

Section 223(f) Insured Refinancing

Legal Opinion: GHM-0099

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Subject: Section 223(f) Insured Refinancing

January 13, 1994

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

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

SUBJECT: Country Village Apartments  
Mira Loma, California  
FHA Project No. 122-38029

At your request, and in the context of a proposal to refinance a section 221(d)(4) insured mortgage with a section 223(f) insured mortgage, we have reviewed a proposed letter drafted by the attorney for Mira Loma Associates, that is intended to constitute an agreement between Mira Loma Associates, the owner/mortgagor of Country Village Apartments, and the Commissioner. The letter was submitted in connection with an effort to secure a firm commitment from HUD for the section 223(f) mortgage insurance, and it would involve Mira Loma Associate's amendment and extension of its Lease and Nonconversion Agreement with Country Village, Inc., (CVI), a California nonprofit mutual benefit corporation, until 2034, five years after the termination of the term of the section 223(f) mortgage. The proposed agreement between the mortgagor and the Commissioner made reference to the fact that the project is presently subject to a Lease and a Nonconversion Agreement with a nonprofit corporation. At our request you have also obtained, and provided for our review, copies of the existing Lease and Nonconversion Agreement. The Lease dated January 1, 1982 makes reference to the fact that Country Village has a section 221(d)(4) insured mortgage that was recorded on April 27, 1965, and is further subject to a HUD regulatory agreement recorded on the same date.

In response to a proposal by Mira Loma Associates to convert the 1,194 unit rental project into condominiums, the tenants formed CVI. On January 1, 1982, CVI entered into a Nonconversion Agreement with Mira Loma Associates that provides for monthly payments to the owner by CVI in return for the owner's agreement not to convert the rental project to condominiums for a term beginning on January 1, 1982 and ending on December 31, 2002. In conjunction with the Nonconversion Agreement, Mira Loma Associates, on the same day, leased the project to CVI for a term matching that of the Nonconversion Agreement. The lease provides, in part, that CVI will pay a "rental in an amount equal

to all sums due and owing under the HUD [section 221(d)(4)] mortgage and HUD Agreement, including principal and interest in the HUD Mortgage, mortgage insurance, tax impounds, and payments to the Reserve Accounts."

On January 12, 1982 the parties entered into an Amendment to the Nonconversion Agreement and an Amendment to the Lease, amending, among other provisions, the end of the term of the two contracts to January 31, 2003. On May 15, 1992, the parties entered into a Second Amendment to the Lease and a Second Amendment to the Nonconversion Agreement in response to significant disagreements that had arisen between Mira Loma Associates and Country Village, Inc. regarding the interpretation of certain provisions in the Lease and Nonconversion Agreement and their desire to resolve their disputes and further modify both the lease and the nonconversion agreement without resorting to litigation. The total term of the Lease and the total term of the Nonconversion Agreement were again extended, this time to December 1, 2007. In addition to other amendments, the parties agreed to a change in the annual nonconversion payment adjustment calculation and an amendment to the Lease that provides a mechanism for obtaining and paying for earthquake insurance coverage on the project.

#### Review of Proposed Agreement

You have specifically requested my Division to review the document submitted by the attorney for Mira Loma Associates as part of the section 223(f) insured refinancing of Country Village Apartments and want us to advise you "whether the proposal is legally acceptable." You have further stated that you "have no objection to the concept [presumably referring to the owner/mortgagor's agreement to extend its lease and nonconversion agreement with the nonprofit corporation] as long as it does not take away any of the Commissioner's rights with respect to the property." It is our opinion that the proposed agreement between Mira Loma Associates and HUD is unacceptable, as presently written, because the owner/mortgagor is unilaterally proposing amendments to the terms of its existing Lease and Nonconversion Agreement with Country Village, Inc. Country Village, Inc. is not a signatory to the proposed document. We point out that HUD is not a party to either the project Lease or to the project Nonconversion Agreement. The Lease and the Nonconversion Agreement are contracts that have been entered into between Mira Loma Associates and Country Village, Inc. and any future amendment to their respective terms and conditions is a legal matter to be memorialized in a Third Amendment to the Lease and a Third Amendment to the Nonconversion Agreement, which may be filed of record immediately following the new section 223(f) mortgage and the new HUD Regulatory Agreement.

The present terms of both the existing Lease and the Nonconversion Agreement are based upon, and are intertwined with, the current section 221(d)(4) insured financing. By means of this proposed agreement with HUD, the mortgagor/lessor is unilaterally proposing an amendment and extension of the terms of

those contracts as a consequence of the new section 223(f) insured financing. However, an extension of the terms of the contracts is not legally required for purposes of the section 223(f) insurance, although such extension would operate for the benefit of the tenants. It is our opinion that it is in the best interest of the tenants through CVI/lessee to directly renegotiate with the owner/lessor an extension of both the Lease and the Nonconversion Agreement for the term of the new section 223(f) insured mortgage or whatever additional term beyond the maturity of the new section 223(f) that they find mutually acceptable.

In this particular case, we do not believe that it is advisable for the Department to enter into an agreement with the mortgagor, which may be misinterpreted as interfering with the existing contractual relationship between the nonprofit corporation and the mortgagor, thereby exposing HUD to a potential risk of litigation should something go wrong between the parties. The concern is that once we establish the parameters regarding the lease extension, including lease payment terms, we will be giving the owner leverage vis a vis its negotiations with CVI when it would, in our opinion, be preferable to remain at arms length. The tenant nonprofit corporation, by way of its Lease and its Nonconversion Agreement, as well as through potential extensions, appears to have found an effective means under California law to maintain Country Village Apartments for affordable housing.

#### Subordination of Existing Lease

As a consequence of our review of the existing Lease between Mira Loma Associates and Country Village, Inc., we have reached the additional conclusion that the existing Lease and its two amendments need to be subordinated of record to the new section 223(f) insured mortgage. Article XIV of the lease dated January 12, 1982 provides:

This Lease shall be subject to the HUD [section 221(d)(4)] mortgage, but shall not be subject and subordinated to any other mortgages or deeds of trust in any amount or amounts whatsoever hereafter placed on or against the Leased Premises or on or against Landlord's interest or estate therein without the written consent of Tenant. Upon the request of any mortgagee or beneficiary, Tenant agrees to execute any amendment to this Lease which does not, in the opinion

of Tenant's counsel, adversely affect Tenant's rights hereunder.

It is clear from the above Lease language that, as written, the Lease would prime a later recorded section 223(f) insured mortgage in the absence of a subordination agreement. Mira Loma Associates is the owner/mortgagor of Country Village Apartments subject to the leasehold interest in the project that is held by Country Village, Inc. The subordination agreement should be executed by Mira Loma Associates and Country Village, Inc. before

or contemporaneously with HUD's section 223(f) mortgage and recorded immediately following the recordation of the new section 223(f) insured mortgage and the new HUD regulatory agreement for the project.

As set out earlier in this memorandum, you stated in your incoming memorandum that you have no objection to the concept of the proposed transaction "as long as it does not take away any of the Commissioner's rights with respect to the property." In light of your comment, it is our recommendation that the Nonconversion Agreement and its two amendments also should be subordinated of record to the new section 223(f) insured mortgage in the same manner as the lease. Otherwise, in the event of a default and HUD acquisition of the property, the value to HUD of this security will be impaired by the Nonconversion Agreement, which may, under California law, survive a foreclosure sale by the Department. If that should, in fact, be the case then a purchaser of the project from HUD would take title to the property subject to the preexisting Nonconversion Agreement, which may have a decidedly negative impact upon the market value of the project.

If you have any questions concerning this memorandum, please contact Edward M. Ferguson at 708-4107.