



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

ASSISTANT SECRETARY FOR HOUSING-  
FEDERAL HOUSING COMMISSIONER

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**Special Attention of:**

**Notice: H 08-04**

**All Multifamily Hub and Program Center  
Directors and Staff**

Issued: July 31, 2008

Expires: July 31, 2009

**All Project Owners and HUD-Approved  
Mortgagees**

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Cross References: H 07-05

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**SUBJECT:** Guidelines for Assumption, Subordination, or Assignment of  
Mark-to-Market (M2M) Program Loans in Transfer of  
Physical Assets (TPA) and Refinance Transactions

These Guidelines amend and restate HUD's draft Guidance dated June 2006, titled "Draft Policy for Assumption and Subordination of Mark-to-Market ("M2M") Notes in Transfer of Physical Assets ("TPA") Transactions." The Guidelines outlined in this Notice apply to any Request to assume, subordinate, and/or assign a loan evidenced by a Note (defined below), and to waive the due-on-sale or refinance clause contained therein. This Guidance also applies to Requests to assume and/or subordinate loans originated under M2M's predecessor program, the Portfolio Reengineering Demonstration Program ("Demonstration Program"). The Guidelines contained in this Notice are effective immediately for all such transactions.

The Guidance outlines a request process and review criteria for owners who wish to refinance or sell a property ("Property") that has received the benefits of a debt restructuring under M2M or the Demonstration Program, and where the loans evidenced by a Mortgage Restructuring Note ("MRN"), and/or a Contingent Repayment Note ("CRN"), or a Demo Note (all as further defined below), will be assumed and/or subordinated, or where HUD will approve debt assignment, modification or forgiveness with respect to a MRN and/or CRN to a qualifying nonprofit purchaser. These requests may be approved, rejected or modified by HUD in its sole discretion. To initiate the process, owners and purchasers would submit a request for waiver of the due-on-sale or refinance clause ("Request"). In response to the Request, OAHP will provide owners and purchasers with a checklist which must be filled out and returned to OAHP.

This Guidance does not apply to transactions wherein the MRN and/or CRN, or the Demo Note(s) will be paid-in-full at the consummation of the sale or refinance of the Property.

This Guidance only applies where HUD is the holder of the MRN, CRN, and/or Demo Note(s).

## **Defined Terms**

- 1) “Assignment” - Transfer of MRN and/or CRN to a qualified non-profit entity (see “QNP”).
- 2) “Assumption” - Transactions in which a purchaser will assume a seller’s obligations under the loans evidenced by a MRN and/or CRN, or Demo Note(s).
- 3) “CRN” – Contingent Repayment Note originated under M2M, which is secured by a mortgage that is usually in a third lien position encumbering a Property.
- 4) “CRP” – Capital Recovery Payment, an incremental repayment of an Owner’s required contribution toward M2M rehabilitation and transaction costs, with a market rate of return, subject to conditions as specified in M2M legal documents.
- 5) “Demo Note(s)” – Notes originated under the Demonstration Program, typically secured by mortgages in a second or third lien position encumbering a Property.
- 6) “MAHRA” – The Multifamily Assisted Housing Reform and Affordability Act of 1997, Title V of the Departments of Veterans Affairs, Housing and Urban Development and Independent Agencies Appropriations Act, 1998 (Pub. L. No. 105-65, 111 STAT. 1384, approved 10/27/97, as amended, which established M2M.
- 7) “Modification” – Changes made to loan documents that evidence or secure a Note to implement the Guidance decisions. All assumptions, subordination or assignments under this Guidance will include certain minimum modifications to loan documents in order to evidence the change in responsible parties and eliminate the CRP (when applicable, as defined in the M2M loan documents). As a defined term used throughout this Guidance, however, Modification means changes made to a Note or the other documents that further evidence or secure a Note beyond the minimum modifications, such as a change to the term, interest rate, payment terms, cash flow or surplus cash splits, and/or other changes consistent with this Guidance, all of which must be in a form and substance satisfactory to HUD.
- 8) “MRN” – a Mortgage Restructuring Note originated under M2M, which is secured by a mortgage that is usually in a second lien position encumbering a Property.
- 9) “Note(s)” - MRN, CRN and/or Demo Note(s).
- 10) “Proceeds” - All cash and other consideration paid to or on behalf of the seller or seller’s related entities, fees and consideration paid to the purchaser or purchaser’s related entities, including, without limitation, developer fees, deferred payments to seller/affiliates, disposition of project accounts, including operating reserves, escrows, security deposits and allocation of accounts payable, whether paid now or to be paid in the future.
- 11) "QNP" – A nonprofit entity whose Request involves the acquisition of a Property, pursuant to and as more particularly defined in OAHF’s Operating Procedures Guide, Appendix C. A QNP is the same as a Priority Purchaser under 24 CFR 401.2.

- 12) “Remaining Proceeds” - Proceeds less any payment required by HUD to compensate HUD for a reduction in value of a Note, where applicable.
- 13) “Request” - A request for HUD to allow the assumption, subordination, or assignment, forgiveness or modification, of a MRN and/or CRN, or the assumption and/or subordination of the Demo Note(s), as applicable, in connection with a TPA or refinance transaction, submitted to HUD on the prescribed form.
- 14) “Subordination” - Transactions in which the loan(s) evidenced by a Note will be subordinated to a new first mortgage loan.
- 15) “Surplus Cash” - Cash remaining at the end of each fiscal year from the operations of the Property after payment of:
  - i. All sums due or currently required to be paid under the terms of (a) a fully amortizing loan secured by a first lien encumbering the Property and (b) any subordinate FHA-insured or HUD-held mortgages with cash flow priority to the Note(s);
  - ii. All amounts required to be deposited in the reserve fund for replacements;
  - iii. All other obligations of the Property, unless funds for payment are set aside or deferment of payment has been approved by the Secretary; and
  - iv. Capital Recovery Payments, as defined and set forth in the loan documents that further evidence or secure a MRN or CRN.
- 16) “TPA” – The sale or transfer of ownership of a Property, or a transfer of an interest in the entity that owns a Property, directly or indirectly.

## **Background**

M2M is administered by HUD’s Office of Affordable Housing Preservation (OAHP). The primary objective of a M2M rent and debt restructuring is to reposition a property financially and physically to provide long-term affordable housing, with the resources available to operate the property. M2M allows HUD to restructure the debt that is FHA-insured or Secretary-held on certain properties with above market project-based Section 8 HAP contract rents. At the conclusion of a M2M rent and debt restructuring, above-market rents are reduced to comparable market rents and, generally, an owner obtains a new first mortgage loan that is supportable at those market rents.

The M2M underwriting incorporates statutory requirements designed to encourage owners to operate their restructured Property efficiently and enable owners to undertake needed repairs. The underwriting establishes reserves to maintain the Property through repair escrows and increased reserve deposits and incorporates a debt service coverage cushion. The result of a successful restructuring will be a Property that is financially and physically viable at market rents, benefiting the owner, tenants and other stakeholders. To achieve these goals, generally the existing mortgage

is refinanced with a new, first mortgage loan, sized to be serviceable by the market rents; HUD pays off the exiting FHA-insured first mortgage through a claim on behalf of the Property owner under the existing mortgage insurance contract. An owner's obligation to repay the claim is evidenced by an MRN and/or a CRN, or a Demo Note. These Notes have periodic payment obligations to HUD which are to be made solely from future Surplus Cash from the Property, with full repayment anticipated from Property refinancing at maturity or disposition of the Property. Consequently, to ensure that the claim payments are ultimately repaid, and consistent with statutory requirements, the repayment terms of the MRN, CRN and Demo Notes include a "due-on-sale or refinance" clause.

Notwithstanding the Congressional mandate for including due-on-sale or refinance provisions in the MRN, CRN, and Demo Notes, HUD maintains some discretionary enforcement flexibility, and in certain instances, it may be in HUD's best interests to waive the due-on-sale or refinance requirement contained in a Note. For example, HUD may consider waiving the due-on-sale or refinance requirement and may agree to accept a partial prepayment of a Note rather than requiring payment in full in the event of a TPA or refinancing, when:

- A Property is to be sold to acceptable ownership, and the current owner is unwilling or unable to perform its obligations to HUD.
- The income-based use restriction encumbering the Property will be significantly extended.
- Non-HUD funds are to be provided for additional rehabilitation beyond the scope of rehabilitation provided under the M2M or Demonstration Program rent and debt restructuring; or
- A TPA will resolve other ownership and/or Property related issues identified by HUD.

For HUD to elect not to enforce its rights under the due-on-sale or refinancing provision, HUD will consider whether, under the terms of the proposed transaction: 1) the Property remains financially viable, 2) the financial value of the Note(s) is maintained, 3) HUD receives a full or partial repayment of the Note(s) from transaction Proceeds in an amount determined by HUD, and/or 4) the transaction is otherwise in HUD's best interests. The goal of this Guidance is to maintain at least the same financial footing and preservation goals that were established at the time of the debt restructuring under M2M or the Demonstration Program.

Notwithstanding HUD's agreement to waive the due-on-sale or refinance clause contained in the Note(s) in connection with a particular transaction: 1) repayment terms and the due-on-sale or refinance clause in the Note(s) otherwise remain in full force and effect, 2) any remaining balance on the Note(s) remains due and payable in accordance with its respective terms, and continues to encumber the Property in a manner satisfactory to HUD, and 3) any future sale or refinance of the Property is subject to this Guidance.

## **General Guidance Requirements**

All applicants must fully disclose all Proceeds. As part of the Request, the owner and purchaser, if there is a TPA, should certify to this disclosure, and renew and update such certified disclosure through the date of closing of the TPA or refinancing.

In transactions where there are no Proceeds and there will be no Modification other than to memorialize a change in responsible parties, HUD will consider the Requests without a partial pay-down of the Note(s).

In transactions where there are Proceeds and/or a proposed Modification, OAHP will review and either approve, modify, or deny the Request. OAHP will determine the amount of the payment to HUD on the Note(s) to be required as a condition of such approval. If approval is conditioned upon a payment on the Note(s), the remaining balance due on the Note(s) remains due and payable in accordance with its terms.

OAHP will review and approve, modify or deny all QNP Requests for the assignment, Modification or forgiveness of a MRN and/or CRN. If the TPA to the QNP is approved and there will be Proceeds paid to the seller and/or QNP, the transaction will be reviewed and approved in accordance with this Guidance prior to the assignment, Modification or forgiveness of the MRN and/or CRN.

MRNS, CRNs and Demo Notes, together with the obligations contained in the documents that further evidence or secure the Note(s) can be assumed only as part of the TPA, except for a conveyance to a QNP, in which event the Property may be conveyed “subject to” the Note(s) and other loan documents. All TPAs involving a Property with an encumbrance securing a Note are subject to approval under this Guidance and remain subject to all other statutory, regulatory, and administrative requirements.

## **Evaluation and Approval Criteria**

HUD will apply the following criteria when reviewing and evaluating Requests:

There are three primary evaluation criteria. A proposed transaction should meet the requirements of the first two:

- 1) **Maintains Property Viability:** In reviewing Requests, HUD will apply underwriting standards of M2M to test the ongoing viability of the Property. In HUD’s opinion, the proposed transaction must not negatively impact the physical or financial viability of the Property for the term of the existing Use Agreement, or in cases of assignment, modification, or forgiveness of debt to a QNP, for the extended term of the Use Agreement.
- 2) **Maintains Value of the Note(s):** The proposed transaction should not result in a negative financial impact to HUD. HUD will measure the value of the Note(s) by the expected

payments that would have been received compared to the payments anticipated under the proposed transaction. HUD may condition approval upon a payment on the Note, in an amount determined by HUD, to mitigate or off-set any negative impact.

- 3) **Remaining Proceeds:** If there are Proceeds available from the proposed transaction after satisfying the criteria described in 1) and 2) above, HUD may condition approval on an amount due as a partial pay-down on the Note(s) that will reflect a portion of the value created through the debt restructuring under M2M or Demo program.

Each of these three criteria is described in greater detail below.

- 1) **Maintains Property Viability:** The criteria of preserving the physical and financial viability of the Property applies to all Assumption and Subordination transactions:
  - a. All proposed transactions must have first mortgage debt service coverage equal to or greater than 1.20x, as determined by OAHP. Any proposed first mortgage should have a fixed rate of interest and be fully amortizing.
  - b. At the time of the M2M rent and debt restructuring, the underwriting required an adequate “operating expense cushion,” normally between 7%-10% of the total expenses, to be incorporated into the underwriting (operating expense cushion is the amount of funds remaining when projected operating expenses, deposits to reserves, and debt service have been paid). The Request should demonstrate, to OAHP’s satisfaction, that the proposed operating expense levels are adequate and that the operating expense cushion requirement continues to be satisfactory in the underwriting for any proposed new financing.
  - c. The Request should demonstrate, to OAHP’s satisfaction, the adequacy of the proposed Reserve for Replacements account, security deposit accounts, operating accounts, escrows, and vacancy estimates.

NOTE: QNPs may request forgiveness, modification or assignment of the MRN and/or CRN. In these instances, any new first mortgage debt service coverage should not be less than 1.20x, and any refinancing during the term of the new Use Agreement should also maintain a minimum 1.20x debt service coverage ratio. In addition, the operating expense cushion described above should be satisfied in the underwriting for any proposed new financing. In cases where new financing is not FHA-insured or the MRN/CRN will be assigned or forgiven to a QNP, HUD no longer controls the Reserve for Replacements account. In such cases, the purchaser should provide assurances satisfactory to OAHP that the Reserve for Replacements account balance will be used for capital repairs and replacements only in accordance with the Owner's HAP contract and applicable rules and regulations.

- 2) **Maintain Value of the Note(s):** If the proposed transaction will impact the value of the Note(s), for example, if HUD is being asked to subordinate the Note(s) to a new first mortgage and the proposed underwriting shows a future reduction in Surplus Cash available

for payments on the Note(s), HUD will calculate and compare:

- a. The Net Present Value (NPV) of the Surplus Cash payment stream to the Note(s), based upon the M2M underwriting, through the maturity date of the Note(s), including an assumption of full payoff at maturity;
- b. The NPV of the Surplus Cash payment stream to the Note(s), based upon current Property performance (as reflected in the audited financial statements), through maturity of the Note(s), including an assumption of full payoff at maturity; and
- c. The NPV of the Surplus Cash payment stream to the Note(s) projected from the underwriting of the proposed transaction.

HUD will calculate NPVs using a 5.5% discount rate, based upon OMB-approved discount rates used in the M2M program to date. For Demo Notes, payment stream to those Notes will be analyzed following the methodology outlined in 2.a, b, and c, above, using the “Net Income,” “Remaining Net Cash,” or “Restricted Net Cash” payment terms specified in the Notes rather than the Surplus Cash as defined in the M2M Notes.

If the proposed transaction shows a decrease in the NPV of the cash flow stream from the Note(s) when compared to the payment stream from the M2M underwriting (or at HUD’s discretion, the NPV as currently performing), HUD may:

- a. Require a pay-down to the Note(s) equal to the difference between the original M2M NPV and proposed NPV.
- b. Determine that it is in HUD’s best interest to accept a lower amount if, for example, significant underlying assumptions of the underwriting have not been realized.
- c. Reject the transaction.

**NOTE:** This criterion is deemed satisfied if there are no Modifications to the Note(s) or to the existing first mortgage.

**NOTE:** This NPV determination criterion does not apply to transactions where HUD approves the forgiveness or assignment of debt to a QNP.

**NOTE:** Unless there is explicit contrary direction in the Request, HUD will calculate a pro-rata reduction in seller and purchaser Proceeds equal to the sum required by HUD to pay down the Note(s).

- 3) **Remaining Proceeds:** After satisfying both the Property viability and the value of the Note(s) criteria described above, OAHP will review any Remaining Proceeds in the proposed transaction.

- a. HUD's Determination of Remaining Proceeds: HUD will re-examine Proceeds, including, without limitation, cash and deferred payments to seller/affiliates, disposition of operating accounts, reserves, escrows, allocation of accounts payable and rents receivable, disposition of Security Deposits, and developer fees to the purchaser/affiliates.
- b. Remaining Proceeds to be Applied to Note(s): HUD may require, as a condition of approval, that part of the Remaining Proceeds be applied as partial repayment of the Note(s), to be determined on a case-by-case basis. Generally, however, HUD may condition its approval upon repayment of the **greater of**:
  - i. An amount equal to one-half of the Remaining Proceeds otherwise being paid to the seller/affiliate (i.e., HUD will require payment at least equal to seller Proceeds); or
  - ii. An amount equal to one-third of the Remaining Proceeds being paid to or realized by the seller/ affiliates plus the remaining Proceeds being paid to or realized by the purchaser/ affiliates.

Factors HUD will consider in its determination of condition for partial repayment on the Note(s) may include:

- An analysis of whether and how the proposed transaction furthers the affordable housing preservation mission of HUD;
- Review of the owner/seller's current legal and financial obligations under the legal documents executed as part of the M2M restructuring;
- The agreed-upon owner/HUD cash flow split from Surplus Cash, as documented in the M2M restructuring;
- The strength of the proposed transaction relative to current Property performance; and/or
- The extent to which the availability of Proceeds results from the M2M debt restructuring.

**NOTE:** Remaining Proceeds will be net of any pro-rata reduction in Proceeds required by HUD to pay-down the Note(s).

Additionally, HUD will review Requests to ensure to HUD's satisfaction that the proposed transaction continues to promote HUD's policy and property performance goals, including preservation of affordable housing and responsible utilization of Government resources.

### **Levels of Evaluation and Approval**

All Requests must be sent to the respective Multifamily Hub/Program Center, including those involving debt forgiveness, Modification or assignment to QNPs. As described below, certain



transactions will be reviewed and approved by the Multifamily Hub/Program Center, while others will be forwarded to OAHP for review and approval.

1) Multifamily Hub/Program Center Review and Approval:

- a. The Multifamily Hub/Program Center has authority to review and approve a Request where there are **no**:
  - 1. Proceeds to the seller and/or purchaser,
  - 2. Modifications to the existing first mortgage, or
  - 3. Modifications to the Note(s).
  
- b. The Multifamily Hub/Program Center has authority to review and approve a Request where the present owner seeks to refinance an existing first mortgage, and:
  - 1. There are no Proceeds to the owner
  - 2. The new first mortgage is FHA-insured;
  - 3. The debt service payment is not increased;
  - 4. The first mortgage unpaid principal balance is not increased;
  - 5. The first mortgage term is not extended; and
  - 6. There are no changes to Property ownership at any level.

Any Request not meeting the criteria in a) or b), above, will be forwarded from the Hub/Program Center to OAHP.

2) OAHP Review and Approval:

- a. OAHP has the delegated responsibility to review and approve Assumptions and Subordinations involving Proceeds and/or requested Modifications to the existing Note(s) or any first mortgage.
  
- b. All QNP transactions involving assignment, Modification or forgiveness of Note(s), without exception, will be reviewed and approved by OAHP.

**Evaluation and Approval Processing Conditions**

1) The Multifamily Hub/Program Center will apply the following conditions in reviewing and approving Requests:

- a. TPAs, in all cases, will be processed and approved by the Multifamily Hub/Program Center according to established procedures, including collection of a TPA transfer fee in accordance with 24 CFR 200.40(h). (All TPAs must be processed with a full review pursuant to Handbook 4350.1, Rev.1, including the determinative criteria, except TPAs involving transfers to QNPs with non-FHA-insured first mortgage loans, which will require Hub/Program Center approval of

the purchaser through the prior participation APPS/2530 process.)

- b. **Outstanding Note(s) Payments from Prior Fiscal Years:** Upon receipt of a Request, the Multifamily Hub/Program Center will confirm with OAHP that all payments from Surplus Cash payments due on Note(s) for all completed fiscal years have been received by HUD. The Owner will remit all outstanding Surplus Cash payments to HUD prior to approval of the Request. If there are disputed Surplus Cash payments, if not otherwise required under this Guidance, the Request will be referred to OAHP for approval. (For Demo Notes, the Owner will remit all outstanding Notes payments from prior fiscal years to HUD prior to approval of the Request, based on the “Net Income,” “Remaining Net Cash,” or “Restricted Net Cash” payment terms specified in the Notes.) **Absent this clearance, the preliminary TPA approval shall not be granted.**
- c. **Anticipated Note(s) Payments for the Partial, Current Fiscal Year:** The Multifamily Hub/Program Center will also require, as a condition of approval, to be paid at closing, an estimated partial-year Surplus Cash payment to the Note(s) for the current year, up to the proposed closing date. (For Demo Notes, an estimated partial year payment will be calculated based upon the specific payment terms of the Notes.)

2) OAHP will apply the following procedures in reviewing and approving Requests:

- a. Assumption/Subordination Loan Committee: OAHP and the Multifamily Office of Asset Management will meet as an Assumption/Subordination Loan Committee to review and approve, reject or modify all Requests with Proceeds or Modifications. The Committee will:
  - i. determine the acceptability of the proposed transaction, and any required payments on the Note(s), as described above, and
  - ii. advise the requesting Multifamily Hub/Program Center of the approval, rejection, or modification of the Request.
- b. Outstanding Note(s) Payments from Prior Fiscal Years: Upon receipt of a Request, OAHP must confirm that all payments from Surplus Cash due on the Note(s) for all completed fiscal years have been received. The Owner must remit all outstanding Surplus Cash payments to HUD prior to approval of the Request. (For Demo Notes, the Owner will remit all outstanding Notes payments from prior fiscal years to HUD prior to approval of the Request, based on the “Net Income,” “Remaining Net Cash,” or “Restricted Net Cash” payment terms specified in the Notes.) **Absent this clearance, the preliminary TPA approval shall not be granted.**
- c. Anticipated Note(s) Payments for the Partial, Current Fiscal Year: OAHP may also require, as a condition of approval, to be paid at closing, an estimated

partial-year Surplus Cash payment to the Note(s) for the current year, up to the proposed closing date. (For Demo Notes, an estimated partial year payment will be calculated based upon the specific payment terms of the Notes.)

- d. As a condition of HUD's approval to waive the due-on-sale or refinance terms and allow assumption of the Note(s), the CRP should be eliminated as an eligible project expense. (This does not apply to transactions approved by the Multifamily Hub/Program Center as described above.)

### 3) Additional Processing Requirements

- a. The owner/seller and purchaser must provide a release that authorizes HUD to release information regarding the transaction to the owner and prospective purchaser.
- b. Either the owner must complete the rehabilitation work required within the first year after the M2M rent and debt restructuring, or the purchaser should provide as part of the Request, a proposed rehabilitation plan incorporating the M2M rehabilitation items not completed.

**NOTE: HUD's objective is to complete the review and approval process within 45 days of OAHP's receipt of a complete Request.**

If you have questions regarding these Guidelines, please contact Phyllis Cozzens, by email at [Phyllis\\_F\\_Cozzens@HUD.gov](mailto:Phyllis_F_Cozzens@HUD.gov), or by phone at 202-402-8370, or contact the respective Project Manager at the Multifamily Hub/Program Center.

The information collection requirements contained in this notice have been approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3501-3520) and assigned OMB Control Number 2502-0275. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection displays a valid control number.

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Brian D. Montgomery, Assistant Secretary for  
Housing—Federal Housing Commissioner