



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

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

Special Attention of

All Multifamily Housing Staff
All Office of Insured Health Care
Facilities Staff

Notice H 08-09

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Cross References

SUBJECT: Accounts Receivable ("AR") Financing

The purpose of this Notice is to provide guidance on how to address a request for HUD consent to accounts receivable (AR) financing associated with certain health care facilities with FHA-insured loans under the Section 232 program. The AR Loan that is the subject matter of this Notice is one secured by the AR of a health care facility operator that receives governmental and/or non-governmental reimbursements for services provided to patients, while the FHA-insured loan is secured by a mortgage on the real estate and related personal property.

An AR Loan usually takes the form of a working capital loan secured by Medicare, Medicaid, long-term care insurance and private pay accounts receivable, and is provided by a qualified bank or other financial institution (AR Lender) to the Parent Corporate Entity of an Operator, an Owner/Operator, or an Operator/Lessee of one or more health care facilities.

Background

The senior healthcare industry, which includes health care facilities, has been undergoing consolidation due to the effect of economies of scale through corporate ownership, and the resulting corporate business model has proven to be an effective method of operation for health care facilities. A significant number of health care facility operating entities are now part of larger corporate structures that manage their business operations using centralized financial controls as well as risk management controls and standardized financial reporting systems.

A majority of skilled health care facility operators now use AR Loan financing mechanisms to ensure that adequate funding is available to meet ongoing cash flow needs. Typically, the operator provides patient services which are reimbursed by Medicaid and Medicare 30 to 90 days after the services are provided. The timing of these reimbursements, however, varies from state to state and can be subject to significant delays. The remaining patients either pay for their services from their own private resources (private-pay) or have private insurance coverage. Without standby AR Loan mechanisms in place, operators are at risk of experiencing short term cash flow liquidity

shortfalls.

With AR financing, operators subject to short-term liquidity shortfalls have a financial mechanism that can provide funding to finance ongoing operations until reimbursement funds are received. In addition, the use of an AR Lender supplements HUD oversight with an outside monitoring capability of the financial operations of an operator, resulting in additional oversight and proactive intervention with the operator if unusual or troubling financial trends appear.

Industry leaders in healthcare AR lending have developed sophisticated day-to-day monitoring systems that track the financial activities of their borrowers. These systems provide comprehensive daily and weekly financial reports designed to immediately identify unusual financial patterns adversely impacting the financial condition of the operator. Most AR Lenders have immediate response systems in place to identify, correct, and/or manage financial problems as they begin to develop.

Applicable Programs

HUD will evaluate AR Loan requests utilizing the guidance provided below for the following programs:

1. Section 232 for new construction or substantial rehabilitation,
2. Section 232 pursuant to Section 223(f)¹ for purchase or refinance,
3. Section 232 pursuant to Section 223(a) (7) for refinancing, and
4. Section 241 for supplemental loans
5. Section 223 (d) Operating Loss Loans

For existing health care facilities with FHA-insured financing under these programs, Owners/Mortgagors and Operators/Lessees are subject to their existing Leases, Regulatory Agreements, and all prior HUD approvals. HUD will evaluate a request for its consent to an AR Loan from an operator of a health care facility with an existing FHA-insured mortgage following the guidance set forth in this Notice. In addition, the guidance in this Notice may be used when processing a transfer of physical assets (TPA) that involves AR financing.

Document Review and Programmatic Considerations

HUD has consented to, and may continue to consent to, AR financing for existing and future facilities approved by FHA for mortgage insurance under the Section 232 program. The primary consideration in reviewing a request for consent to AR financing is the effect of the AR financing on the financial viability of the project. A well-structured AR financing agreement will support the financial viability of a project by assuring a steady cash flow at a cost and with provisions that facilitate, rather than jeopardize, the ability of the project to meet its financial obligations. Prior to any request for HUD consent to an AR Loan, HUD suggests that the Owner, Operator, AR Lender, and FHA Mortgagee meet with the Office of Insured Health Care

¹ Negative working capital (accounts payable exceeding accounts receivable) may not be included as existing indebtedness in proposed section 232 refinance transactions.

Facilities (OIHCF) and HUD legal counsel to discuss the request.

HUD will accept for review an AR Loan based on a percentage that is consistent with prudent business practice, of state, local or federal governmental third party AR that are aged for a period that also is consistent with prudent business practice for such loans. Generally, the percentage should not exceed 85%, and the AR should not be aged greater than 120 days. A higher percentage may be accepted by HUD only if it is determined to be financially feasible for the project. Aging of AR greater than 120 days may be accepted by HUD if there are extenuating circumstances that cause an excessive delay in a state's Medicaid or any other governmental reimbursement. The Department recognizes the fact that the AR Lender may secure its loan with government and non-government AR.

Given HUD's experience with AR Loans to date, the following provides a list of the types of agreements, financial reports, or other documents that contain the kind of information that HUD has found to be important when considering a request for HUD consent to an AR Loan.

1. A narrative and financial analysis, which addresses:

- Terms and conditions of the AR Loan
- Proposed security for the AR Loan
- All fees associated with the AR Loan
- Interest rate on the proposed AR Loan

A detailed financial analysis that is sufficient to demonstrate whether or not the project can support a Debt Service Coverage Ratio (DSCR) acceptable to HUD. (DSCR is defined by HUD as net operating income divided by total debt service. Net Operating Income for new mortgage insurance applications continues to be determined in accordance with the MAP Guide, Chapter 8, and for existing insured projects in accordance with HUD Handbook 4370.2, REV-1, Chapter 3, paragraph 3-4.B).

2. An AR Loan Agreement between the Operator and the AR Lender that establishes the terms/conditions and fees associated with the AR loan, and related AR loan documents, as may be used in a transaction, such as those described under the AR Loan Documents section of this Housing Notice.
3. A narrative that describes the legal structure of the Mortgagor entity and the Operating entity and discloses all tiers of ownership. If the Mortgagor or Operator has multiple tiers of ownership, the narrative includes a diagram or chart identifying all parties and clarifying their relationship to one another. In addition, helpful to HUD's consideration is a narrative that describes the collection and flow of funds from the Operator's receipt of AR to the AR Lender and the Operator's uses of the AR loan proceeds.
4. Conflicts of interest. If the parties to the AR loan have closely related interests, they may seek to establish an AR loan arrangement that benefits them at the expense of the financial viability of the project. Therefore, it is important that any current or potential

conflicts of interest among the parties to the AR loan request and the financial viability of the project be identified, including, but not limited to, the following parties:

- All principals of the owner/mortgagor
- All principals of the operator/lessee
- FHA Mortgagee
- All parties to the AR Loan Financing
- Depository Banks
- General Contractor, if applicable
- Management Agent, if applicable
- Consultants, if applicable

5. A Deposit Control Agreement (DCA-Governmental Receivables), sometimes referred to as a Lockbox Agreement. This agreement outlines the instructions to the depository bank regarding its receipt of funds from governmental reimbursements and disbursement of funds to the AR Lender. The parties to the Agreement include the Operator, Depository Bank, AR Lender and may include the FHA Mortgagee. Governmental Receivables include AR from Medicaid, Medicare, or any other federal/state/local governmental entity that reimburses a health care facility for patient services. Ideally, both the AR Lender and the FHA Mortgagee will be parties to the document, which expressly states their respective first and second lien security interests in the AR. Some banks, however, will not allow the holder of a second lien interest in the deposit accounts to be a party to the DCA. In that situation, the AR Loan Agreement and the Rider to Lessee Regulatory Agreement should be amended to require the Operator to enter into a DCA-Governmental Receivables with the FHA Mortgagee once the AR Loan is paid in full and terminated.

6. Deposit Control Agreement (DCA-Non-Governmental Receivables), also referred to as a Blocked Account Agreement. This agreement outlines the instructions to the depository bank upon receipt of private pay and private insurance funds and their disbursement to the AR Lender. The parties to the document include the Operator, AR Lender, FHA Mortgagee and Depository Bank.

NOTE: Deposit Control Agreements vary considerably from transaction to transaction; therefore, a sample Deposit Control Agreement is not attached. For Deposit Control Agreements for Governmental and Non-Governmental Receivables that have been used in previous transactions, HUD attorneys may refer to OGC's Discussion Group in SharePoint.

In addition to looking for documents such as those listed above, HUD consent to a typical AR Loan also is based on evidence that important safeguards and conditions are stated and agreed upon by the parties. The particular terms that should be included depend on an evaluation of the proposed transaction as a whole, but the following section describes some important safeguards and conditions that should be considered and indicates where they appear in the sample documents.

1. Whether funds advanced under the AR Loan are used as provided in the Rider to Intercreditor Agreement.
2. Whether cross collateralization of AR is permitted only for those health care facilities subject to FHA Mortgages, which are identified in the request for HUD's consent to the AR Loan. This provision also appears in the Rider to the Intercreditor Agreement.
3. For new applications for FHA Mortgage Insurance, whether the Mortgagor/Lessor and the Operator/Lessee have executed the HUD Regulatory Agreements and Rider to the Lessee Regulatory Agreement. For existing FHA-insured mortgages when HUD consent to AR financing is requested, whether the Operator has executed a Rider to the existing HUD Regulatory Agreement to require professional liability insurance, quarterly and annual financial reports certified by an officer of the Operator/Lessee, and a copy of annual Medicare/Medicaid Cost Reports, if requested. In addition, the Rider to the existing HUD Regulatory Agreement indicates that it is permissible for the Lessee to pledge its AR to an AR Lender in such manner as permitted by the Commissioner.
4. Whether the FHA Mortgagee and AR Lender have entered into an Intercreditor Agreement with a Rider that contains terms and conditions acceptable to HUD, and allows the AR Lender a first priority interest in the AR of the Operator, and provides that the FHA Mortgagee has a second lien position in the AR until the AR Loan is repaid, at which time the FHA Mortgagee will then obtain a first priority security interest in the AR.
5. Whether the AR Lender has sufficient experience (generally, at least three years) in providing AR financing and the necessary experience and financial controls in place to monitor the financial operations of the operator.
6. For existing FHA-insured mortgages, whether the mortgagor and operator are in compliance with all business agreements with the Department (i.e., not in default on those business agreements, current on financial statement submissions, passing scores on physical inspections, etc.).

Accounts Receivable Loan Documents

To assist HUD employees, included with this Notice are sample documents that are intended to familiarize HUD staff in the type of documents they may be reviewing when HUD consent to AR financing is requested. The documents are presented only as samples, but they do contain the types of information discussed in this Notice.

1. An "Accounts Receivable Cash Flow of Funds" diagram. (Attachment A).
2. An Intercreditor Agreement that expresses the priority of the collateral for the AR and FHA lenders, their respective rights to that collateral, and the remedies to one or both if the AR Loan or FHA Mortgage were to go into default. Equipment and inventory of the Operator, to the extent such equipment is required for the Operator's licensing and

certification, is included as part of the FHA Mortgagee's mortgage security. (Attachment B).

3. Rider to Intercreditor Agreement outlines and controls the use of the AR loan proceeds, and provides for cross-collateralization of facilities with FHA-insured financing. (Attachment C).
4. Rider to the Lessee Regulatory Agreement outlines provisions for professional liability insurance, AR financing, and financial reports. (Attachment D).
5. Subordination, Non-Disturbance and Attornment Agreement (SNDA) subordinates the Operator's Lease to the FHA-insured mortgage, and provides for non-disturbance of the Operator's Lease under certain conditions. This document provides protection to the Operator/Lessee only if it is performing under the Lease despite a default on the mortgage by the Mortgagor. A SNDA may not be appropriate if the Mortgagor and Operator are related entities, but a Subordination Agreement may be appropriate. (Attachments E & F).
6. A Lessee Legal Opinion, provided by operator/lessee's counsel, is often used to demonstrate, among other things, that the lessee has the power and authority to execute the listed transaction documents, that the transaction documents have been duly executed by and constitute legally binding obligations of the lessee, and that the mortgagee's, HUD's, and AR lender's respective security interests in the AR have attached and have been or will be perfected in accordance with the Uniform Commercial Code of any applicable state. (Attachment G).

If you have any questions concerning this Notice, please contact the Office of Insured Health Care Facilities at 202-708-0599.

Sincerely,

Brian D. Montgomery
Assistant Secretary for Housing -
Federal Housing Commissioner

Attachments: Zip File

Attachment A – Accounts Receivable Cash Flow of Funds

Attachment B – Intercreditor Agreement

Attachment C – Rider to Intercreditor Agreement

Attachment D – Rider to Lessee Regulatory Agreement (HUD 92466-NHL)

Attachment E – Subordination, Non-Disturbance and Attornment Agreement

Attachment F – Subordination Agreement

Attachment G – Lessee Legal Opinion