictions as those in place prior to prepayment. The Use Agreement must be executed upon approval of the prepayment and recorded in conjunction with the Department's discharge of the existing Regulatory Agreement (see item C. below).

The Use Agreement must meet the following requirements:

A. The seller must obtain the appropriate Section 250 Use Agreement, with the additional 20 years of restricted use inserted by the local Office of General Counsel, from their Multifamily Hub/Program Center (Hub/PC), according to the Section of the Act under which the project was initially financed (i.e., Section 221(d)(3), Section 231, or Section 236). The seller should verify the 20 years of additional restriction has been incorporated into the Use Agreement.

B. HUD and the seller must execute, and seller must record the Section 250 Use Agreement at or before the closing of the transaction.

C. The Use Agreement may be executed by the Hub/PC Director and proof of recordation must be presented prior to the release and discharge of the existing HUD Regulatory Agreement.

D. The Use Agreement must provide for continuation in the event of foreclosure.

E. The Use Agreement must be recorded ahead of any new financing placed on the Project.

F. Proceeds from the sale must be placed in escrow until HUD receives the original recorded Use Agreement and a legal opinion that the Use Agreement has the first lien position. HUD will not issue a release of the Regulatory Agreement and will not consent to release the sales proceeds from escrow until all Use Agreement recording requirements have been satisfied. Once these documents are received, HUD will approve the remittance of the sales proceeds to the selling Nonprofit Owner.

2. Renewal and Assignment of Project-Based Section 8 Housing Assistance Payments (HAP) Contracts

If there is a project-based Section 8 HAP contract (HAP contract) in place at the property, the Hub Director or designee must ensure that a 20-year Renewal Contract is executed at or before the time of closing of the transaction. There are three ways to satisfy this requirement:

The seller and Hub Director may mutually agree to terminate the existing HAP contract and execute a 20-year Renewal Contract, which includes the "Preservation Exhibit" that is provided in Attachment 1 of this Notice. The term of the Renewal Contract must be equal to 20 years. The Preservation Exhibit must be completed to provide that upon expiration, the 20-year Renewal Contract shall automatically renew for an additional term at least equal to the number of years remaining on the existing HAP contract that is being terminated by mutual agreement of HUD and the seller. The seller will execute the Renewal Contract at or before the closing, and then assign the HAP contract to the purchaser at the time of closing using the "Assignment, Assumption and Amendment Agreement of Section 8 Housing Assistance Payments Contract" form provided as Attachment 2 to this Notice.

If the HAP contract termination date coincides with the closing date of the sales transaction, the purchaser may execute a 20-year Renewal Contract at the time of closing. In this case, the purchaser must submit all required contract renewal request information for consideration by HUD prior to the closing.

If the project is being sold to a profit motivated purchaser exercising an Option One Mark-up-to-Market contract renewal, the seller and Hub Director must mutually agree to terminate the existing HAP contract. The purchaser must submit all required contract renewal request information prior to closing. The purchaser will then execute the 20-year Renewal Contract, including the required Preservation Exhibit which will provide that the resulting Renewal Contract will automatically renew for the number of years remaining on the terminated HAP contract.

Please note: projects that have completed restructuring under Mark-to-Market are eligible to participate in transactions described in this Notice. These Owners may not terminate the existing HAP contract; instead, the existing HAP contract must be assigned to the purchaser at the time of the closing.

3. Rent-Setting and HAP Contracts

The Owner may sell the project to a Nonprofit or profit-motivated purchaser. A rent increase may be approved by the Hub/PC Director in conjunction with the execution of the Renewal Section 8 HAP contract. The allowable rent increase will depend on the contract renewal option requested and in accordance with the guidelines below. In no case will the Department approve a rent level that exceeds market comparables as evidenced by a Rent Comparability Study prepared in accordance with the *Section 8 Renewal Policy Guide* ("The Renewal Guide"). [4] Sellers and purchasers participating in this Notice are not eligible to renew the HAP contract under Option 4 of the Renewal Guide.

If the purchaser is a Nonprofit organization, the selling Nonprofit Owner may request a Mark-up-to-Budget rent increase under the Transfer Program or Capital Repair Program under Chapter 15 of the Renewal Guide. If the Section 8 HAP contract rent increase is made in anticipation of "post rehab" condition of the property, the rent increase may be approved in advance of the repairs, to take effect when the proposed physical improvements are completed, as described in Chapter 15 of the Renewal Guide.

If the Nonprofit Owner is proposing to sell to a profit-motivated purchaser, the Owner may request a Mark-up-to-Market rent increase. However, because Mark-up-to-Market rent increases are only available to profit-motivated Owners, the Renewal Contract may not be executed by the selling Nonprofit Owner. Instead, the Renewal Contract should be prepared in accordance with the Renewal Guide and should be executed by the purchaser at the time of closing of the sale. (see item C in section 2 above, Renewal and Assignment of Section 8 Housing Assistance Payments (HAP) Contracts.

To protect low- and moderate-income tenants who live in other HUD subsidized units, including Rent Supplement, Rental Assistance Payment (RAP), Below Market Interest Rate (BMIR), and Section 236 properties, rents on non-Section 8 units may be increased by no more than 10 percent as a result of the transaction and the purchaser must submit a plan indicating the rent burden any proposed rent increase will have on un-assisted tenants and if necessary phase-in such rent increases to minimize impact as much as possible.[5]

The purchaser must also submit a narrative addressing what subsidies, such as Housing Choice Vouchers, LIHTC equity, and bond financing will be provided as part of the transaction, and detailing what steps will be taken to protect current tenants from rent increases that may occur in relation to these other funding sources. The Hub/PC Director must assure that no involuntary displacement of existing tenants occurs as a result of the transaction. This will include careful review by the Hub/PC Director of the impact on

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[4] The *Section 8 Renewal Policy Guide* may be found at http://www.hud.gov/offices/hsg/mfh/exp/guide/s8renew.pdf.

[5] See *Section 8 Renewal Policy Guide*, Chapter 15, and HUD Handbook 4350.3 REV-1, *Occupancy Requirements of Subsidized Multifamily Housing Programs*

any tenants with incomes that exceed LIHTC income restrictions, and confirmation that the purchaser will comply with any and all applicable federal policy related to relocation.

4. Physical Improvements

The purchaser must conduct a Capital Needs Assessment and submit a plan with a time table for repairs, and dedicated funding to meet the physical needs of the project over the term of the new Use Agreement or the HAP contract, whichever is longer. [6] Any significant repair needs (accessibility repairs, major building systems or life safety items) must be addressed through a capital repair effort to be initiated upon closing of the transaction. The repair plan should also meet the outstanding requirements for approval of Section 250(a) prepayment, IRP Decoupling or Transfer of Physical Assets as may be required for that type of transaction.

If the project receives federal financial assistance, including, but not limited to, project-based Section 8 housing assistance (for a definition see 24 CFR 8.3), then the purchaser must include in the Capital Needs Assessment its plan for any alterations to dwelling units or common areas necessary for compliance with HUD's Section 504 regulation at 24 CFR Part 8.

5. Financing Plan

The transaction must include a financing plan demonstrating operational feasibility over the term of the proposed Use Agreement or HAP contract, whichever is longer. Where non-FHA financing is proposed, the Hub/PC Director must verify that the proposed financing includes a sufficient Debt Service Coverage ratio and interest rates appropriate for the project and the market. The Hub/PC Director should take particular care to assess the risks posed by adjustable-rate or balloon payment mortgages or other financing terms and conditions that could trigger future default or financial instability. Please refer to Section 6 below for additional guidance on analyzing project financing.

6. Purchaser Capacity

The Nonprofit Owner must sell the property to an experienced owner (nonprofit or for-profit) of affordable rental housing. The Hub/PC Director must verify that the purchaser has the capacity to complete the repair program and manage the project successfully as affordable housing over the term of the proposed Use Agreement or HAP contract, whichever is longer. The Hub/PC Director or designee is to evaluate the qualifications of the proposed purchaser and closely review the submitted narrative, financing plan and resumes of the development team. The prospective owner must satisfy the Hub/PC that they bring sufficient experience, and management expertise to successfully operate the project over the term of the proposed Use Agreement or HAP contract in place at the project, whichever is longer.

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[6] Refer to the Multifamily Accelerated Processing (MAP) Guide, at http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/mfh/map/maphome, for parameters on Capital Needs Assessments to determine physical needs of multifamily properties.

The Hub/PC Director should complete a review of the proposed purchaser's experience of owning and operating affordable rental housing, completing repair programs of a similar scale to that proposed by the transaction, preventing involuntary displacement of tenants, and successfully meeting debt obligations. The purpose of this review is to evaluate whether the sale transaction poses a risk to the Department, the project residents and the surrounding community. This review must include Previous Participation documentation (form HUD-2530) submitted by the proposed purchaser, and review of past and current real estate owned by the proposed purchaser.

For a troubled project, HUD will require an experienced owner/managing agent who has demonstrated the ability to successfully own and manage troubled projects. In cases where there will be significant repair and/or upgrades, the prospective owner/managing entity must be judged to have sufficient experience, capability and capacity to timely complete the rehabilitation requirements. All proposed transactions will be assessed based on items A through D, below.

A. Purchasers must provide the following information to the Hub for review:

1. An explanation of the organization and structure of the purchasing entity;

2. A description of the organization's history and experience in operating affordable rental housing;

3. An explanation of the business transaction reflected in the Source and Use of Funds Statement, including the terms of any non-FHA financing proposed for the transaction;

4. An explanation of the purchaser's relationship to the management agent and whether it expects to make changes in the management of the project, particularly within the first year;

5. The organization's success in completing or overseeing capital repairs in multifamily properties at a similar scale to those proposed in the transaction;

6. An explanation of why the purchaser believes the proposed repair program and/or deposit to the reserve for replacement account will be adequate to maintain the project in safe, decent and sanitary condition;

7. The proposed rents for any unassisted residents at the property, and how the unassisted residents will be protected from displacement; and,

8. An explanation of how it will correct any financial deficiencies reflected in the interim financial statement, including eliminating payables at closing and making sure the various escrows (property tax, insurance) and trust accounts (tenant security deposit) will be properly funded as a result of the transaction.

B. Evaluation of purchaser. The proposed purchaser must meet all of the following criteria:

   1. Has provided evidence of successful experience owning and operating affordable multifamily housing properties.

   2. Has provided evidence of successful operation of HUD or other affordable multifamily properties.

C. Evaluation of proposed management agent. The proposed management agent must meet all of the following criteria:

   1. The proposed management agent must have the appropriate staffing and leadership skills, knowledge, and experience to successfully manage the project. This includes an evaluation of the prospective managing entity's knowledge and experience addressing reasonable accommodations requests under the Fair Housing Act or section 504 of the Rehabilitation Act of 1973. The type and length of experience required will vary depending upon the degree of difficulty of managing the particular project. Management agents who lack the requisite experience will be rejected.

   2. For a troubled project, HUD may require an experienced managing agent who has demonstrated the ability to successfully manage troubled multifamily projects. In cases where there will be significant repair and/or upgrades, the prospective managing entity will be reviewed to determine that they have sufficient experience, capability and capacity to complete the rehabilitation.

   3. If the existing agent will remain in place, that agent must have a demonstrated record of success at the target project to be acceptable. The Hub/PC Director must decide whether an existing agent in a troubled project will remain, based on staff evaluations and recommendations. An incumbent agent is subject to full review by the Hub. The Hub will require the same standards of performance from an incumbent agent as it would from a new agent.

D. Evaluation of proposed financing. The Hub/PC must ensure that the following requirements are satisfied:

   1. The Hub/PC must verify that the proposed financing includes a sufficient debt service coverage ratio, and interest rates appropriate for the project and the market. Particular care must be taken to assess the risks posed by adjustable rate or balloon payment mortgages.

   2. All accounts payable must be cleared at the time of the sale. If deemed necessary by the Hub/PC, an adequate escrow or letter of credit may be required.

3. The Hub/PC should review all HUD or other mortgagee controlled escrow and reserve accounts to ensure present balances together with monthly deposits will be sufficient to pay near term billings. Frequently, a sale will lead to reassessments that result in property tax adjustments. The Hub may decide to require adjusted deposits to these escrows, if it has reason to believe the property will be facing substantial changes in its property tax or property insurance bills. The Hub should also review reserve and escrow accounts to ensure that present balances and monthly deposits will be sufficient to cover the costs of replacements and maintenance over the term of the Use Agreement or HAP contract, whichever is longer.

4. Hubs should review the sources and uses statement provided by the applicant as a possible source of additional funds.

V. Multifamily Hub/Program Center Processing of Nonprofit Sales Transactions

A. Responsibilities of Hub/PC Director.

The Hub/PC Director will review the proposed transaction to ensure compliance with this Notice and to oversee the execution of the required HAP contract (if applicable) and Use Agreement.

Many of the requirements in this Notice mirror the HUD requirements for approval of prepayment, Transfer of Physical Assets (TPA), IRP Decoupling and/or Assignment of the HAP contract. The seller does not need to submit a distinct package for review to meet the terms of this Notice, if the Hub/PC Director believes the exhibits submitted for a prepayment, TPA, IRP Decoupling and/or Assignment of the HAP contract are sufficient.

The Hub/PC will continue to forward Section 250 prepayment approval requests, IRP Decoupling Applications and Transfer of Physical Assets packages to HUD Headquarters for review and approval, as applicable.

The Project Manager must assure that information about the prepayment is entered into iREMS to track and monitor Use Agreements. Guidance on tracking and monitoring of Use Agreements will be issued separately. The iREMS Servicing screen allows for the following Use Agreement information to be recorded and tracked:

1. Ability to record reasons for restrictions of Use Agreement;

2. Use Agreement effective date and expiration date;

3. Reason for restriction;

4. Date of recordation;

5. Number of units that must be maintained by property (Use Restricted);

6. Ability to enter date Owner submitted compliance certification; and

7. Ability to record comments on Owners compliance with Use Agreement requirements.

B. Responsibilities of Seller.

The seller should submit the applicable prepayment, TPA or IRP Decoupling application to HUD under the outstanding guidance.

If the purchaser is a Nonprofit, the seller should submit the request for a Section 8 Renewal contract with a selection of the contract renewal option and with the term of the contract required by this Notice and the seller will execute an Assignment of HAP contract to the purchaser at the time of closing.

If the purchaser is a profit-motivated organization exercising the option for a Mark-up-to-Market rent increase, the purchaser will execute the Renewal Contract at the time of closing. Upon approval of the prepayment of the mortgage subject to Section 250, the seller shall execute and record the Section 250 Use Agreement prior to the closing of the sale. The seller will receive the proceeds from the sale following the closing of the transaction and Use Agreement Recordation.

C. Responsibilities of the Proposed Purchaser.

The purchaser will submit a narrative including all information required in Section IV, Paragraph 6 of this Notice, for review by the Hub office and approval by the Hub/PC Director.

If the purchaser is a Nonprofit organization, the purchaser will take an assignment of the HAP contract from the selling Owner. If the purchaser is a profit-motivated entity, the purchaser must execute the renewal HAP contract at the time of closing.

If you have questions, please contact your Desk Officer in Headquarters, Office of Asset Management.

/s/

Carol Galante
Acting Assistant Secretary for Housing –
Federal Housing Commissioner

Attachment 1
Attachment 2