



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

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

Special Attention of

NOTICE 2010-26

All Multifamily Hub Directors

Issued: **December 20, 2010**

All Multifamily Program Center Directors
All Multifamily Operations Officers

Expires: **December 31, 2011**

All Multifamily Directors of Project Management
All Multifamily Field Counsel
All Contract Administrators
Multifamily Property Owners and Managers

Cross References:

Notice H 2004-21
Notice H 2002-16
Notice H 2006-08

Subject: Subordination of Section 202 Direct Loans

I. Purpose

This Notice establishes policy and procedures for the review of requests to subordinate Section 202 direct loans **ONLY** in cases where refinancing these loans under Notice H 04-21 (Post-1974 Section 202 Projects) is not feasible. Subordination of a Section 202 direct loan may, under certain circumstances, provide benefits to both the Department and its industry partners in the preservation of low and moderate-income elderly housing.

The subordination of a Section 202 direct loan is a tool that may prove advantageous to Section 202 owners and developers using Low Income Housing Tax Credits (LIHTC) to do substantial rehabilitation. Also, the Department benefits from long-term use agreements and an upgraded physical plan for the tenants.

Hub/Program Center (PC) staffs are responsible for reviewing requests to subordinate Section 202 direct loans. Hub/PC Directors may reject requests that do not meet standards in this Notice, or recommend approval or approval with conditions to Office of Asset Management (OAM) in Headquarters (HQ). The Hub/PC Director may not consider variances and/or waivers to the requirements of this Notice. In the case of a referral, HQ OAM will issue a final approval or disapproval of requests submitted. Hub/PC Directors may reject requests without seeking HQ's concurrence when deemed necessary.

II. Background

The Department has received several requests from owners to subordinate Section 202 direct loans. While the Department has broad statutory authority as outlined in 12 U.S.C.1701, formal policy and procedures that support the Department's additional investment via the subordination of the direct loan were not established. Owners may not refinance these 202 loans pursuant to Notice H 04-21. Nevertheless, recapitalization, to provide capital improvements, emergency repairs and upgrades will enhance HUD's ability to preserve the housing for its original use.

III. Applicants

Applicants may be:

- (1) a single-purpose private nonprofit organization that has tax exempt status under Section 501(c)(3) or Section 501(c)(4) of the Internal Revenue Code of 1986,
- (2) a nonprofit consumer cooperative, or
- (3) for purposes of developing a mixed-finance project, a for-profit limited partnership with a nonprofit entity as the sole general partner¹.

IV. Applicable/Target Projects

Owners with projects with Section 202 direct loans that have immediate needs for rehabilitation, significant or emergency repairs, and cannot be refinanced using outstanding 202 refinance procedures may propose a transaction to fund rehabilitation in which the existing 202 debt is subordinated to a new mortgage.

V. Programmatic Requirements

The following threshold criteria and submission requirements must be satisfied in order for the Department to consider an owner's request to subordinate a Section 202 direct loan. Owner submissions must show that subordination is necessary to achieve long-term project preservation. The owner must demonstrate that the Section 202 loan and new financing can be repaid within the parameters of this Notice.

1. In the event of a change in control (transfer of physical assets) of or change in the principals of the ownership entity or transfer of ownership, all parties must comply with HUD's previous participation certificate clearance procedures (a/k/a

¹ The American Homeownership and Economic Opportunity Act of 2000 (P.L. 106-569), approved December 27, 2000, revised the definition of an eligible Owner entity to include a for-profit limited partnership with a nonprofit entity as the sole general partner. In view of the statutory change, an administrative decision was made to permit such Owners to participate in the Section 202 and Section 811 programs for the purposes of developing a mixed-finance project. Section III.A. of the Section 202 and 811 NOFAs provides the eligibility requirements of the Owner entity when it is later formed by the Sponsor.

HUD 2530-clearance).

2. The owner/successor owner must meet all the statutory requirements for ownership of a Section 202 project as defined in The American Homeownership and Economic Opportunity Act of 2000.
3. The owner must demonstrate that it can repay the subordinated loan and proposed new debt.
4. The owner may propose a rent increase, provided that no equity is being taken out of the transaction. Any proposed rent increase will be reviewed for reasonableness and to ensure that resulting proceeds are being put into the project.
5. The owner must agree to execute and record a use agreement extending low-income affordability. The agreement will extend project affordability to 20 years from the date of the original mortgage maturity, or the date of full repayment of the fully amortized subordinated Section 202 loan, whichever is longer. The agreement will also provide for continued HUD oversight and monitoring. The Use Agreement must be in first security position and cover all land and buildings described in the original Section 202 loan.
6. HUD may require a lump sum payment of principal. The owner may seek HUD approval for a deferred payment schedule, which will also require modification(s) to the Regulatory Agreement. Some examples of possible modifications follows:
 - a. The loan may be recast to provide for annual payments from surplus cash toward the subordinate Section 202 Note or interest accruing thereon;
 - b. The loan may be recast to provide for interest only payments with balloon payment of principal at the negotiated maturity of the subordinated loan;
 - c. The loan may be recast to provide for monthly payments to interest only until the negotiated maturity of the subordinated loan;
 - d. The Owner may pay a lump sum at approval of the subordination and re-amortize the balance to a negotiated maturity of the subordinated loan;
 - e. The Owner may extend the current maturity date of the subordinated loan to reduce monthly payments (the length of extension may be limited by law).

VI. Review Guidance

The following threshold criteria and submission requirements must be satisfied in order for the Department to consider an owner's request for loan subordination. Owner submissions must show that loan subordination is necessary to achieve long term project preservation.

1. The owner must be in compliance with all HUD business agreements and project operations must meet HUD standards as demonstrated by:
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- a. A current 60 or above REAC PASS score or the submission of a repair plan demonstrating that all physical needs of the project will be addressed as part of the subordination transaction.
 - b. Satisfactory Management and Occupancy Review ratings for the prior three cycles or evidence that the agent receiving an unsatisfactory or below average review has been replaced, or will be replaced at the time the subordination request is made, with an agent acceptable to HUD.
 - c. Current financial reporting submissions (Annual Financial statements and/or Accounting Reports) with all compliance flags resolved for the prior three year reporting period.
 - d. Current mortgage payments over the prior three year period.
 - e. No outstanding Notices of default or violation.
 - f. Owners must be in current compliance with all applicable fair housing and civil rights requirements contained in 24 CFR 5.105(a), including the Fair Housing Act and its physical accessibility requirements, Title VI of the Civil Rights Act of 1964, and Section 504 of the Rehabilitation Act of 1973, and submit a certification of compliance with these requirements as a condition of this subordination request (see 24 CFR 891.155 for civil rights requirements for the Section 202 program). In addition, owners must not: 1) be defendants in a Fair Housing lawsuit filed by the Department of Justice alleging a pattern or practice of discrimination or denial of rights to a group of persons raising an issue of general public interest pursuant to 42 U.S.C. 3614(a); 2); be recipients of a letter of findings identifying systemic noncompliance under Title VI of the Civil Rights Act of 1964, Section 504 of the Rehabilitation Act of 1973, or Section 109 of the Housing and Community Development Act of 1974; or 3) be recipients of a charge from HUD concerning a systemic violation of the Fair Housing Act or has received a cause determination from a substantially equivalent state or local fair housing agency concerning a systemic violation of a substantially equivalent state or local fair housing law proscribing discrimination because of race, color, religion, sex, national origin, disability or familial status. Unless the lawsuit, letter of finding, charge or cause determination have been resolved to HUD's satisfaction before the subordination request, an owner's subordination request will not be considered.
 - g. Consistent with the purposes and intent of 31 U.S.C. 3720B and 28 U.S.C. 3201(e), owners will not be eligible for subordination if they possess any delinquent federal debt unless a negotiated repayment schedule is established and the repayment schedule is not delinquent, or other arrangements satisfactory to HUD are made prior to the subordination request.
2. The Hub must indicate what public benefit is provided (i.e. long-term preservation of affordable housing, financial and physical repositioning of the project, etc.)
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3. All new participants from the ownerships must have HUD's Previous Participation Clearance (HUD 2530) approval prior to an approval of a prepayment proposal under this Notice. Likewise, information regarding project principals must be current, complete, and accurate.

VII. PC and Hub Review and Recommendation

The PC and Hub must review the request to determine compliance with the requirements of this Notice. The Hub Director will submit a recommendation to HQ to approve, or to approve with conditions, the subordination request. This recommendation must be submitted to the Director of Asset Management. HQ will review the recommendation and provide a final approval or rejection of the request.

If you have questions regarding this Housing Notice, please contact your local HUD field office or contact your desk officer in the Office of Asset Management.

/s/

David H. Stevens
Assistant Secretary for Housing –
Federal Housing Commissioner