FHA INSURED LOANS FOR LONG TERM HEALTHCARE FACILITIES: RECENT DEVELOPMENTS AS A POPULAR PRODUCT EVOLVES TO MEET GROWING NEEDS

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I. Introduction

The "Great Recession" continues, and the commercial financial markets remain difficult for many borrowers. In this environment, healthcare providers have continuing challenges as they seek financing for their facilities. The financing market can be expected to continue difficult into 2011 and perhaps beyond. For owners of long term care facilities, one bright spot in the financing world has been mortgage financing insured by the Federal Housing Administration ("FHA") under Section 232 of the National Housing Act.[2] After all, what is not to like - long terms (35-40 years), low fixed rates, no personal recourse and no required guaranties by high-income individuals. Even better, these loans are assumable by qualified purchasers. Of course, nothing in life is free, and in order to enjoy these benefits, borrowers must comply with a host of specific substantive and procedural requirements.

Within the past year,[3] the volume of Section 232 mortgage loans has grown dramatically, and new concerns have arisen, particularly from the novel "master lease" structure for portfolio loans, and further refinements to the treatment of accounts receivable financing.

The U.S. Department of Housing and Urban Development ("HUD") developed and adopted the Lean Processing program in 2008 and phased in its use during 2009. Initially, the program began under the Office of Insured Health Care Facilities ("OIHCF") and was processed

[1] The authors gratefully acknowledge the assistance of Mr. Alex Fenner and Ms. Amanda Nichols who contributed valuable research.

[2] 24 C.F.R. § 232 (2009). The National Housing Act of 1934 was adopted as part of President Roosevelt's "New Deal" in order to promote stability in the nation's housing market by making mortgage credit more available to homeowners by establishing a program of insuring mortgages made by private lenders.

[3] Andrea C. Barach & Wendy A. Chow. *Government Insured Financing Available for Healthcare Facilities—We're From the Government and We're Here to Help—Really*!, 13 QUINNIPIAC HEALTH L.J. 203 (2010).

out of the Seattle Multifamily Hub Office.[4] Since its adoption, and due to the increased volume of applications, OIHCF, now known as Office of Healthcare Programs ("OHP"), has been working to further centralize and standardize the program in order to focus more attention on the creditworthiness of the borrower and the principals of the borrower. OHP is working toward further standardization and modernization of the forms to be used, as well.[5]

At the time of adoption, the HUD Health Systems Advisor, William Lammers, predicted with great enthusiasm that it would become possible to close a Section 232 loan in just 30 days from the date the application was submitted.[6] However, due to the unexpected and unprecedented increase in application volume, despite the streamlining efforts, the processing times have remained discouragingly long, and the average time a project application remains in the queue has risen from four to five months to between eight to ten months.[7] With the current economic downturn, borrowers have been turning away from the commercial financing market and towards these insured loans in ever increasing numbers. Further increasing the volume of applications has been the trend for larger for-profit providers to finance (or refinance) large portfolios of projects in recent years.[8]

The overwhelming success of the *Lean* program, and its vastly increased volume of applications, has caused HUD to re-examine and revise some of its procedures and program rules. This article will summarize the major provisions of these Section 232 loans and examine some of the recent changes applicable to these popular programs for healthcare owners.

II. FHA Insured Loans For Long Term Healthcare Facilities – A Refresher on Section 232

A. Lenders and Loan Insurance Under Section 232

Section 232 of the National Housing Act[9] establishes the insured mortgage loan programs available to owners of long term healthcare facilities, such as nursing homes, assisted living

[4] U.S. Dep't of Housing & Urban Dev., Off. of Housing, *232/223(f) LEAN Processing Training- for Lenders* (2008).

[5] Federal Housing Administration, *HUD 2010 Annual Management Report* (November 2010), http://www.hud.gov/offices/hsg/fhafy10annualmanagementreport.pdf (hereinafter "HUD 2010 Annual Management Report).

[6] William Lammers, Health Sys. Advisor, Office of Insured Health Care Facilities, ELA March 2007 Conference on Financing American Hospitals Today, Section 242: Mortgage Insurance for Hospitals Overview (2007), http://portal.hud.gov/fha/healthcare/materials/ela.pdf (hereinafter Lammers' Presentation).

[7] U.S. Department of Housing and Urban Development, HUD LEAN 232 Program Update as of November 2, 2010, (Nov. 02, 2010), http://portal.hud.gov/hudportal/documents/huddoc?id=FHA_DOC_195.pdf.

[8] In 2001 a 75 facility portfolio was approved by HUD, but there were relatively few large portfolios until fairly recently. For example, an August 2010 closing of a 16 facility portfolio was the largest closed since 2005. Since then, the authors are aware of several other large portfolios in the processing queue. HUD Approves Largest health-Care Package for CFG, Inc. (Commercial), ALLBUSINESS NEWSLETTER at 1 (June 1, 2002).; Press Release, Walker & Dunlop, Walker & Dunlop Closes Larges HUD Healthcare Portfolio Since 2005 – Florida (August 24, 2010) on file with author.

[9] 24 C.F.R. § 232 (2009).

facilities, board and care homes and certain other forms of intermediate care facilities. It does not include acute care hospitals, as these facilities may be financed under programs authorized under Section 242 of the National Housing Act[10] (which is beyond the scope of this article.)

All of the loans under Section 232 are made by one of the 92 private lenders currently qualified as FHA lenders under the Multifamily Accelerated Processing Program.[11] After the FHA lender underwrites and closes the loan in accordance with HUD procedures, the loan is "endorsed" to HUD under the specific Section 232 program and the FHA insures the mortgage loan. If the mortgage loan goes into default, the FHA lender can assign the loan documents to HUD in return for HUD's payment of the insurance claim.[12]

In general, FHA lenders may securitize the closed loans into pools of one or more mortgage loans which are packaged and sold to investors as Government National Mortgage Association ("GNMA") Mortgage Backed Securities (or, more colloquially, "Ginnie Maes"). Under the Ginnie Mae program, upon payment of a fee to GNMA and in reliance on and addition to the FHA mortgage insurance, GNMA guaranties to the investors the timely payment of principal and interest on the securities. Because investors will be purchasing the Ginnie Maes and will want some assurance of the expected yields, the lender will provide for a period during which prepayment is prohibited (so that the investor's yield is guaranteed for a certain time period) and thereafter prepayment is permitted but may carry a premium[13]. Using GNMA multifamily mortgage backed securities allows an increased supply of mortgage credit because funds from the capital markets are channeled into the mortgage market, and since GNMA guaranties are backed by the full faith and credit guarantee of the U.S. Government,[14] the Ginnie

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[10] 24 C.F.R. § 242 (2009).

[11] HUD 2010 Annual Management Report, supra note 5, at pages 23-24. Lenders qualify as FHA lenders by applying to HUD and demonstrating ability to meet HUD underwriting requirements, including successful completion of required training programs offered by HUD.

[12] It is interesting to note that § 232 loans were expressly excluded from the mortgages eligible for Partial Payment of Claims ("PPC"). Although there is no explanation as to their exclusion, it is reasonable to assume that § 232 loans were not viewed as presenting the same risks as loans under other FHA programs. The PPC program allows HUD to pay a portion of the unpaid principal balance to the lender and recast the remaining balance into a revised, smaller loan that reflects a financially viable debt load for the property, with a new second priority mortgage in favor of HUD securing the amount of the partial insurance payment. *See*, U.S. Department of Housing and Urban Development, HUD Asset Management Handbook Chapter 14: Partial Payment of Claims (November 2010), http://www.hud.gov/offices/adm/hudclips/handbooks/hsgh/4350.1/43501c14HSGH.pdf.

[13] For example, a 35 year mortgage loan could be closed to prepayment for the first ten years, then starting in the eleventh year prepayment would be permitted with a 3% premium, in the twelfth year with a 2% premium, in the thirteenth year with a 1% premium and may be prepaid at par starting in the fourteenth year. Often the prepayment prohibition may extend for a shorter period, with higher premiums once the loan is open to prepayment. A borrower can negotiate these terms with its lender, but different prepayment terms will affect the interest rate charged by the lender.

[14] Mortgage Bankers Association, *The Future of FHA and Ginnie Mae*, (September 2010), http://www.mbaa.org/files/ResourceCenter/FHA/TheFutureofFHAandGinnieMae.pdf. *See also* Arthur Q. Frank & James M. Manzi, *GNMA Multifamily Research* (May 1, 2003); Federal Reserve Bank of San Francisco, *Ginnie Mae*

(footnote continued on following page …)

Mae securities are more attractive to investors, which in turn results in lower interest rates. As an alternative to the Ginnie Mae, the lender may obtain an FHA-insured pass-through participation certificate, which offers slightly less default protection (generally 99 percent of principal and interest at the FHA debenture rate), but this has been less popular in recent years since the GNMA fee was reduced.[15]

B. Specific Programs within Section 232

The following is a summary of the different programs available to owners of healthcare facilities under Section 232:[16]

1. Section 232: Financing for the acquisition or construction of an eligible healthcare project, or substantial rehabilitation of an eligible healthcare project. Substantial rehabilitation means either (i) the cost of repairs, replacements or improvements exceeds the greater of 15 percent of the estimated replacement cost (after completion) or (for assisted living facilities $6,500 per unit), or (ii) two or more major building components are being substantially replaced.[17]

2. Section 232/223(f): Financing to refinance an existing mortgage (conventional or FHA) on an eligible healthcare project that the borrower has owned (generally for a minimum of two years). Rehabilitation costs may be included, so long as they do not constitute "substantial rehabilitation" as in that case it would be a Section 232 loan, not a Section 232/223(f) loan.[18]

3. Section 232/223(a)(7): Refinancing of an existing mortgage that has been insured by FHA. Like the 223(f) loans, the lenders are able to use GNMA Mortgage Backed Securities.

C. Economics of the Loan Terms.

All of the Section 232 loans are fixed interest rate loans with terms ranging between 35-40 years.[19] The term may be shortened if three-quarters of the remaining useful life of the

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Project Loans Maintain Affordability (August, 2003), http://www.frbsf.org/publications/community/investments/0308/article2b.html.

[15] GNMA Multifamily Research, *supra* note 14.

[16] 24 CFR §§ 200(A), 242 (2010); U.S. DEPARTMENT OF URBAN HOUSING, PROGRAMS OF HUD, *available at* http://www.huduser.org/resources/hudprgs/ProgOfHUD06.pdf.

[17] Guide to Multifamily Accelerated Processing (MAP), CH. 3: Eligible Multifamily Mortgage Insurance Programs §§ 4(C)(1),(2) (2002), http://www.hud.gov/offices/hsg/mfh/map/mapguide/chap03.pdf (March 15, 2002) (hereinafter MAP GUIDE). A "unit" in an assisted living facility is a separate residential living unit for not more than four persons per unit or per bathroom. Nursing facilities have beds rather than units, so the cost per unit is not used for those projects.

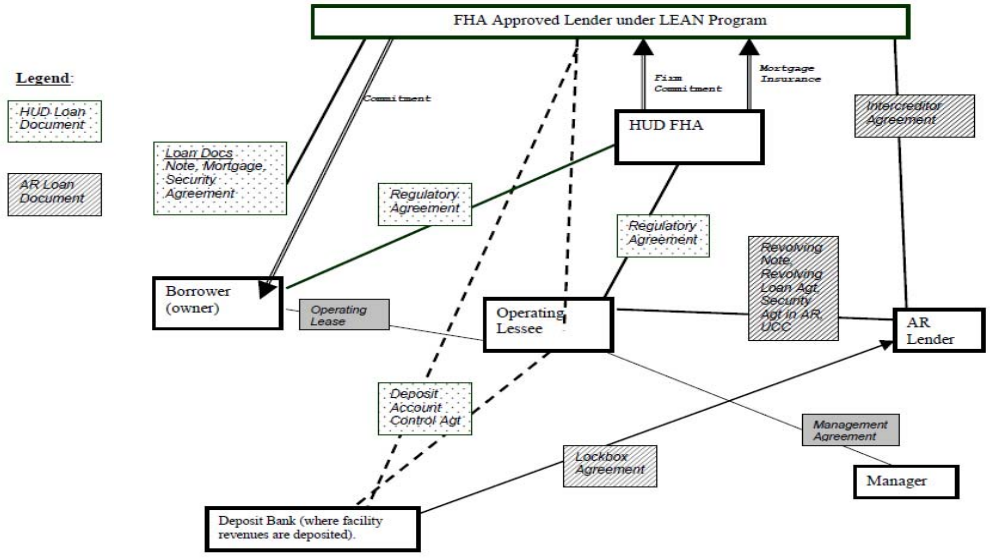
[18] *Id.*

[19] MAP GUIDE, *supra* note 17, ch.3 §§ 2 (D), (E).

facility is a shorter period.[20] In most cases, the loans may be nonrecourse to the borrower, meaning that enforcement in the event of default is limited to enforcing on the collateral, which will be a first priority mortgage on the facility and the assets associated with the facility. As discussed later in this article, the structures used for these loans can be quite complicated, since the facilities are commonly subject to an operating lease, and also often have obtained working capital financing through a pledge of accounts receivable.

Figure 1 is a chart showing a typical structure for a Section 232 loan, including accounts receivable financing, and shows that the structure can be quite complicated.

Figure 1.



D. Eligible Projects

Skilled nursing facilities, intermediate care facilities, board and care homes, and assisted living facilities are "eligible projects" under Section 232.[21] In general, these facilities serve an elderly and frail population who require some level of continuous healthcare or assistance services, but the definition is broad enough to also include other intermediate care facilities such as behavioral healthcare residential treatment facilities or psychiatric hospitals providing residential care (as opposed to acute care) so long as the services are residential and are provided under state license.[22] Eligible projects must be operated under a state license, except that in certain states that do not license assisted living facilities, the requirement for a state license may

[20] *Id.*

[21] 24 CFR § 200.3 (2010).

[22] MAP GUIDE, *supra* note 17, ch.3 § 9 (A)(2).

be waived. In the underwriting process, if a certificate of need is required in the state in which the facility is located, it must be submitted to the lender. If no certificate of need is required by the state, then the underwriter will require some sort of market study in order to establish that there is a demonstrated need for the services being provided by the facility. In addition, since many facilities include both licensed and unlicensed (independent living) units, Section 232 loans may include facilities containing unlicensed independent living so long as the independent living beds do not exceed 25 percent of the total beds in the facility.[23]

E. Eligible Borrowers

To qualify for a Section 232 loan, a borrower must be a single asset, single purpose entity.[24] It may be organized as a non-profit entity or a profit-motivated entity[25], but in either event, it may only own the single asset which is the subject matter of the Section 232 loan and its organizational documents must limit its purposes to the ownership and operation of the single asset.

1. Nonprofit vs. Profit-motivated Borrowers. Both nonprofit and profit motivated entities may apply for FHA insured financing of eligible projects. Nonprofit borrowers are entitled to higher maximum loan amounts than borrowers which are profit motivated. This reflects the underlying assumption that a nonprofit borrower is not distributing "profits" or surplus revenues from the facility to financially enrich its owners. If a loan is underwritten on a nonprofit basis, the loan documents will restrict the borrower's ability to use residual receipts remaining after payment of operating expenses and debt service for any expenses other than repairs, improvements or enhancements to the project. For some nonprofit borrowers which are part of larger organizations, this can prove problematic. The nonprofit borrower may desire to use cash on hand in one facility to assist another facility within the same nonprofit group of entities, but may not do so if the facility has been financed with a Section 232 loan as a nonprofit.

2. Leased Projects. Under Section 232, an eligible project may be leased to an operating lessee so long as both the lease and the operating lessee are approved by HUD. The operating lessee will hold the license from the state, be responsible for the day-to-day operation of the facility, and receive payments for services to the patients or residents of the facility in due course. The operating lessee may be affiliated with the mortgagor owner, or it may be an unrelated third party, although it is quite common for the owner which obtains the Section 232 financing to lease the facility to an affiliated operating lessee for a rental amount equal to the debt service plus real estate taxes as well as insurance and a small reserve. Operating leases must comply with HUD requirements, including a requirement that the operating lease may not

[23] MAP GUIDE, *supra* note 17, ch.3 § 9.

[24] MAP GUIDE, *supra* note 17, ch.3 §2(B).

[25] The term “profit-motivated” rather than “nonprofit” refers to the fact that a nonprofit facility owner may elect to be considered as a “profit-motivated” borrower rather than being underwritten as a nonprofit borrower and being subject to more restrictions on distribution.

be assigned without HUD prior approval, any change in bed authority requires HUD consent, and nonprofits may only lease to other nonprofits.[26]

Planning Point: Because operating lessees are not required to be single purpose, single asset entities, sometimes several facilities may be leased to the same operating lessee. If a facility owner owns more than one facility in the same entity and desires to refinance using Section 232 mortgage loans, one way to meet the requirements under the Section 232 program is to form new entities to hold each of the facilities and then have the new entities lease each facility to the original owner, which will now be the operating lessee for all of the facilities that it once owned outright. Depending on the state laws concerning healthcare licenses, this process may not require full re-licensure of each of the facilities and thus may be very attractive for certain borrowers.

3. Managed Projects. An eligible project may be managed by a management agent (either affiliated or independent) under a separate management agreement. All agreements must permit HUD to require the owner to terminate the management agreement (i) immediately in the event of a default under the loan documents attributable to the management agent (ii) upon 30 days written notice for failure to comply with the provisions of the management certification; or (iii) when HUD becomes mortgagee in possession after the loan has been endorsed to HUD by the lender.[27] Upon any such termination, the management agent must turn over all the project's accounts, investments and records to the owner immediately (but in any event within 30 days), and the owner must agree to make arrangements for acceptable alternative management of the project. One requirement that can be troublesome in certain instances is the requirement that there not be any "hold harmless" clause that excuses the manager from all liability for damages and injuries.[28]

4. Previous Participation Clearance – Who Must Be Disclosed? All entities and principals of entities that expect to be a borrower, operating lessee, or manager of an eligible project must be cleared in a process which verifies that each such entity (or its owners, directors or officers) have not participated in other FHA insured financing which is in default.[29] In general, the "principals" required to submit Previous Participation Certificates (also known as HUD-2530 Forms) are, in addition to the entity itself, (i) the entity's executive officers (defined as the President, Vice President, Secretary, Treasurer and any other executive officers who are directly responsible to the Board of Directors or equivalent governing board); (ii) any of its general partners (with any ownership interest) for entities that are partnerships; (iii) for entities that are limited partnerships, limited partners with 25 percent or more ownership interest; or (iv) stockholders of any entity which is a corporation or LLC members for any entity which is a limited liability company with, in either case, 10 percent or more ownership interest.[30] HUD

[26] MAP GUIDE, *supra* note 17, ch.3 § 9(G).

[27] MAP GUIDE, *supra* note 17, ch.10 § 6(A).

[28] *Id.*

[29] MAP GUIDE, *supra* note 17, ch.10 § 6.

[30] MAP GUIDE, *supra* note 17, ch.10 § 8.3(D); *See also* 24 CFR § 200.215(e)(2) (2010).

strongly encourages the submission to be made using its APPS online electronic submission format which requires obtaining enrollment credentials from HUD.

5. Regulatory Agreement. All FHA-insured loans require the borrower and any operating lessee, and sometimes the management agent, to sign a Regulatory Agreement.[31] The Regulatory Agreement provides, in general, that the project may be used only for the specific use stated, that the borrower must be a single asset entity, and that there may be no discrimination in the services provided to the residents or patients. In addition, the Regulatory Agreement provides that there must be reserves for replacement, establishes required record keeping and accounting procedures, and provides that any transfer of the project requires the prior consent of HUD. The Regulatory Agreement is executed by the project owner (or lessee, as the case may be) and HUD. Any violation or event of default under the Regulatory Agreement entitles HUD to take over the note and mortgage documents and, eventually, foreclose on the project. The Regulatory Agreement is placed of record immediately after the mortgage is recorded. The Regulatory Agreement will contain limitations on the use of residual receipts (for nonprofit borrowers) or surplus funds (for profit-motivated borrowers). Nonprofit borrowers, in particular, will be forbidden to use residual receipts for any purposes (even purposes otherwise within the charitable purpose of the nonprofit) other than specific project needs, without the prior consent of HUD.

F. Eligible Costs – No Equity Take-Out

The principal amount of any Section 232 loan will be limited to the total amount of eligible costs. This is very important, because no return of equity is permitted from the proceeds of a Section 232 loan.[32] Thus, if an owner of a facility has built up substantial equity in the facility (which may occur if there has been substantial amortization over a number of years under the facility's existing financing, or may occur as the result of increases in market value overall), the Section 232 loan will be limited in amount to the proceeds necessary to repay the prior loan and pay approved closing costs. Some lenders will make a "bridge" loan to a facility, which will have a term of one to two years. In the initial bridge loan closing, if there is sufficient value to support a larger loan the borrower can receive a return of equity, and then, when the bridge loan is refinanced with a Section 232 loan, there would not be any return of equity. The period of time between the closing of the bridge loan and its eligibility to be refinanced under Section 232 is sometimes referred to as the "seasoning period," and there are detailed requirements concerning the length of time that a loan must be "seasoned" and the nature of debt which may be refinanced with the proceeds of a Section 232 loan.[33] Affiliate debt, consisting of loans made by an affiliate of the borrower to the borrower, may not be refinanced with the proceeds of a Section 232 loan in any event. In addition, the debt that may be refinanced must be directly

[31] MAP GUIDE, *supra* note 17, ch.3 § 2(A).

[32] MAP GUIDE, *supra* note 17, ch.3 § 11(J).

[33] U.S. Department of Housing & Urban Dev., Office of Housing, *232/223(f) LEAN Processing Training for Lenders* (2008).

related to the project, such as purchase, construction, capital improvements, working capital associated with the project, and similar project-related expenses.[34]

G. Maximum Loan Amount

The statutory maximum loan amounts range from 85 percent to 95 percent of the appraised value of the project, subject to other limiting factors. Recently, the limits have been reduced to reflect negative market experience in an effort to reduce future loan defaults. Under the recent reductions, the loans will range from 75 percent to 90 percent of appraised value. Even with the revised, lower limits, it is clear that Section 232 loans remain a very attractive financing alternative for many long-term care facilities. The HUD underwriter will determine the maximum loan amount in the application process. There are three criteria which will limit the maximum amount of the loan. The test which results in the lowest amount will set the maximum loan amount.

1. Appraisal Criterion. In the underwriting, an appraisal of the facility will establish an appraised value. Based upon the type of facility and the type of borrower, skilled nursing, assisted living, for profit or not-for-profit, the maximum loan amount under this test will be between 75 percent and 90 percent of the appraised value. As seen in this table, HUD has lowered the maximum amount of the loans across the board.[35] In addition, due to negative experience in the assisted living segment of long-term care, HUD has further reduced the maximum loan amounts for assisted living facilities. These reductions are not statutory, and in certain cases it may be possible to apply for a loan in excess of these limits if there are suitable mitigating factors.

Type of Entity Loan	Skilled Nursing – Revised Guidelines	Skilled Nursing (statutory limits)	Assisted Living- Revised Guidelines	Assisted Living (statutory limits)
New construction or substantial rehab - for profit borrowers	80 percent	90 percent	75 percent	90 percent
New construction or substantial rehab – nonprofit borrowers	85 percent	95 percent	80 percent	95 percent
Refinance or acquisition - for profit borrowers	80 percent	85 percent	80 percent	85 percent
Refinance or acquisition – nonprofit borrowers	85 percent	90 percent	85 percent	90 percent

[34] *Id.*

[35] U.S. Dep't of Housing & Urban Dev., *HUD's LEAN 232 Program Office of Insured Health Care Facilities (OIHCF): Update as of February 19, 2010*.

This test is fairly easy to apply and in these authors' experience, is generally the limiting factor to the size of the loan. For example, if the borrower owns a skilled nursing facility that appraises at $10 million, and desires to refinance that facility with a Section 232 loan, if the borrower is profit motivated, the maximum loan size, under the revised sizing rules, will be 80 percent of the appraised value, or $8 million. If the borrower in question is non-profit, then the maximum loan size would be 85 percent of the appraised value, or $8.5 million.

2. Eligible Costs Criterion. As discussed above, the proceeds of a Section 232 loan may be used only to pay eligible costs.

3. Debt Service Coverage Criterion. For all projects financed under Section 232, the current guidelines require a minimum debt service coverage ratio of 1.45.[36] This represents a tightening of requirements from the statutory requirements set forth in the MAP Guide that requires debt service for Section 232 loan not to exceed 90 percent (for profit-motivated mortgagors) or 95 percent (nonprofit mortgagors) of the project's estimated net earnings attributable to realty and nonrealty (excluding proprietary earnings) and for Section 232/223(f) loans not to exceed 85 percent of the project's estimated net income for profit-motivated borrowers, or 90 percent of estimated net income for nonprofit borrowers.[37] If the project is exempt from real estate taxes, then the mortgage can exceed the debt service limit by capitalizing the savings from any such tax abatement, so long as the tax abatement runs with the land (not with the sponsor) and the additional mortgage amount supported by the abatement must be amortized over the life of the abatement.[38] Since the statutory minimum debt coverage is less strict, it is possible to submit an application with less coverage, but it would need strong mitigating factors in order for it to be approved.

H. Secondary Financing

The Section 232 insured mortgage must be secured by a first priority mortgage or deed of trust on the project. In addition, there are strict rules on the types of subordinate financing that is allowed to be secured by liens subordinate to the insured mortgage. In general, the only types of permitted secondary financing are the following:

1. Surplus Cash/Residual Receipts Note. Subordinate financing which is payable only from residual receipts (for nonprofit borrowers) or surplus cash (for profit-motivated borrowers) with a maturity date not earlier than the final maturity date of the Section 232 loan is permitted under certain circumstances. Any such note evidencing such a loan must be on form FHA-2223 ("Surplus Cash Note") or, for nonprofit borrowers, must be form FHA-1710 ("Residual Receipts Note").[39] These form notes are not negotiable and must be used without any alterations. The term of the note must not be any shorter than the FHA insured mortgage note, and repayment of principal and payment of interest is limited to surplus cash or

[36] *Id.*

[37] MAP GUIDE, *supra* note 17, ch. 8, § 8(A)(1)(c).

[38] *Id.*

[39] MAP GUIDE, *supra* note 17, ch.8 §10(A).

residual receipts (as those terms are used in the Regulatory Agreement). Unpaid interest may be accrued, but failure to pay interest may not be an event of default.[40] The amount of the note, must not exceed the amount that, when added to the FHA insured loan, does not exceed 92.5 percent of the fair market value of the project determined in the underwriting of the FHA insured loan.[41] Any pledge of cash flow may not exceed 50 percent of the surplus cash or residual receipts of the project. The note may be secured by a second priority mortgage, but only to the extent that it is closed at the same time as the FHA insured first mortgage, and the second mortgage may not be foreclosed at any time before the termination of the first mortgage, and may not include any sort of cross-default provision with the first mortgage.[42] As a practical matter, these terms are unlikely to be attractive to most commercial lenders or banks.

2. Governmental Secondary Financing. If the secondary loan is provided by a governmental agency or instrumentality the amount can be higher – up to 100 percent of the difference between the FHA insured loan and the fair market value.[43] This would include 501(c)(3) tax exempt bonds issued by nonprofit organizations as well as other forms of tax exempt financing. Even so, the other restrictions on the terms of the financing still apply. Also, no additional subordinate financing is permitted (i.e., no third mortgages).

3. FHA Insured Supplemental Financing under Section 241. If a project needs additional financing after the closing of the initial loan under Section 232, in certain circumstances supplemental FHA financing secured by a second lien mortgage is available under Section 241, which is the program under which FHA will insure supplemental loans for projects which have already been financed with FHA insured first mortgages. The reasons for a Section 241 supplemental loan vary. Sometimes they are used to finance renovation or construction costs (such as an expansion wing or major reconstruction) when such additional construction is required and the original Section 232 loan remains closed to prepayment and thus cannot be refinanced. For example, if conditions or regulatory requirements change after the original insured loan has closed, the borrower may have an urgent need for renovation in order to maintain regulatory compliance and it is rather difficult to obtain commercial secondary financing due to the requirements under the Section 232 program discussed in section 1 above. Section 241 loans are also processed under the *Lean* program, and in general have similar requirements as the Section 232 requirements.

4. Accounts Receivable Financing. In general, the FHA financing must be secured by a first priority security interest in the accounts receivable of the project. However, as discussed in more detail in part III(D) of this article, qualified accounts receivable financing may be secured by priority liens in the project accounts receivable with the FHA financing to be secured by subordinate liens in the project accounts receivable.

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[40] *See* Form FHA-2223 (2010), available at http://www.hud.gov/offices/adm/hudclips/forms/fhaforms.cfm.

[41] MAP GUIDE, *supra* note 17, ch.8 §10(B).

[42] MAP GUIDE, *supra* note 17, ch.8 §10(D.

[43] MAP GUIDE, *supra* note 17, ch.8 §10(B).

I. Sale of Project, Change of Ownership, Assumption of Loan

1. TPA Process – Sale of Project. Most conventional loans include a "due-on-sale" clause which provides that if the collateral for the loan is sold (or for any reason no longer owned by the borrower) the entire loan is immediately due and payable. This means that for conventionally financed projects, when the project is sold, the buyer must obtain its own new loan, and the proceeds of the new loan will be used to pay the purchase price and allow the seller to pay its prior loan in full. FHA insured financing may be assumed by a purchaser of the financed facility in certain cases. The procedure for approving the transfer is called "TPA" which stands for "Transfer of Physical Assets." In overview, the TPA process allows HUD to underwrite the credit of the proposed new owner of the facility, but it is substantially simpler than obtaining the original FHA insured loan in the first place. This is because the TPA process contains a lesser amount of facility underwriting, as the facility itself will have already been approved when the initial loan was made. The checklist for TPA submissions includes the same data about the new purchaser assuming the loan as would be submitted with a new application in order to establish that the purchaser is an eligible borrower, but there are fewer requirements concerning the facility itself, as the facility has already been determined to be an eligible project.[44]

2. Modified TPA - Changes Short of a Sale. The Regulatory Agreement and other loan documents executed at the initial closing of a Section 232 loan will require that any change of ownership, change of identity or change in control of the borrower, the operating lessee or the manager requires HUD's prior written consent. The process of obtaining consent to a change in control is called the modified TPA process. In most cases, the facility is not changing ownership, and thus there will be no deed or other transfer document recorded. Rather, there may be a new lessee, or a new manager. HUD processes these requests using the same checklist of submission items that is uses for a full TPA request, except that not all of the checklist items are applicable.

III. Recent Developments – A Magical Mystery Tour of Outstanding Hot Issues

A. Popularity of 223(a)(7) Refinancing Loans

The FHA Section 223(a)(7) program is a streamlined refinancing program that is limited to the refinancing of multifamily properties (including healthcare facilities, under Section 232/223(a)(7)) already subject to mortgage finance insured by FHA. This is not a new program, and is not limited to healthcare facilities. Because it allows borrowers to "reset" their interest rates to take advantage of current low rates, it has become more popular recently for owners of healthcare projects. This recent popularity may be a factor driving the increased volume of HUD insured loans that has been causing processing delays.[45] The borrower can refinance at current

[44] U.S. Department of Housing and Urban Development, *Loan Modification (Interest Only) Checklist* (2010), http://portal.hud.gov/hudportal/documents/huddoc?id=LoanModi_Checklist.doc.

[45] HUD's LEAN 232 Program Office of Healthcare Programs Update, U.S. Department of Housing and Urban Development (January 25, 2011). OHP acknowledges the "rapidly increasing volume" of these loans and establishes revised processing queues.

market rates with a loan up to the original principal amount of the prior mortgage which will be for a term co-terminus with the prior mortgage, or, based on an acceptable property inspection, for a term equal to the original term of the prior mortgage. Naturally, this is only possible if the prior loan has been in existence for long enough that it is past any period for which prepayment is forbidden.

In the past, there has been less incentive for a borrower incurring the transaction costs required to refinance under Section 223(a)(7), particularly when a refinance under Section 223(f) allows an increased loan amount to cover repairs and renovations. However, interest rates are at historic lows, and a Section 223(a)(7) loan may be offered at rates in the 4 percent-4.5 percent range. If the prior Section 232 loan was at 7 percent, for example, the debt service savings would be substantial. Also, if the prior loan has been in place for a number of years, the amortization is sufficiently large enough that the difference between the original principal amount and the current payoff amount will cover the closing and transactional costs. For these reasons, the volume of (a)(7) financings has been growing.

B. LEAN Processing Revisions and Queues

The *Lean* processing program began in 2008, and during the 2008 fiscal year (ended September 30, 2008) FHA insured mortgages (under Section 232) for 189 projects containing 21,679 beds for a total of $1.2 billion.[46] The volume has increased each year thereafter. During the 2009 fiscal year (October 1, 2008 through September 30, 2009) HUD processed 271 loan applications for healthcare facilities under Section 232 and insured mortgages for 255 projects containing 30,155 beds for a total of $2 billion.[47] During the 2010 fiscal year, the volume of applications rose 283 percent over the prior year, with the result that in fiscal year 2010, HUD processed 768 applications under Section 232 and endorsed 309 loans totaling $2.6 billion covering 35,789 beds.[48] As of October 1, 2010 there were 255 applications in the processing queue. It may be said that the program has been a victim of its own success, as increasing numbers of borrowers file applications to take advantage of the attractive loan terms.

The initial response to the volume increase was to establish two separate channels for processing.[49] Initially, the so-called "Green Lane" queue was established for Section 223(a)(7) refinancing loans so that these simpler deals could speed through the HUD process, and then the "Green Lane" was expanded to include other Section 232 loans that presented lower risks, which

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[46] Mortgage Insurance for Nursing Homes, Intermediate Care, Board & Care and Assisted-Living Facilities; Section 232 and Section 223(f), U.S. Department of Housing and Urban Development (December 30, 2009), http://www.hud.gov/offices/hsg/mfh/progdesc/nursingalcp232.cfm.

[47] U.S. Department of Housing and Urban Development, *Description of HUD Programs*, (February 17, 2011) http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/mortgage_insurance/about_the_office_of_healthcare_programs.

[48] HUD 2010 Annual Management Report, *supra* note 5 at pages 23-24.

[49] HUD *Update as of* November 2, 2010, *supra* note 7; Cambridge Provides $6.03 Million HUD Lean Mortgage Loan to Refinance Crystal Pines Nursing Home in Crystal Lake, Illinois, Cambridge Realty Capital Companies ePulse Newsletter (December 2010).

were defined to be projects which met each of the following criteria: (i) risk assessment criteria, (ii) no regulatory waivers requested, (iii) no outstanding or unresolved underwriting issues, and (iv) (beginning in August, 2010) all forms 2530 being filed electronically through APPS. The remaining applications were assigned to the regular lane (perhaps the "Red Lane" is an appropriate, though not official, moniker). The goal was to speed the simple projects through the Green Lane, and the intent was to keep processing queues, at least in the Green Lane, down to an acceptable wait time. However, during 2010, the great popularity of these loans meant that even Green Lane waiting times were increasingly long.

Beginning in November 2010, and in response to the rapidly growing waiting times in processing (from approximately four months to up to ten months in October 2010), the HUD Office of Healthcare Programs has established five separate processing queues, and a given application will be assigned to one of these five queues depending upon the kind of application. These queues are:

223(f) Regular Queue – Section 232/223(f) projects (refinancings) that do not meet Green Lane criteria

223(f) Green Lane Queue – Section 232/223(f) projects that meet Green Lane criteria and are not part of a Large or Midsize Portfolio

223(f) Portfolio Queue – Projects that are part of a Large or Midsize Portfolio which has been previously approved under HUD Notice H 01-03, as discussed below

Other Program Queue – Projects under Section 232 New Construction or Substantial Rehabilitation, Section 241(a) Supplemental Loans and Section 232 Blended Rate applications. These projects are not as common and can be more difficult to underwrite; creating a separate queue for them was intended to speed the other queues.

223(a)(7) Queue – Projects that were financed under Section 232 in the past, and are now being refinanced with no new proceeds or increased loan amount. As of January 2011, the Section 223(a)(7) queue has been divided between an (a)(7) "Green Lane" for all (a)(7) loan applications that do not propose any extension of the loan term, do not include accounts receivable financing, and do not involve any change of entity, and with the remaining (a)(7) loan applications to remain in the "standard" (a)(7) queue.[50]

Based on the analysis performed by the OHP in October 2010, OHP believes that the processing queues should level off at an eight to nine month level for most queues.[51] In order to prevent large portfolios from creating "bottlenecks", OHP has also changed the rules to require all members of the portfolio to have complete applications before being assigned a place in the

[50] U.S. Dep't of Housing & Urban Dev., *HUD's LEAN 232 Program Office of Insured Health Care Facilities (OIHCF): Update as* .January 25, 2011.

[51] U.S. Dep't of Housing & Urban Dev., *HUD's LEAN 232 Program Office of Insured Health Care Facilities (OIHCF): Update as of* November 2, 2010.

queue.[52] Before this change, a portfolio could submit one complete application as a placeholder, and then work on the remaining applications while the placeholder application was in the queue, moving up the line. Delays arose because if there were application problems, or incomplete items in the applications that were then submitted once the placeholder was at the front of the line, processing would slow or stop while these application deficiencies were remedied.

C. Portfolios and the Master Lease Structure – New Ways to Manage Risk

1. Market Risk Issues. In the past, the FHA insured loan programs were of most interest to the smaller companies which often own a single facility, or at most two or three facilities. In part, this was because these smaller companies, many of which are nonprofit, have always had more difficulty accessing the commercial financing markets due to lower capitalization and less solid credit. However, in the past few years, the larger healthcare companies which own and operate chains of facilities have increasingly turned to FHA insured financing. Instead of loans for one facility at a time, or two or three, the applications have included an entire portfolio of facilities. This trend has led HUD to review its procedures for processing portfolio loans. Unlike commercial lenders, it is a statutory requirement that each insured mortgage loan is made to a borrower which only owns the single project being financed. Thus, a portfolio of projects would be financed with a group of individual mortgages to each individual affiliate which would be closed together on parallel terms but would not otherwise share any security or payment obligations. In recent years, HUD has realized that its mortgages will be more secure if it develops a structure to allow the stronger facilities within a portfolio to support the weaker ones.

There are two elements of risk that can cause a loan to go into default: (i) risk associated with the particular borrower's credit, and that borrower's particular project and its operations; and (ii) general market risk caused by the overall economy in which the project operates. The first category of risk is the reason for detailed underwriting of any loan, with consideration to the specific operating environment of each facility and the borrower's credit status. To the extent that a loan is secured by a portfolio of projects in different areas, with different operational risks, the overall loan risk can be reduced. The second category, general market risk, is very hard to avoid, as all operators will be facing the same global concerns of Medicare and Medicaid regulations and rates, for example. However, two facilities in two different geographic areas may face quite different challenges for certain matters, such as the availability of employees willing to work at a long term care facility. For these reasons, commercial lenders often require that a loan be secured by liens on a group of facilities rather than a single facility.

Perhaps in counterpoint, however, when a portfolio of facilities is owned by the same organization (albeit in different affiliated entities) there is an enhanced credit risk because the entire portfolio will be subject to an adverse credit effect on the parent entity. Thus, although in some respects a portfolio improves the overall credit, there is also the increased risk of concentrating the financing into a related portfolio. If HUD were to approve FHA insurance for three separate facilities, owned by three separate borrowers, it would expect that the credit risk

[52] *Id.*

inherent to one of these borrowers would be independent from each of the other borrowers. However, if all three borrowers were in fact indirectly owned by the same parent company, an adverse financial event that affected the parent company could adversely affect all three borrowers, and thus the level of risk insured by the FHA insurance would be higher than anticipated.

2. Traditional Portfolio Processing. Packages of loan applications for multiple facilities owned by affiliated companies have created issues for HUD for a number of years. HUD's rules for underwriting portfolios of loans for facilities under affiliated ownership were summarized in Notice H 01-03 which was issued in 2001.[53] Part of the application package for any Section 232 loan includes a HUD Form H 01-03 which requires the borrower to set forth all projects owned by affiliates seeking FHA insurance within an 18 month period before and after the submission date. Use of this form allowed HUD to determine if, in fact, there was going to be a portfolio of projects ultimately submitted, and if so, HUD could use its portfolio processing rules for underwriting instead. It is interesting to note that even as early as 2002, industry insiders were aware that HUD personnel were becoming concerned with the risks of portfolio loans and realized that FHA lenders needed to pay very careful attention to ensure that borrowers accurately disclosed their intentions for multiple facility portfolios.[54]

A medium size portfolio is 11 or more properties with a total insured financing in excess of $75 million. For medium size portfolios, in addition to the underwriting of each facility, HUD requires a rating agency review of corporate credit to be approved by the headquarters office of HUD. Large size portfolios are portfolios (of any number of properties) in which the total insured financing is in excess of $250 million. For large size portfolios, in addition to the rating agency review of corporate credit, the rating agency must perform a standardized three-part analysis including corporate credit, site visits, and status and performance review of properties and lines of business on all other assets held by the principals of the borrower's ownership group which must be approved by HUD headquarters[55].

3. New Master Lease Structure. As HUD officials realized that the existing portfolio underwriting procedures might be insufficient to reflect the risk of a very large insured loss if a single adverse event applied to an entire portfolio of insured loans, they sought additional ways to mitigate risk. Although credit exposure of a portfolio of loans which were cross-collateralized and cross-defaulted would be stronger than the traditional loan structure of single loans to single purpose borrowers, the structure of FHA insured financing prohibits the

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[53] HUD Notice H 01-03, U.S. Department of Housing and Urban Development, (2001) http://www.hud.gov/offices/adm/hudclips/notices/hsg/03hsgnotices.cfm. HUD Notice H 01-03 requires the submission of a Form 01-03 which discloses to HUD all projects that are expected to be submitted to HUD within a 36 month window (18 months before the application through 18 months after application) so that HUD can evaluate the portfolio risk rather than simply looking at each project separately.

[54] *An Update of Legislative and Miscellaneous Federal Healthcare Matters*, MORTGAGE BANKERS ASSOCIATION BULLETIN 02/9 (Healthcare Financing Study Group Committee on Government Programs) September 24, 2002, at 2.

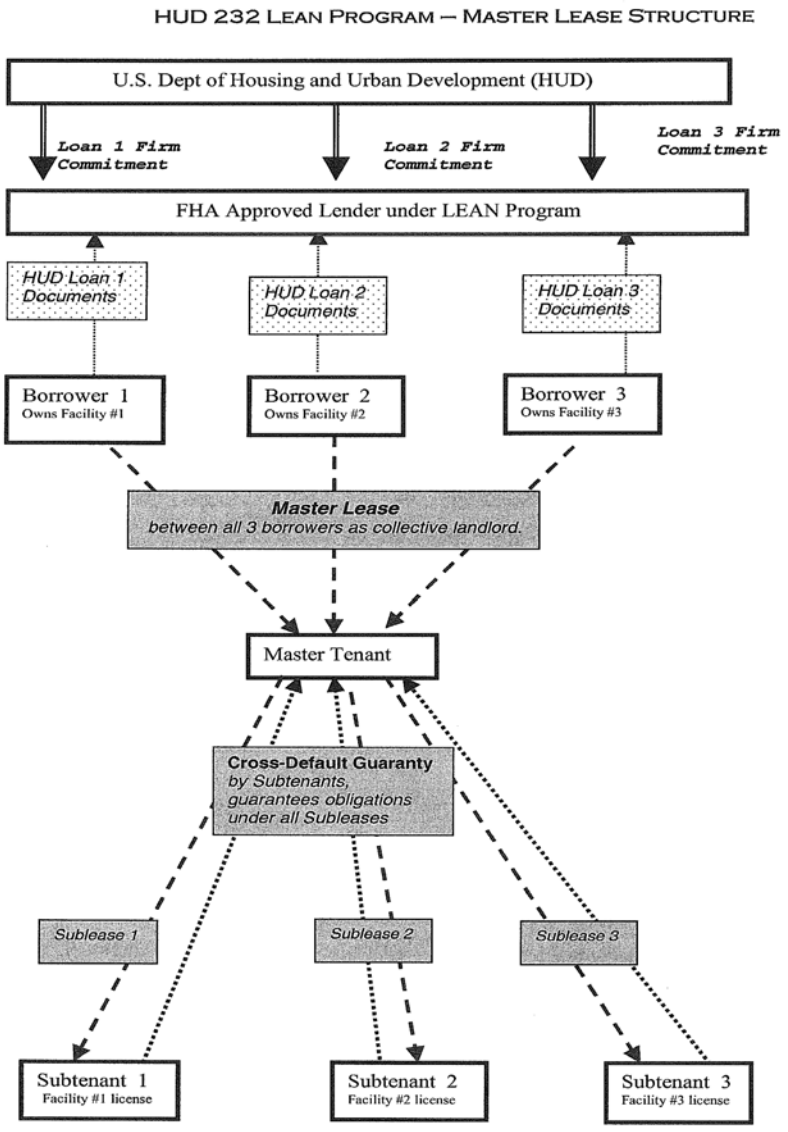
[55] HUD Notice H 01-03 *supra* note 53, Section V describes the credit analysis process for medium and large size portfolios.

sort of pooled collateral that is commonly used by commercial lenders. Therefore, HUD officials worked with certain experienced healthcare FHA lenders to develop a new structure to allow members of a portfolio of facilities to offer credit support to one another, while still maintaining the statutory requirements that Section 232 loans be made only to single purpose single asset entities. Projects proposed for financing that are affiliated by common ownership among the owners or the operating lessee must now receive written approval from HUD, and HUD has the right to require that they be processed under the newly created master lease structure.[56]

Under the master lease structure, each of the facilities in the portfolio is owned by a separate single purpose, single asset entity. Each facility owner leases its facility to a single master tenant. The master tenant then enters into separate subleases to a separate operating company for each of the facilities. The operating company holds the license to the facility, is responsible for day-to-day operation of the facility, and, as license holder, receives the payments for services at the facility. Each of the operating lessees enters into a cross-guaranty agreement guaranteeing to the master tenant the performance under the subleases. In general, each of the facility owners, the master tenant, and each of the operating lessees are all affiliates under indirect common ownership. The rents paid by the master tenant to each of the facility owners is calculated to equal the debt service, real estate taxes and insurance allocable to that facility, plus a small reserve. Likewise, the sub-rent paid by each operating lessee to the master tenant is a similar amount. Since the performance by the subtenants has been guaranteed by all of the other subtenants, however, the master tenant has the operations of all the facilities securing its receipts of sub-rent. Therefore, as a practical matter, the operations of all of the facilities are supporting the loans made to each facility, and this structure accomplishes the goal of improving the credit of each facility loan. Figure 2 illustrates the structure, as applied to a three facility portfolio.

[56] HUD Addendum to Operating Lease, U.S. Department of Housing and Urban Development (June 15, 2010), portal.hud.gov/hudportal/documents/huddoc?id=FHA_DOC_85.doc.

Figure 2



4. Legal Risks of Master Lease Structure. The master lease loan structure is relatively new and has received mixed reviews. On the one hand, some borrowers welcome the opportunity to create a pool of facilities to spread the risk of adverse financial consequences. Other borrowers, however, fear that the rather complicated contractual structure in the master lease financing may create liability risks. Borrowers fear that the contractual relationships established by the master lease, the subleases, and the cross-guaranty could allow a plaintiff against one facility to claim assets of the other facilities to satisfy its claim. For example, using the structure shown on Figure 2, suppose that a tort plaintiff were to have a claim against Subtenant 1 arising from an injury that occurred at Facility 1. Could a plaintiff somehow reach

the assets of Subtenants 2 and 3, or even Owners 2 and 3, as a result of the master lease contracts in place?

(a) *To Pierce or Not to Pierce – the Corporate Veil?* The legal argument for liability is a doctrine known as "piercing the corporate veil." The doctrine rebuts the general proposition that corporations are separate legal persons and holds a parent corporation liable for the obligations of its corporate subsidiary, and holds its shareholders liable for the subsidiary's corporate obligations.[57] Could an enterprising plaintiff claim that because the Master Tenant is a common parent of all three Subtenants, and because all three Subtenants have guaranteed all three Subleases, that the separate corporate existences of all three Subtenants, and perhaps even all three Owners, can be disregarded (thus their corporate veils against liability are "pierced"), thus allowing the plaintiff access to the assets of all these other entities to satisfy its claim?

Courts usually pierce the corporate veil in situations in which the corporate parent and its subsidiaries have failed to conduct their operations as actual separate entities. Often there are assertions of wrongful intent, with the result that a successful plaintiff may have its claims payable both from the subsidiary and its parent, as if they were not distinct, separate legal entities. The master lease structure, however, is rather more complicated. Referring again to Figure 2, liability against Subtenant 1 must first reach upstream to the parent (Master Tenant) and then back downstream to the other subsidiary entities (Subtenant 2 and Subtenant 3). While traditional veil-piercing doctrine allows recovery against an upstream entity like a shareholder or corporate parent, there are two derivative doctrines which allow veil-piercing in other situations. The first doctrine, "reverse piercing" holds a corporation or subsidiary liable for the obligations of its stockholders or parent. The second doctrine, "single business enterprise" theory, disregards the corporate identities of an entire group of entities, treating the whole group as one enterprise liable for the debts of all of its members.[58]

Returning to the master lease structure on Figure 2, consider the application of these doctrines. Using only the traditional veil-piercing doctrine, a plaintiff against Subtenant 1 could recover only against two entities: Subtenant 1 and (only if successful in its piercing argument), its parent entity ("Parent Corp"). However, by using the derivative doctrines described above, the enterprising plaintiff could pursue other affiliated entities in one of two ways. He might pierce to reach Parent Corp and then reverse pierce to reach a different affiliated subsidiary, such as Subtenant 2. Or, he could ask the court to disregard all of the separate forms within a group of subsidiaries under the single business enterprise theory. It is important to note that there is currently no case authority that considers structures such as the master lease structure on Figure 2, and thus it is very difficult to determine if such approaches have any realistic chance of success, or if they remain merely interesting law school hypotheticals. In practice, the determination whether a subsidiary could fit into a "single business enterprise" group or be accessed by reverse piercing may well depend on veil-piercing rules that differ across jurisdictions.

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[57] *See* 18 AM. JUR. 2d Corporations §47 (2010).

[58] *See Green v. Champion Ins. Co*., 577 So. 2d 249, 259 (La. Ct. App. 1991).

Some jurisdictions require fraud or similar abuse of the corporate form on the part of an entity before its corporate veil can be pierced. In other jurisdictions, a sufficiently close relationship between two entities will allow veil-piercing even absent evidence of misconduct. Under the former rule, typical negligence actions are less likely to trigger veil-piercing.[59] A 2009 bankruptcy court discussed this distinction in detail, contrasting Colorado's "control-and-wrongdoing requirement" with New York's more permissive "control-or-wrongdoing rule."[60]

(b) *Specific State Law Provisions*. The outcome of a claim to pierce the corporate veil will depend on the applicable state law. While it is not practical in this article to conduct a 50 state survey, it may be helpful to examine specific state case law precedent for four states to illustrate the way that the doctrine is applied in different jurisdictions.

(i) *Tennessee*. Since 1979, the Tennessee Supreme Court has recognized an "instrumentality rule" to determine whether a parent corporation may be held liable for the debts of its subsidiary. In *Continental Bankers Life Insurance Co. of the South v. Bank of Alamo*,[61] the Court listed a three-factor test: (1) the parent corporation, at the time of the transaction I question, exercises complete dominion over its subsidiary, via financial control and authority over policy and business practice to the extent that the corporate entity, as to that transaction, had no separate mind, will or existence of its own; (2) such control must have been used to commit fraud or wrong, to perpetuate the violation of a statutory or other positive legal duty, or a dishonest and unjust act in contravention of third parties' rights; and (3) the aforesaid control and breach of duty must proximately cause the injury or unjust loss complained of.[62] The Tennessee Supreme Court has recently affirmed this test.[63] Tennessee courts have never embraced a single business enterprise theory, so plaintiffs attempting to recover against sibling entities will rely on a two-step reverse piercing process. Even the first step—reaching the corporate parent—will prove difficult as the *Continental Bankers* test requires both control and wrongdoing. To satisfy the first prong, a plaintiff would have to trace the subsidiary's alleged negligence to some business decision of the parent. To satisfy the second prong, a plaintiff would further have to show that the parent isolated its subsidiary in an attempt to avoid responsibility for negligence to which it contributed. Even if a plaintiff succeeded against the

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[59] *See, Town Hall Estates Whitney, Inc. v. Winters*, 220 S.W.3d 71 (Tex. Ct. App. 2007) (in a suit against a nursing home, holding that piercing the corporate veil required "something more than mere unity of financial interest, ownership and control.").

[60] *See In re Saba Enterprises*, 421 B.R. 626, 648-52 (Bankr. S.D.N.Y. 2009).

[61] *Continental Bankers Life Ins. Co. of the South v. Bank of Alamo*, 578 S.W.2d 625 (Tenn. 1979). In this case, a borrower's corporate subsidiary deposited $50,000 at the defendant bank, which claimed that this deposit was intended as security for a $100,000 loan to the borrower. When the borrower defaulted on the loan, the bank refused to allow the subsidiary to recover its deposit, and sought to pierce the corporate veil that separated the subsidiary's separate legal existence from that of its borrower. The court declined to pierce the corporate veil, and instead honored the separate legal existence of the subsidiary corporation because it evinced a "mind of its own" in the transaction and the parent company's control was not exercised to "commit fraud, misrepresentation, or a dishonest or unjust act on the bank."

[62] *Id*. at 632.

[63] *Gordon v. Greenview Hospital*, 300 S.W.3d 635, 653 (Tenn. 2009).

veil of a corporate parent, it would still have to prevail on a reverse-piercing argument to recover against other related entities.

Thus, while Tennessee law probably permits reverse piercing in the parent/subsidiary context,[64] the plaintiff would still have to satisfy the *Continental Bankers* second prong. A plaintiff might try to show that a parent corporation maliciously isolated a healthcare facility operator to avoid liability, but this would be difficult to prove when the structure had been created for an entirely different reason – namely, to qualify for FHA insured financing.

(ii) *Illinois*. Illinois courts considering piercing the corporate veil often cite *Ted Harrison Oil Co. v. Dokka*,[65] which lists two mandatory conditions: "for a court to pierce the corporate veil (1) there must be such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist; and (2) circumstances must exist such that adherence to the fiction of a separate corporate existence would sanction a fraud, promote injustice, or promote inequitable consequences."[66] While the second Illinois prong leaves room for veil-piercing based on mere control, precedent generally involves fraud or similar wrongdoing, and Illinois has not adopted a single business enterprise theory. Courts typically require evidence that the corporation is acting only as a "mere façade" for the shareholders.[67] While the Tennessee rule focuses on how a corporation uses an entity under its control, the Illinois test focuses instead on the effect of judicially recognizing "separate corporate existence." This distinction bears significance in theory—it might allow veil-piercing without a finding of purposeful fraud or abuse, but successful veil-piercing attempts in Illinois still involve purposeful wrongdoing.[68] A legitimate business purpose defense would contravene the factors of either test that turn on a determination that the corporation is a "mere façade" for the shareholders.[69] Thus, like Tennessee, it would appear unlikely that a plaintiff could successfully pierce the corporate veil in the master lease situation.

(iii) *Indiana*. Indiana maintains a traditional veil-piercing test, and several of its appellate courts have also endorsed a more distinctive single business enterprise theory. The traditional test held by the Indiana Supreme Court in *Aronson*[70] states that "the burden is on the party seeking to pierce the corporate veil to prove that the corporate form was so ignored, controlled or manipulated that it was the mere instrumentality of another and that the misuse of the corporate form would constitute a fraud or promote injustice."[71] The court

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[64] *Nadler v. Mountain Valley Chapel Business Trust*, 2004 WL 1488544 (Tenn. Ct. App., 2004).

[65] *Ted Harrison Oil Co., Inc. v. Dokka*, 617 N.E.2d 898 (Ill. Ct. App. 1993)

[66] *Id*. at 901 (citing *People ex rel. Scott v. Pintozzi*, 277 N.E.2d 844, 851-52 (Ill. 1971).

[67] *Ted Harrison*, 617 N.E.2d at 902; *Fontana v. TLD Builders, Inc.*, 840 N.E.2d 767, 778.

[68] *See, Fontana, 840 N.E.2d* at 781-82 (finding that the second mandatory prong was satisfied when defendant corporation rapidly sold off assets to frustrate creditors).

[69] *Ted Harrison*, 617 N.E.2d at 902; *Fontana*, 840 N.E.2d at 767, 778.

[70] *Aronson v. Price*, 644 N.E.2d 864 (Ind. 1994).

[71] *Id*. at 867.

provided a set of factors (sometimes known as the *Aronson* factors) relevant to both the instrumentality and fraud prongs: (1) undercapitalization; (2) absence of corporate records; (3) fraudulent misrepresentation by corporation shareholders or directors; (4) use of the corporation to promote fraud, injustice or illegal activities; (5) payment by the corporation of individual obligations; (6) commingling of assets and affairs; (7) failure to observe required corporate formalities; or (8) other shareholder acts or conduct ignoring, controlling or manipulating the corporate form.[72]

Indiana courts have applied this test strictly against parties attempting to pierce the corporate veil. In one case[73] the court reaffirmed the traditional test with a sharp analytical distinction. The corporate veil could not be pierced merely to "promote substantial justice," the court clarified: instead, courts could only disregard the corporate form when it had been "misuse[d] . . . to promote injustice."[74] Thus Indiana's traditional veil-piercing test tends to mirror Tennessee's standard: abuse of the corporate form will allow veil-piercing, but incidental injustice will not. However, in some situations, plaintiffs can circumvent Indiana's burdensome traditional rule under a single business enterprise doctrine. In one such case,[75] the court allowed veil-piercing even though the original plaintiff "failed to present much evidence relevant to the *Aronson* factors." When the veil-piercing inquiry concerns two "affiliated corporations" rather than a corporation and its stockholders, the court held that one entity can be liable for the obligations of the other if the two are "effectively one and the same corporation."[76] Four different factors were used: (1) whether similar corporate names were used, (2) whether there were common officers and employees, (3) whether the corporations were operated for similar business purposes, and (4) whether the corporations shared offices, telephone numbers and business cards.[77] Alternatively, the court could disregard the corporate form when one corporation conducted an operation "for the benefit of the whole enterprise."[78]

In applying this theory to the master lease structure, there tends to be more risk under Indiana's single business enterprise theory than from the traditional rule. The theory focuses on three elements: (1) the actual identity of corporations, as indicated by common ownership, directors and employees; (2) the existence of a joint enterprise, indicated by similar business purposes and by coordinated, rather than purely self-interested, action by different entities; and (3) presentation to the public, indicated by similar names and shared offices, telephone numbers or business cards.[79] Cross-collateralization could increase the probability that courts perceive a joint enterprise; the operators and owners under the master lease structure already share a

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[72] *Id.*

[73] *Escobedo v. BHM Health Associates, Inc*., 818 N.E.2d 930 (Ind. 2004).

[74] *Id*. at 935.

[75] *Smith v. McLeod Distributing*, 744 N.E.2d 459, 463 (Ind. Ct. App. 2000).

[76] *Id*. at 463-64.

[77] *Id*. at 463.

[78] *Id.*

[79] *See Oliver v. Pinnacle Homes, Inc*., 769 N.E.2d 1188, 1192-93 (Ind. Ct. App. 2002).

business purpose; and Indiana courts have found single enterprises where "one corporation paid for the obligations of the other."[80] No court has recognized a legitimate business purposes defense to single business enterprise piercing, although how courts would apply these doctrines to a master lease situation is yet to be determined.

(iv) *Delaware*. Finally, since so many corporations are domiciled in the State of Delaware, it would be remiss to not examine the laws of that state. Delaware's more established test requires fraud or wrongdoing in order to allow piercing, but a more recent line of cases disregards this requirement. The Delaware Supreme Court issued its seminal veil-piercing decision in 1968[81] and held that veil-piercing "may be done only in the interest of justice, when such matters as fraud, contravention of law or contract, public wrong, or where equitable consideration among members of the corporation require it, are involved [sic]." Thus, even if the court assumed that a parent "wholly dominated and controlled" its subsidiary, it could only disregard the corporate form with an additional element of fraud or injustice.[82] Cases following this newer test require that the "corporate form cause fraud or similar injustice" before authorizing piercing of the corporate veil.[83]

A second line of cases more amenable to veil-piercing has also emerged. For example the chancery court has indicated it would allow veil-piercing if a parent and subsidiary were "operated as a single economic entity such that it would be inequitable . . . to uphold a legal distinction between them." [84] That court found that the plaintiff had raised genuine issues of material fact on its veil-piercing claim and highlighted three relevant factors: (1) that the defendant subsidiary had loaned its parent company money without apparent consideration; (2) that the parent company and subsidiary maintained substantially identical boards of directors; and (3) that officers of the parent were paid from the subsidiary's payroll account.[85] A later decision similarly states that "a court can pierce the corporate veil of an entity where there is fraud or where a subsidiary is in fact a mere instrumentality or alter ego of its owner."[86]

Even when Delaware courts require no fraud or wrongdoing, they will likely accept a legitimate business purpose defense. In *Mabon*, the court suggested that corporations could avoid veil-piercing if they presented "sound business reasons" for activities that appeared to manipulate the corporate form[87] and in *Pauley*, the Delaware Supreme Court refused to pierce

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[80] *Id*. at 1193.

[81] *Pauley Petroleum, Inc. v. Continental Oil Co*., 239 A.2d 629, 633 (Del. 1968).

[82] *Id*. at 632.

[83] *Wallace ex rel. Cencom Cable Income Partners II, Inc., L.P. v. Wood*, 752 A.2d 1175, 1183-84 (Del. Ch. 1999); *see also Mobil Oil Corp. v. Linear Films*, 718 F. Supp. 260, 268 (D. Del. 1989) (stating that to pierce the corporate veil, "[f]raud or something like it is required.").

[84] *Mabon, Nugent & Co. v. Texas American Energy Corp*., 1990 WL 44267 (Del. Ct., 1990).

[85] *Id*.

[86] *Geyer v. Ingersoll Publications Co*., 621 A.2d 784, 793 (Del. Ch. 1992).

[87] *Mabon*, 1990 WL 44267 at 5.

the corporate veil and found that the "separate existence" of parent and subsidiary "serve[d] a most legitimate business purpose."[88] Because groups of facilities should be able to demonstrate that their structures are fragmented, at least to some extent, in order to become eligible for HUD-backed mortgages, they should have a very convincing and viable defense under either line of Delaware cases.

(c) *Conclusions*. As this discussion demonstrates, any potential defense to veil-piercing claims should be considered under the laws of the applicable jurisdiction. The purpose behind the master lease structure is a legitimate business purpose, created to address particular requirements for access to financing. To the extent that HUD requires borrowers to adopt fragmented corporate structures as a condition to being eligible for mortgage insurance, this fragmentation clearly serves a legitimate business purpose. Companies that qualify for FHA-insured loans benefit from lower interest rates, and can dedicate their resulting surplus to patient care or profit. Thus, at least in the jurisdictions discussed in this article, corporations defending fragmentation or cross-collateralization as legitimate business decisions should be able to avoid veil-piercing liability. In all jurisdictions, whatever the recognized doctrines, there will be a good argument that the master lease structure, required by HUD as a precondition to access to financing, simply does not entitle a plaintiff to the "windfall" of additional deeper pocket defendants simply by application of the arcane doctrines that were developed in a very different atmosphere of fraudulent intent and wrongdoing.

D. Accounts Receivable Financing – Follow the Money

1. Summary of the Legal Status of Healthcare Accounts Receivable – What's the Big Deal?

If healthcare facilities were like apartment buildings, almost all residents or patients would pay their rent in advance on the first day of the month, and the owner would have the accumulated prepaid rent in its operating account, available to be used to pay debt service, salaries, and other operating expenses. For many assisted living facilities, the scheduled monthly fee is, in fact, routinely paid a month in advance, and the owner should have ample funds on hand to pay its bills as they come due, assuming an acceptable occupancy level. However, in the world of nursing homes, it is an entirely different picture. Services are provided first, and then billed to the patient or, in almost all cases, the patient's third party payor. For geriatric nursing homes, this payor is predominantly Medicare or Medicaid. Then, 30, 60, or even 90 days after the services were rendered, the submitted invoice for services is finally paid. Therefore, the accumulated balance of accounts receivable for services rendered, billed, but not yet collected can be a very large number, and accounts receivable become a very significant asset owned by the operator.

Standard prudent lending practice is to require a first priority lien on all the assets of the borrower which are used in its business. Thus, lenders require a first priority lien on the borrower's land, buildings, improvements, and personal property. One important element of personal property is borrower's accounts receivable. Liens on accounts are governed by the

[88] *Pauley*, 239 A.2d at 633.

Uniform Commercial Code ("UCC") (UCC Section 9-102) and may be perfected by filing a financing statement in the office of the secretary of state of the state in which the borrower is organized (UCC Section 9-310). HUD insured loans, like almost all other loans, require a borrower to execute a security interest that grants a lien in all of its personal property, including accounts, and also like almost all other loans, the lender will then file a UCC-1 Financing Statement to perfect its lien in that personal property. For Section 232 loans to nursing homes, the situation becomes more complex because there are special provisions concerning accounts receivable for payments from governmental agencies, and as noted above, the majority of the accounts receivable for a typical nursing home are Medicare and Medicaid receivables.

The statute that governs the payment of claims under Medicare Part A provides that "no payment which may be made to a provider of services under this subchapter for any service furnished to an individual shall be made to any other person under an assignment or power of attorney."[89] The provision does not apply to assignments made to government agencies or assignments pursuant to court order, and also excludes payments made to an agent of the provider, so long as the agent's compensation is unconnected to the amount collected and independent of the actual collection of payments.[90]

The statute that controls the payment of claims under Medicare Part B contains similar language. It provides that "no payment under this part for a service provided to any individual shall…be made to anyone other than such individual or…the physician or other person who provided the service, and including assignment to a government agency, per a court order, or to a collection agency."[91]

Under the Medicaid program, the federal government regulates how states use federal money to fund state plans for medical assistance. The federal Medicaid statute requires that state plans "provide that no payment under the plan for any care or service provided to an individual shall be made to anyone other than such individual or the person or institution providing such care or service, under an assignment or power of attorney or otherwise."[92] The Medicaid provision also lists several exceptions, including assignments to government agencies and by court order and payments to collection agencies.[93]

Congress enacted the provisions prohibiting assignment of Medicare and Medicaid payments to combat the prevalence with which entities that had bought the government receivables would file fraudulent claims. These entities, called "factors," would buy government receivables at a discount from the healthcare provider, and the factors would collect the

[89] 42 U.S.C.A. § 1395g(c).

[90] *Id.*

[91] 42 U.S.C.A. § 1395u(b) (6).

[92] 42 U.S.C.A. § 1396a(a) (32).

[93] *Id.*

payments.[94] Because the factors' profits depended on successful collection of payments, the system lent itself to "incorrect and inflated claims" and "[s]ubstantial overpayments to many such organizations…, one involving over a million dollars."[95] Thus, in 1972, Congress amended the Social Security Act to prohibit the assignment of receivables; in 1977, it further amended the act to prohibit the transfer of receivables by power of attorney.[96]

Courts have ruled that the anti-assignment provisions of the Medicare and Medicaid statutes only prohibit assignment of the right to direct payment from the government; they do not bar third parties from receiving Medicare and Medicaid funds.[97] Typical financing arrangements where loans are secured by Medicare and Medicaid receivables do not violate the federal anti-assignment provisions.[98] As long as the government can make the Medicare and Medicaid payments directly to the provider, the provider may dispense with those payments at its own discretion, including turning the funds over to a lender.

Courts have upheld arrangements where a healthcare provider granted a security interest in Medicare and Medicaid receivables to a lender.[99] For example, in *In re Missionary Baptist Found. of Am.,*[100] an operator of nursing homes granted a security interest in its accounts receivable to a bank as loan collateral. The security agreement specifically stated that the accounts receivable would include Medicare and Medicaid receivables.[101] The nursing home operator subsequently encountered financial hardship, and the bank terminated its financing arrangement with the borrower.[102] The bank began applying available assets, including accounts receivable, to the loan balance.[103] After the nursing home operator filed for bankruptcy, the bankruptcy trustee sued the bank.[104] He claimed that the bank's loan agreements with the nursing home operator were invalid because they allowed the bank to take a security interest in Medicare and Medicaid receivables, despite the anti-assignment clauses in the federal statutes.[105]

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[94] Gregory R. Salathé, Note, Reducing Health Care Costs Through Hospital Accounts Receivable Securitization, 80 VA. L. REV. 549, 562 (1994).

[95] H.R. Rep. No. 92-231 (1971), reprinted in 1972 U.S.C.C.A.N. 4989, 5090.

[96] Charles E. Harrell and Mark D. Folk, Financing American Health Security: The Securitization of Healthcare Receivables, 50 Bus. Law. 47, 56-57 (1994).

[97] *Lock Realty Corp. IX v. U.S. Health, LP*, 2007 WL 724750 (N.D. Ind., 2007) (citing DFS Secured Healthcare *Receivables Trust v. Caregivers Great Lakes, Inc*., 384 F.3d 338, 350 (7th Cir. 2004); *In re E. Boston Neighborhood Health Ctr. Corp*, 242 B.R. 562, 573 (Bankr. D. Mass. 1999).

[98] *Credit Recovery Sys., LLC v. Hieke*, 158 F.Supp.2d 689, 693 (E.D. Va. 2001).

[99] *See, In re Missionary Baptist Found. of Am.*, 796 F.2d 752 (5th Cir. 1986); *Lock Realty Corp. IX v. U.S. Health* (supra note 97). *In re Am. Care Corp*., 69 B.R. 66 (Bankr. N.D. Ill. 1986).

[100] *Matter of Missionary Baptist Foundation of America, Inc*., 796 F.2d at 754 (5th Cir. 1986)

[101] *Id*. at 755.

[102] *Id*. at 755.

[103] *Id*.

[104] *Id*.

[105] *Id*. at 756.

The court held that the security interest was valid.[106] First, the court reasoned that the procedure by which the bank received the payments did not violate the Medicare and Medicaid statutes because it did not require that the government directly pay the bank.[107] The government made direct payment to the nursing home operator's account at the lending bank, and the bank would subsequently sweep that account and apply the proceeds to the loan balance.[108] Second, the court reasoned that Congress enacted the anti-assignment statutes to combat factoring, and it did not view the bank's lending arrangement as comparable to a factoring arrangement.[109]

While Medicare and Medicaid laws do not proscribe the assignment or creation of a security interest in government receivables, the statutes do require direct payment to the provider. To constitute direct payment, the government's payment must first pass through the control of the provider.[110] Because the payment does end up being received directly by the provider, a lender may be concerned that the provider might divert the funds upon receipt to other purposes rather than paying the loan. Thus, a "double lockbox" mechanism has been developed to minimize this risk.

In the first step of the process, the Medicare and Medicaid payments owed to the provider are paid into the provider's deposit account.[111] Only the provider may issue instructions on this account.[112] The lender does not have a security interest in this deposit account; however, it does have a security interest in the deposited proceeds of the Medicare and Medicaid receivables.[113] Second, the provider instructs the bank to sweep daily the first deposit account's funds into a second deposit account.[114] Although the second deposit account is in the provider's name, the lender controls the account.[115] This control enables the lender to perfect a security interest in the second deposit account, pursuant to the Uniform Commercial Code Section 9-312.[116] Lastly, the lender disburses the funds in the second deposit account to pay off the provider's obligations.[117]

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[106] *Id*. at 759.

[107] *Id*.

[108] *Id*.

[109] *Id*. at 758.

[110] Medicare Claims Processing Manual, ch.1, § 30.2, https://www.cms.gov/manuals/downloads/clm104c01.pdf (last visited June 18, 2010).

[111] John Francis Hilson, Practicing Law Institute, Asset-Based Lending: A Practical Guide to Secured Financing, § 1:2.6, 1-20 (2010).

[112] *Id*. at 1-21.

[113] *Id*. at 1-21.

[114] *Id.*

[115] *Id.*

[116] *Id*. at 1-20.

[117] *Id*.

The lender can perfect its security interest in the Medicare and Medicaid receivables by filing a financing statement with the appropriate state office.[118] The lender can perfect its interest by filing because the Uniform Commercial Code explicitly includes healthcare insurance receivables as a type of "account."[119] By perfecting its security interest in the underlying collateral, the lender also perfects its security interest in the proceeds of that collateral.[120] In a situation with private receivables, the lender's perfected security interest allows the lender to assume the role of the provider if the provider defaults on the loan.[121] In this way, the lender is able to collect payments directly from the payor—it does not have to wait for the payments to go though the provider.[122]

The Medicare and Medicaid anti-assignment statutes prevent direct payment to the lender.[123] Thus, to ensure enforcement of the security interest, lenders use the double lockbox mechanism to perfect their interests in the second deposit account.[124] As mentioned above, though, at least one court has indicated that it would support court orders directing direct payment to lenders as a means of enforcing a security interest.[125] Because of the Medicare and Medicaid anti-assignment provisions, the lender cannot have a security interest in the provider's first deposit account.[126] The lender can have a security interest in the provider's second deposit account and can issue instructions for that account.[127] To perfect an interest in a deposit account, the lender must have control of that deposit account.[128] The lender automatically has control over the account if it is the bank where the deposit account is located.[129] If the lender is not the depositary bank, the provider, the lender, and the depositary bank must have a written agreement enabling the lender to issue instructions on the account.[130] Lastly, the lender can exercise control over the deposit account by becoming the depositary bank's customer with respect to that account.[131]

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[118] U.C.C. § 9-310(a) (2001); U.C.C. § 9-501(a) (2001).

[119] U.C.C. § 9-102(2) cmt. 5(a) (2001).

[120] U.C.C. § 9-315(c) (2001).

[121] Kimberly Easter Zirkle, Note, Not So Perfect: The Disconnect Between Medicare and the Uniform Commercial Code Regarding Health-Care-Insurance Receivables, 9 N.C. BANKING INST. 373, 379-80 (2005).

[122] *Id*.

[123] *Id*.

[124] *Hilson*, supra note 111, at 1-20.

[125] *See Lock Realty Corp. IX*, 2007 WL 724750

[126] *Hilson*, supra note 111, at 1-20.

[127] *Id*. at 1-21.

[128] U.C.C. § 9-314 (2001).

[129] U.C.C. § 9-104(a) (1) (2001).

[130] U.C.C. § 9-104(a) (2) (2001).

[131] U.C.C. § 9-104(a) (3) (2001).

2. Accounts Receivable Financing – HUD Rules and the Realities of Third Party Lenders.

As discussed above, the lengthy delay between the date of service and the date of payment is a fact of life for many healthcare providers, and can be a very heavy burden on a provider's operations. While the provider waits for payment, it must still pay its employees, keep the lights on, and provide meals for the residents, and all those things require money. In an ideal world, the provider would have sufficient accumulated financial reserves to finance the delay in payment, but in the real world, many providers seek accounts receivable financing from lenders. There are a number of lenders which have developed programs and expertise in healthcare accounts receivable financing, and in general these lenders use the double account structure described above.

Until fairly recently, operating lessees of facilities with Section 232 mortgage financing could pledge their accounts receivable freely to any working capital lender without any requirement for HUD approval. Since the operating lessee usually holds the healthcare license of the facility, almost all revenues of the project will initially be received by the operating lessee as payment for services rendered, and as discussed above, the value of the accounts receivable (representing the spread of time between the date services are provided to patients and the date payment is received for those services) can be substantial. Allowing an operating lessee to pledge away such a substantial project asset without lender consent seems to have been a major omission, but recall that healthcare loans (Section 232 for long term care and Section 242 for hospitals) represent only 2.4 percent of the total insured loan funds administered by HUD on behalf of FHA.[132] The remaining 97.6 percent are single family residential loans and multifamily residential loans.[133] As discussed above, residential rental properties rarely require accounts receivable financing and so long as most tenants are paying rent in advance, as required by their leases, the accounts receivable of an apartment project is a very small portion of the total asset value of the project. For that reason, the traditional forms and policies for FHA insured loans did not contain thorough provisions for accounts receivable, and in certain circumstances (older loans on facilities subject to operating leases), allowed the asset value represented by accounts receivable of the operating lessee to escape being pledged as collateral at all. For a number of years, industry insiders warned that HUD was going to close the "loophole" and require HUD consent for any such pledge by operating lessees.[134]

The first change by HUD (before the *Lean* program was adopted) was to require a rider to the loan documents that provided any future working capital financing would require HUD approval and the execution of an intercreditor agreement. An intercreditor agreement is an agreement signed by the senior and junior lenders which sets forth the priorities of the liens in favor of each lender and provides procedures to be used by each lender in the enforcement of such liens in the event of default (for example, usually the junior lender is barred from

[132] Fiscal Year 2010 Annual Management Report, Federal Housing Administration (2010), http://www.hud.gov/offices/hsg/fhafy10annualmanagementreport.pdf.

[133] *Id*.

[134] *An Update of Legislative and Miscellaneous Federal Healthcare Matters*, supra note 54 at 2.

foreclosing on its junior lien without the consent of the senior lender.) These requirements were further explained in Notice H 08-09 which set forth HUD's requirements to approve working capital loans while also acknowledging their business rationales.[135] In many ways, this Notice was a very positive step, as it demonstrated understanding of the need for accounts receivable financing and provided fairly clear guidelines for the approval of such loans.

One of the modifications created under the *Lean* program, after the initial requirements concerning intercreditor agreements, was express recognition that accounts receivable financing was financially beneficial to many projects, under certain circumstances, and in fact could be viewed as an asset to the viability of the project and the proposed FHA insured loan so long as guidelines were met. HUD established procedures for the approval of accounts receivable financing on insured facilities.[136] Under Section 232 Lean processing rules HUD has the right to consent to any accounts receivable financing, and will generally do so as long as the financing supports the financial viability of the project. HUD will accept accounts receivable loans to be provided by an unrelated third party lender with experience in healthcare lending, based on a percentage no larger than 85 percent of all accounts receivable less than 120 days old. Existing accounts receivable financing must be described in the initial application for the loan, with a detailed financial analysis demonstrating whether the project can support the accounts receivable loan as well as the proposed FHA insured loan. Accounts receivable financing must be provided from a recognized lender with experience (typically at least three years) in this type of financing and sufficient financial controls to monitor the financial operations.

Accounts receivable financing may be provided under a single loan to more than one facility, but only if all of the facilities are financed with FHA insured loans. There can be no cross-collateralization between facilities, some of which are financed with FHA insured financing and some of which are financed with non-FHA loans. There is an approved form of intercreditor agreement that will be entered into between the FHA lender and the accounts receivable lender, which will have a rider to it which will provide that the account receivable lender's interest in the accounts receivable is prior to the FHA lender's interest. It will also require that the accounts receivable lender receive funds in the account and disburse the monthly payments to the FHA lender before any funds are released to the borrower. Also, advances under the accounts receivable loan must be applied first to pay debt service to the accounts receivable lender and second, to pay current operating expenses of the facility, before any other payments to the borrower or its principals.[137]

In one of the many other changes under *Lean* processing, HUD promulgated two forms of agreements for use when there is not any separate accounts receivable financing, in order to replicate the typical double account receivable structure used by accounts receivable lenders. The facility first establishes an account for receipt of its governmental payer payments (Medicare

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[135] HUD Notice H 08-09, U.S. Department of Housing and Urban Development, (November 17, 2008), http://www.hud.gov/offices/adm/hudclips/notices/hsg/03hsgnotices.cfm.

[136] *Id.*

[137] U.S. Dep't of Housing & Urban Dev., Off. of Housing, 232/223(f) LEAN Processing for Section 232 Health Care Facilities (December 2008), on file with author.

and Medicaid) with a depository bank, and that account is swept daily under the provisions of a Deposit Account Instructions and Service Agreement among the owner, the FHA lender, and the bank ("DAISA"). Under the DAISA, the facility owner "owns" the accounts as required for governmental receivables, but "instructs" the bank to sweep the account on a daily basis with all such proceeds deposited into a second account. This second account is the "lockbox" account which receives deposits of non-governmental accounts directly, and this account is the subject of a Deposit Account Control Agreement ("DACA"), which is also a HUD form signed by the owner, the FHA lender, and the bank. Under the DACA, so long as there is a no default, the funds may be used by the owner, and in general the owner will have a third account into which it will deposit the funds released to it under the DACA and out of which it will pay its operating expenses. Both the DAISA and the DACA must be executed by the bank in which the accounts are held.[138] In theory, this makes sense and conforms to current lending procedures. In practice, this can create significant difficulties. The forms are rather new, and many banks are unfamiliar with them, so banks may be reluctant to sign them without negotiation with their legal departments. Depending on the bank, and the legal department, this can create delay and frustration. For example, the current HUD forms limit the bank's liability to its negligent acts, but bank forms generally require that the standard be "gross negligence or willful misconduct". While this change may be negotiated in certain situations, it needs to be addressed early in the process. Another example is that the forms require the bank to waive its right of banker's lien and set off rights, and these waivers may not be acceptable to the bank. Even if the forms are substantively similar to the bank's form, or forms the bank has used in the past, as a practical matter banks are accustomed to using their own printed forms, and are reluctant to start with an unfamiliar form. The request to use a different form often results in significant delay if it must be negotiated with the bank's legal counsel. Thus, borrower's counsel is well advised to request copies of the DAISA and DACA early in the process and start working with the bank to eliminate needless delay closer to the closing date.

In addition to the forms of DAISA and DACA, HUD is working to promulgate forms to be used for the second priority liens that will be subordinate to a recognized and approved third party accounts receivable lender. It is probably fair to say that these forms, as well, are still works in progress, and HUD recognizes that there may need to be modifications based on the particular needs of each transaction and lender.[139]

The most important point for borrowers and their counsel to remember is to address the accounts receivable documents as early as possible in the underwriting of an FHA insured loan. Also, if possible, it is helpful for borrowers to seek their accounts receivable financing from lenders who have experience with Section 232 loans. It may even be possible for a lender to have on hand a form document that has been used before and approved in the past by OHP personnel at HUD.

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[138] Deposit Account Control Agreement Form, U.S. Department of Housing and Urban Development, http://portal.hud.gov/hudportal/documents/huddoc?id=DepositCAAAR(non-govt).doc. DAISA form should be available in the future from the same HUD portal.

[139] U.S. Department of Housing and Urban Development, Office of Housing, *232/223(f) LEAN Processing Training-for Lenders* (2008).

IV. Conclusion – The Rollicking Ride Continues

As FHA insured loans become an increasingly important funding source for owners of long term health facilities, we can expect continued "growing pains" as lengthening queues compel new procedures and policies. Despite the great efforts being made by officers at HUD, the volume of applications is growing faster than the expansion of processing capacity at the OHP. Some salutary effects of the growth have taken place. The program processing protocols have been revised in significant ways to acknowledge the realities of the underwriting of long term care facility credit, particularly in the treatment of accounts receivable financing and the risks of multiple facility portfolios. While some of the recent changes are still difficult for many practitioners, and some of the newly promulgated forms have yet to be refined completely, progress is ongoing. The financing offered under Section 232 is very important to providers, and it is of critical importance to all of the stakeholders in the Section 232 program that these financing vehicles remain available to the industry. For that to occur, the ultimate financial viability of the loan programs must be preserved. For those reasons, the new developments under these programs are important to all the parties concerned with the financial viability of the nation's providers of long term care to Americans.