

Elig. of 223(f) Ins. Proj. for 223(d) Oper. Loss Loan

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Subject: Elig. of 223(f) Ins. Proj. for 223(d) Oper. Loss Loan

July 17, 1992

MEMORANDUM FOR: Linda D. Cheatham, Director, Office of Insured
Multifamily Housing Development, HMI

/s/ Mel Belin

FROM: David R. Cooper, Assistant General Counsel,
Multifamily Mortgage Division, GHM

SUBJECT: Eligibility of a Section 223(f) Insured Project
for a Section 223(d) Operating Loss Loan

This memorandum has been prepared in response to your request for a legal opinion on whether a project with a mortgage insured under Section 207 pursuant to Section 223(f) of the National Housing Act (Act) would be eligible to apply for and receive an operating loss loan insured pursuant to Section 223(d). Members of your staff have informed this Division that they are not aware of a single Section 223(f) project whose application has been approved to receive an operating loss loan.

Section 223(d) and 223(f) Program Background

Section 612(h)(3) of the Housing Act of 1961, Pub. L. No. 87-70 amended Section 223 of the National Housing Act by adding subsection (d) permitting the insurance of "operating loss loans" for losses that occurred "during the first two years following the date of completion of the project, as determined by the commissioner. . . ." The original intent of Congress in creating the operating loss loan program is illustrated by the Committee Summary of the Act contained in S. Rep. No. 281, 87th Cong., 1st Sess., reprinted in 1961 U.S. Code Cong. & Admin. News 1923, 1969:

Section 507 would give FHA authority to assist mortgagors of multifamily housing projects (including those insured under FHA secs. 213, 220, 221, 222, 231, 232, or 233) in cases where occupancy of the projects is delayed with the result that the income from the projects is not sufficient to pay project expenses and payments on the mortgages.

Testifying before Congress, Robert C. Weaver, Administrator of the Housing and Home Finance Agency stated that the purpose of an operating loss loan is to assist insured projects "in cases where occupancy of the projects is delayed with the result that the income from the project is not sufficient to pay project expenses

and payments on the mortgage." Hearings Before a Subcomm. of the House Comm. on Banking and Currency on Various Bills to amend the Federal Housing Laws, 87th Cong., 1st Sess. (1961) at page 345; identical statement in S. Rep. No. 287, 87th Cong., 1st Sess. (1961) at page 47.

Section 223(d) was substantially amended by Section 427 of the Housing and Community Development Act of 1987. The original operating loss loan program was retained but was split into two subsections, (d)(1) and (2). A new operating loss loan program was created and is contained in subsection (d)(3). Under the original program a mortgagor of a multifamily project with a mortgage insured by HUD can apply for an operating loss loan provided that the loss "occurred during the first 24 months after the date of completion of the project, as determined by the Secretary; and . . . in an amount not exceeding the operating loss." The new operating loss loan program found in section 223(d)(3) permits the insurance of a loan:

In an amount not exceeding 80 percent of the unreimbursed cash contributions made . . . by the project owner for the use of the project, during any period of consecutive months (not exceeding 24 months) in the first 10 years after the date of completion of the project, as determined by the Secretary.

Neither the legislative history accompanying the original passage of section 223(d) in 1961, nor the legislative history accompanying the substantial amendment of section 223(d) in 1987 directly address the issue to be answered by this memorandum, i.e., whether a project with a mortgage insured pursuant to Section 223(f) is eligible for an operating loss loan.

The Housing and Community Development Act of 1974, Pub. L. No. 93-383 amended Section 223 of the National Housing Act by adding subsection (f) permitting the insurance of a mortgage executed in connection with the purchase or refinancing of existing properties. The legislative history accompanying the passage of section 223(f) is meager, and it sheds no light on the question of whether Congress directly addressed the issue of a section 223(f) project's eligibility for a section 223(d) operating loss loan.

24 C.F.R. 207.32a(f)(5) provides the following eligibility requirement for properties that apply for section 223(f) mortgage insurance:

Before filing an application for mortgage insurance, the project, except one which meets the requirements of paragraph (k) of this section, must have been fully completed and at least three years must have elapsed

from the date of completion or initial occupancy, as

determined by the Commissioner, whichever is later.
(Emphasis added).

The only exception to the three year requirement is, as referred to in the above quote, with regard to paragraph (k), relating to a mortgage refinancing a project financed with State or local assistance. Section 223(f) does not contain a requirement that a multifamily project (as opposed to a nursing home) have an existing FHA-insured mortgage in order to be eligible for a mortgage insured under the section. In fact, Section 223(f) does not require that there be an existing mortgage of any kind against the multifamily project, except in the case of a project located in an older or declining neighborhood that is applying for mortgage insurance under section 223(f)(2).

Issues Issues

The language of Section 223(d) and Section 223(f) as well as the legislative history do not specifically establish whether Congress intended to permit operating loss loans for Section 223(f) projects. In order to properly answer your question concerning a Section 223(f) project's eligibility for an operating loss loan, we believe the following issues are relevant in order to help us to reach a conclusion.

(1) Does completion of a project for purposes of an operating loss loan only refer to new construction or substantial rehabilitation work, or could it refer to the lesser rehabilitation work that is done within the section 223(f) program: (A) since substantial rehabilitation qualifies for "completion of a project" then why cannot something lesser than substantial rehabilitation qualify for completion of a project? (B) since the 223(f) handbook refers to insurance upon completion does this mean that less than substantial rehabilitation which can occur in connection with the Section 223(f) program also constitutes "completion of the project?"

(2) In light of our conclusion regarding the issue above (as discussed in the "Analysis" section of this memorandum) that completion refers to new construction or substantial rehabilitation work only, would a project insured under section 223(f) be eligible for a section 223(d)(1), (d)(2) operating loss loan under the original operating loss loan program?

(3) In light of our conclusion regarding issue no. 1 (as discussed in the "Analysis" section of this memorandum) that completion refers to new construction or substantial rehabilitation work only, would a project with a section 223(f) insured mortgage be eligible for a section 223(d)(3) operating loss loan under the new operating loss loan program?

Analysis Analysis

1. The first issue requires a determination as to whether the phrase "completion of a project," as used in Section 223(d), (i.e. a project is eligible for an operating loss loan if the loss occurred within the requisite number of years following "completion of the project") only refers to new construction or the substantial rehabilitation of an existing project, and not to the lesser rehabilitation work done within the Section 223(f) program. A multifamily project's eligibility for both the section 223(d)(1), (d)(2) program and the section 223(d)(3) program is tied to "the date of completion of the project, as determined by the Secretary."

As quoted earlier in this memorandum, the Senate Committee Summary accompanying the bill creating the original operating loss loan program stated that it was the intent of Congress to cover the loss that may occur in those "cases where occupancy of the projects is delayed with the result that the income from the projects is not sufficient to pay project expenses and payments on the mortgages." It is very important to note that a newly constructed project is starting from a zero occupancy base, and it takes time to reach a level of occupancy that is sufficient to pay project expenses and service the debt. In the case of substantial rehabilitation the existing structure is partially or totally gutted, which results in the displacement of most, if not all of the project residents. The reoccupancy of the project following the completion of the substantial rehabilitation is subject to the same delays faced by a newly constructed project. By way of contrast, we have been informed by Kerry Mulholland of your staff that the lesser rehabilitation work done in connection with the Section 223(f) program should result in the displacement of no more than an insignificant number of tenants. In fact, since the section 223(f) program does not require any rehabilitation work to be done to the project in order for the project to be eligible for an insured mortgage, it is entirely possible that there may be no tenant displacement whatsoever. As we stated earlier, one of the principal concerns of Congress at the time that it created the operating loss loan program was the loss that can result from a delay in the occupancy of a new project. Therefore, it does not appear that the same Congressional concern, i.e, delay of occupancy, would be as relevant for the section 223(f) mortgage insurance program as it would for programs involving new construction or substantial rehabilitation since the Section 223(f) program does not typically involve renting up issues.

The regulations for the section 223(f) program were first published in 1975. The Final Rule with HUD's responses to public comments was published in 40 FR 43898 on September 24, 1975. No public comments were received relative to a need for providing operating loss loans for section 223(f) projects. However, there

is the following statement in the preamble that does shed some light on the Department's interpretation of the word completion:

We consider that it is the authority and intent of the section 223(f) program to provide mortgage insurance for purchase or refinancing of existing housing which has been completed and which is an economically viable rental project. (Emphasis added).

The Department is stating that the section 223(f) program is intended to provide mortgage insurance for existing, previously completed projects that are in full operation and have already attained economic viability. Unlike new construction and substantial rehabilitation cases where there could be significant delays in the renting up of the project, a project insured under section 223(f) must already be economically viable and, therefore, without a rent-up problem. Therefore, it would appear reasonable to interpret the term "completion of a project" in the Section 223(d) program to mean the completion of new construction and substantial rehabilitation, and not the completion of minor repairs incident to the closing of an existing, economically viable project under Section 223(f), which project would typically not have the rent-up problems associated with a new or substantially rehabilitated project, but rather would be already "economically viable."

It might be argued that Handbook 4565.1 "Mortgage Insurance For The Purchase Or Refinancing Of Existing Multifamily Housing Projects Section 223(f)" which provides in paragraph 6-15 that "Commitments shall be issued on an Insurance Upon Completion Basis only," somehow refutes a view that when Section 223(d) is referring to "completion of the project" it is not referring to the less than substantial rehabilitation work done under section 223(f). We do not, however, agree with such an argument. The Handbook statement is not intended to serve as a characterization of the section 223(f) program; rather it reflects the fact that the documents that are used for the commitment and closing of a section 223(f) insured mortgage are the same or very similar to those that are used in insurance upon completion cases for new construction and substantial rehabilitation cases, making understandable the utilization of similar terminology. Further, as quoted in an earlier section of this memorandum, 24 CFR 207.32a(f)(5) sets out the requirement for Section 223(f) projects that, with the exception of certain projects financed with state or local assistance, "at least three years must have elapsed from the date of completion or initial occupancy" of the project prior to the filing of an application for mortgage insurance. The "initial occupancy" of the project is treated as a co-determinant for eligibility along with the "date of completion." Though not necessarily simultaneous with each other, completion of construction and initial occupancy are definitely associated with the original construction of the

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project and not minor repairs incident to closing. Thus, the Section 223(f) program is inconsistent in its treatment of the phrase "completion of the project," referring to one thing in the Handbook and another in the regulation. We, therefore, do not believe the handbook reference to "completion of the project"

refutes our view that as used in the Section 223(d) program the term "completion of the project" refers to new construction or substantial rehabilitation only.

It is our conclusion that the time period for telling whether an Operating Loss Loan is permissible for a given project, i.e., 2 years under section 223(d)(1) and (d)(2), and 10 years under section 223(d)(3), runs from the date of completion of the new construction, or the completion of substantial rehabilitation, and cannot run from the date the less than substantial rehabilitation work done in connection with section 223(f) insurance is completed.

2. The answer to our second issue is now based upon our conclusion in issue no. 1 that the term "completion" only refers to new construction or substantial rehabilitation. Section 223(d)(2)(B) states that for a project to be eligible for a loan made under the original operating loss loan program, "the operating loss shall have occurred during the first 24 months after the date of completion of the project, as determined by the Secretary." We again refer you to 24 CFR 207.32a(f)(5), which sets out the requirement that, with the exception of certain projects financed with state or local assistance, "at least three years must have elapsed from the date of completion or initial occupancy" of the project (whichever is later) prior to the filing of an application for mortgage insurance under section 223(f). Because we have determined that the term "date of completion" refers to the date of completion of new construction or substantial rehabilitation, and section 223(d)(2)(B) limits the time period for an operating loss loan to the first 24 months following completion, and since HUD's regulations require that three years must have elapsed from the date the project was completed before that project is eligible for insurance under section 223(f), it is our conclusion that a project insured under section 223(f) is not eligible for a section 223(d)(1), (d)(2) operating loss loan.

3. Our third issue is also based upon our conclusion that the term completion refers to either the new construction or substantial rehabilitation of the project. The section 223(d)(3) operating loss loan program is intended to cover 80% of the unreimbursed cash contributions made by the project owner, and may not be greater than the operating loss for the applicable period of time. If there was no operating loss there can be no loan, even if the owner made cash contributions that were unreimbursed. However, the statute permits the loan to cover a period of time not exceeding 24 months that falls within the ten

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year period following completion of the project. There is no legislative history that ties this program to a loss suffered during the initial occupancy of the project, and therefore, even if a project was economically viable upon completion it would still be eligible for a (d)(3) loan if it suffered an appropriate loss within the ten year period following completion.

Section 223(d)(4) contains certain requirements applicable to all operating loss loans. The subsection states that any loan must: "(C) be limited to a term not exceeding the unexpired term of the original mortgage; and (D) be insured under the same section as the original mortgage." In our opinion the key term in 223(d)(4) is "original mortgage." For example, it is possible that a project with a mortgage insured under section 223(f) that was completed more than three years but fewer than eight years ago, and that was economically viable at the time the 223(f) mortgage was endorsed for insurance, might begin to suffer operating losses in the eighth and ninth years following completion. A critical issue relates to what the term "original mortgage" refers. If the term "original mortgage" refers only to the mortgage that secured the note for the loan made at the time the project was originally built or substantially rehabilitated, a section 223(f) insured mortgage (which is not permitted to be used in conjunction with new construction or substantial rehabilitation) would not be eligible for a section 223(d)(3) operating loss loan because the "original mortgage" (if it still existed) would have been paid off and replaced by the section 223(f) insured mortgage. On the other hand, if the term "original mortgage" has been interpreted by HUD to mean the "outstanding first mortgage" on the project, a section 223(f) insured mortgage would constitute an original mortgage. It is our opinion, for the reasons set forth below, that the term "original mortgage" means the "outstanding first mortgage."

As previously stated, the Section 223(d) program was created by the Housing Act of 1961. Section 223(d), in its original version, provided that when a project with an FHA insured mortgage suffered an operating loss, as defined therein, the Commissioner could:

Permit the excess of the foregoing expenses over the project income to be added to the amount of such insured mortgage, and extend the coverage of the mortgage insurance thereto, and such additional amount shall be deemed to part of the original face amount of the mortgage.

The Housing and Urban Development Act of 1968 P.L. 90-448 deleted the language from the 1961 Act and substituted:

Insure under the same section as the original mortgage a loan by the mortgagee in an amount not

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exceeding the excess of the foregoing expenses over the project income. Such loan shall (1) bear interest. . . at not to exceed the per centum per annum currently permitted for mortgages insured under the section under which it is to be insured, (2) be secured in such manner as the Secretary shall require, and (3) be limited to a term not exceeding the unexpired term of the original mortgage.

The Committee Summary of the Act contained in H. Rep. No. 1585, 90th Cong., 2nd Sess., reprinted in 1968 U.S. Code Cong. & Admin. News 2873, 2912, stated that section 223(d) was being amended:

To permit an insured project loan covering a 2-year operating loss to bear interest at the current rate in effect at the time of its insurance, instead of at the time of the original mortgage loan.

With the recent increase in interest rates, lenders have become extremely reluctant to grant a loan to cover a 2-year operating loss on a project where this additional loan is limited to the interest rate of the original loan.

The language from the 1968 amendment to section 223(d) that we quoted in the preceding paragraph was incorporated by the 1987 amendment to section 223(d), with minor modification, into section 223(d)(4). Therefore, in light of the above history evidencing Congress' use of the word "original mortgage," as relating to the outstanding first mortgage it is our conclusion that when the current statutory version of section 223(d) uses the term "original mortgage," it is referring to the "outstanding first mortgage." In the limited context of a section 223(f) project the outstanding first mortgage is the Section 223(f) mortgage. Therefore, the term "original mortgage," does not preclude a Section 223(f) project from receiving an operating loss loan under Section 223(d)(3), i.e., the new operating loss loan program.

Assuming that a Section 223(f) project meets the fundamental eligibility criterion for a Section 223(d)(3) operating loss loan, i.e., the loss occurred within ten years from "completion of the project" as that phrase has previously been discussed in this memorandum, we believe that a distinction must still be made between Section 223(f) projects in which the operating loss occurred before the Section 223(f) insurance, and projects where the loss occurred after the Section 223(f) insurance. In the former case, the project is, in our view, not eligible for an operating loss loan. That is because to qualify for Section 223(f) insurance, a determination must be made that the project is "economically viable." We do not believe Congress intended for HUD to insure a project as "economically viable," and then to

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permit an operating loss loan for losses that occurred before the Section 223(f) insurance. In the case, however, where the operating loss occurs after the Section 223(f) insurance, but within ten years from the date of completion of the project, i.e., new construction or substantial rehabilitation, it is our view that the project is eligible for an operating loss loan.

We wish to point out that neither the Section 223(d) statute nor its legislative history require the inclusion of any specific multifamily insurance program in the section 223(d)(3) operating loss program. Section 223(d)(1) provides HUD the discretion

necessary to exclude section 223(f) from eligibility for a section 223(d)(3) operating loss loan when it states that "the Secretary is authorized to insure operating loss loans of certain projects" and when it grants the Secretary the right to provide insurance in his "discretion and upon such terms and conditions as he may prescribe." This "discretion" in Section 223(d)(1) covers the Secretary's authority to insure operating loss loans under the original operating loss loan program, and the new program created by the 1987 legislation. Further, the Department is given additional latitude in restricting eligibility for the new operating loss loan program by section 223(d)(3)(D), which states that "the project shall meet all applicable underwriting and other requirements of the Secretary at the time the loan is to be made." Consequently, in our opinion, Congress has granted HUD the discretion necessary to exclude projects with section 223(f) insured mortgages from eligibility for section 223(d)(3) operating loss loans, but does not mandate their exclusion. To the extent that you do not want to provide operating loss loans for Section 223(f) projects for losses that have occurred after the Section 223(f) insurance, all you would need is a reason that is not "arbitrary and capricious," for not extending the operating loss loan program to cover such situations.

Conclusion Conclusion

It is our opinion that the phrase "completion of the project," as it is used in section 223(d), means the completion of the original construction or substantial rehabilitation of the project, and does not mean the completion of the lesser amount of rehabilitation that is associated with a section 223(f) mortgage. At the time that the original operating loss loan program was created, Congress was principally concerned about projects that experienced operating losses due to the delay in the initial occupancy of the project. In the preamble to the section 223(f) regulations the Department stated "that it is the authority and intent of the section 223(f) program to provide mortgage insurance for purchase or refinancing of existing housing which has been completed and which is an economically viable rental project." Unlike new construction or substantial rehabilitation projects which start from a zero or very low occupancy base, the lesser amount of rehabilitation work done in connection with an

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economically viable section 223(f) insured project results in either minor or no displacement of the existing tenant base. Consequently, in light of the Congressional focus on losses due to delays in initial occupancy for the section 223(d) program and the preamble statements accompanying the regulations for the section 223(f) program, it is our opinion that when section 223(d) refers to completion of the project it refers to the completion of either the original construction of the project, or the completion of its substantial rehabilitation, and not to the lesser than substantial rehabilitation work that may be done in conjunction with a Section 223(f) project.

Because we have interpreted the term "date of completion" to mean the date of completion of new construction or substantial rehabilitation, and since section 223(d)(2)(B) limits the time period for an operating loss loan to the first 24 months following completion, and in light of 24 C.F.R. 207.32a(f)(5) which requires that three years must have elapsed from the date the project was completed before that project is eligible for insurance under section 223(f), it is our conclusion that a project insured under section 223(f) is not eligible for a section 223(d)(1), (d)(2) operating loss loan.

Operating loss loans insured under either section 223(d)(1) and (2), or section 223(d)(3) must meet the additional requirements found in section 223(d)(4)(C) and (d)(4)(D) which state that an operating loss must: "(C) be limited to a term not exceeding the unexpired term of the original mortgage; and (D) be insured under the same section as the original mortgage." After reviewing the legislative history for both the original section 223(d) statute and the amendments that Congress has made thereto, it is our view that Congress intended the term "original mortgage" to mean the "outstanding first mortgage" against the project. For a Section 223(f) project, the "outstanding first mortgage" is the Section 223(f) mortgage.

In our view, a project with a section 223(f) insured mortgage is not statutorily excluded from eligibility for a section 223(d)(3) operating loss loan, unless the operating loss occurred before the Section 223(f) insurance. If the loss occurred before such insurance, we do not believe an operating loss loan is legally permissible. We base this view on the fact that a project cannot qualify for Section 223(f) insurance unless the project is deemed "economically viable." We do not believe Congress intended to permit HUD to insure a project as economically viable under section 223(f), and then to permit operating loss loans for losses that occurred before the insurance. If a project experiences an operating loss in the ten year eligibility period covered by Section 223(d)(3), and such loss occurred after the Section 223(f) insurance, it is technically eligible for an operating loss loan. Neither the Section 223(d) statute, nor its legislative history, however,

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require the inclusion of any specific multifamily insurance program in the section 223(d)(3) operating loss program. Therefore, in our opinion, Congress has granted HUD the discretion necessary to exclude such projects from being eligible for section 223(d)(3) operating loss loans. You would, of course, need to have a reason that is not arbitrary and capricious for such an exclusion.