Secondary Financing Involving State Agencies

Legal Opinion: GHM-0037

Index: 3.365
Subject: Secondary Financing Involving State Agencies

March 16, 1992

MEMORANDUM FOR: Donald A. Kaplan, Director, Office of Insured Multifamily Housing Management, HMI

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

SUBJECT: Secondary Financing Involving State Agencies

This is in response to your request that we provide you with an opinion concerning a secondary financing issue referred to your office by Mary Ann E. G. Wilson, Manager of the Richmond Office. The question posed by Ms. Wilson is whether or not HUD could permit any debt service loans created by the Virginia Housing Partnership Fund for energy conservation and rehabilitation on FHA-insured projects to be repaid from the project's operating income rather than the project's surplus cash account. For the reasons set forth below, it is our opinion that second loans given in favor of a Federal, State or local instrumentality thereof can be repaid from the project's operating account provided the mortgagee of the HUD-insured first mortgage consents to such an arrangement.

FACTS

The Commonwealth of Virginia has created the Virginia Housing Partnership Fund (the Fund), which is being administered through the State Department of Housing and Community Development (HCD). HCD is currently considering a number of requests for funding of projects that already have FHA-insured loans. The funds may be given in the form of grants and loans to be utilized only for project energy conservation and rehabilitation. HCD has recently become aware of the provision in 24 CFR Section 221.520(b) which limits repayment of public agency secondary financing to surplus cash or residual receipts. HCD is unwilling to provide money from the Fund without enforcement remedies in the event of non-payment or other non-performance. HCD has asked for an opinion as to whether or not HUD would permit any debt service loans created by the Fund to be paid from a project's operating income rather than from any available surplus cash.

Ms. Wilson notes that the repayment terms for the loans are very advantageous to the projects involved: interest rates on the project mortgages would range from 2 percent to 8 percent; the amortization periods would be 15 years (possibly 30 years); and there would be substantial forgiveness provisions for the grant amounts. Ms. Wilson further notes that these loan terms surpass anything available to the project owners in the private market.

ANALYSIS

Section 221.520(b) provides as follows:

> The covenant required under paragraph (a) of this section shall not apply where a lien inferior to the lien of the insured mortgage is given in favor of a Federal, State or local governmental agency or instrumentality under such circumstances as may be approved by the Commissioner, provided the source of funds for repayment of the inferior lien is limited to surplus cash or residual receipts.

Subsection (a) of Section 221.520 provides that:

> The mortgage shall contain a covenant against the creation by the mortgagor of liens against the property superior or inferior to the lien of the mortgage except for such inferior liens as may be required in connection with the insurance of an operating loss loan or a supplementary loan.

This office has consistently interpreted Section 221.520(a) and similar regulatory provisions found in other multifamily mortgage insurance programs as only requiring that all HUD-insured mortgages contain a covenant against the creation by the mortgagor of liens inferior or superior to the HUD-insured mortgage referred to in the subsection. It has been this office's position that the aforementioned requirement does not preclude the mortgagee and mortgagor, as parties to a HUD-insured mortgage from agreeing to the creation of liens inferior to the lien of the HUD mortgage. If such an inferior lien is approved by the Department as required by the Regulatory Agreement, repayment is typically limited to surplus cash or residual receipts; however, the Department has on occasion permitted repayment of such inferior liens to be from the project's operating income, (i.e., income that goes into the project operating account, as opposed to surplus cash or residual receipts). In 1985 this Office approved secondary financing documents submitted by the Maryland Community Development Agency (CDA) under which the CDA would give inferior loans on HUD-insured projects and such inferior loans would be payable out of the project's operating income. In all inferior liens created under subsection (a), this office has opined that the mortgagee

must consent regardless of the form of repayment.

Based upon subparagraph (a), a mortgage on a HUD-insured project must contain a covenant which precludes the mortgagor from creating a lien inferior or superior to the HUD mortgage. However, such covenant, pursuant to the language set forth in Section 221.520(b), does not apply to inferior liens given by the mortgagor in favor of a Federal, State or local agency provided repayment of such second loan is limited to surplus cash or residual receipts. The preamble to the rule implementing subsection (b) (and similar sections in other multifamily regulations) does not give any guidance on what the Department's intent was in implementing these regulatory provisions. It is our view that subsection (b) can be interpreted as meaning that if a mortgagor of a HUD-insured project obtains a second lien which is given in favor of a Federal, State or local agency and repayment of such loan is limited to surplus cash or residual receipts, the mortgagor does not have to obtain the mortgagee's consent prior to obtaining such loan. Mortgagee consent is not required in cases involving governmental entities because the mortgage covenant precluding inferior liens has, by regulation, been made inapplicable to this type of inferior lien.1 Loans given by project owners in favor of Federal, State or local agencies are given in order to obtain financing to rehabilitate the project. It appears to have been the Department's intention in including subsection (b) in Section 221.520 and similar regulatory sections, to make it easier for project owners to obtain this type of secondary financing without mortgagee involvement as long as the mortgagee's security was not affected and repayment of such loan would not put a strain on the project income and possibly cause the mortgagor to default on the HUD-insured first mortgage. Even though mortgagee consent to an inferior loan would not be required under Section 221.520(b), HUD's prior consent would be necessary pursuant to Paragraph 6(a) of the Regulatory Agreement.

In the instant case, given that the first mortgagee's consent is being obtained, we consider that the case falls within 221.520(a) rather than 221.520(b). To hold otherwise would lead to an unfair result. If Federal, State or local agency second lenders would only be permitted to have their second loans paid from surplus cash or residual receipts, private second lenders

1 This opinion overrules the portion of a July 22, 1986 opinion issued by this office which held that in a second lien transaction given in favor of a Federal, State or local governmental agency pursuant to Section 221.520(b), " t he mortgagee must renounce its right in writing to declare a default and elect to receive insurance benefits upon execution, delivery and recordation of the second mortgage as a precondition to approval by the Secretary."

would be allowed to receive more advantageous repayment terms on their loans under subsection (a) (since loans under that subsection could, in some cases with HUD and mortgagee consent, be repaid out of project income). We are not aware of any justification for the Department treating a private second lender differently than a Federal, State or local agency second lender. Therefore, if a private lender is permitted to give a second loan which is payable out of project income, assuredly a Federal, State or local agency second lender can give a second loan with the same payment terms. It is our view that subsection (b) was not intended to cover the only situation where secondary financing could be given in favor of a Federal, State or local agency: it was only intended to permit a certain type of secondary financing on an insured project to be available to a mortgagor without mortgagee consent.

Since the secondary financing proposed in this case is to be given in favor of a state agency and the first mortgagee has given its consent, this type of secondary financing should be treated in the same manner as inferior loans permitted pursuant to Section 221.520(a) for private lenders. Therefore, under these circumstances the second loan may come from the project's operating account. In accordance with the above interpretation of Section 221.520(a), this type of secondary financing is permissible provided the prior written consent of HUD is obtained as required by the terms of the Regulatory Agreement.

If you have any questions concerning this opinion, please contact Millicent Potts at 708-4167.