Risky Business: Master Leases and Alternative Mitigation

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Summary of Panel Discussion

- Overview Master Lease Structure - La Fonte Nesbitt
- Master Lease Basics, Features and Cashflow Charts – Nikki Hoffpauir
- Alternative Mitigation – Paul Kisselburg
- HUD OGC Highlights – Brenda Joseph-Chambers

Some Key Reference Materials

- HUD LEAN Handbook 4232.1 REV-1, Section II, Chapter 13.
- Healthcare Regulatory Agreement – Master Tenant (HUD 92337 ORCF)
- Master Tenant Security Agreement (HUD 92340 ORCF)
- Addendum to Master Lease (HUD-92211-ORCF)
- Master Tenant SNDA (HUD 92333 ORCF)
- Cross-Default Guaranty of Sub-Tenants (HUD-92331-ORCF).

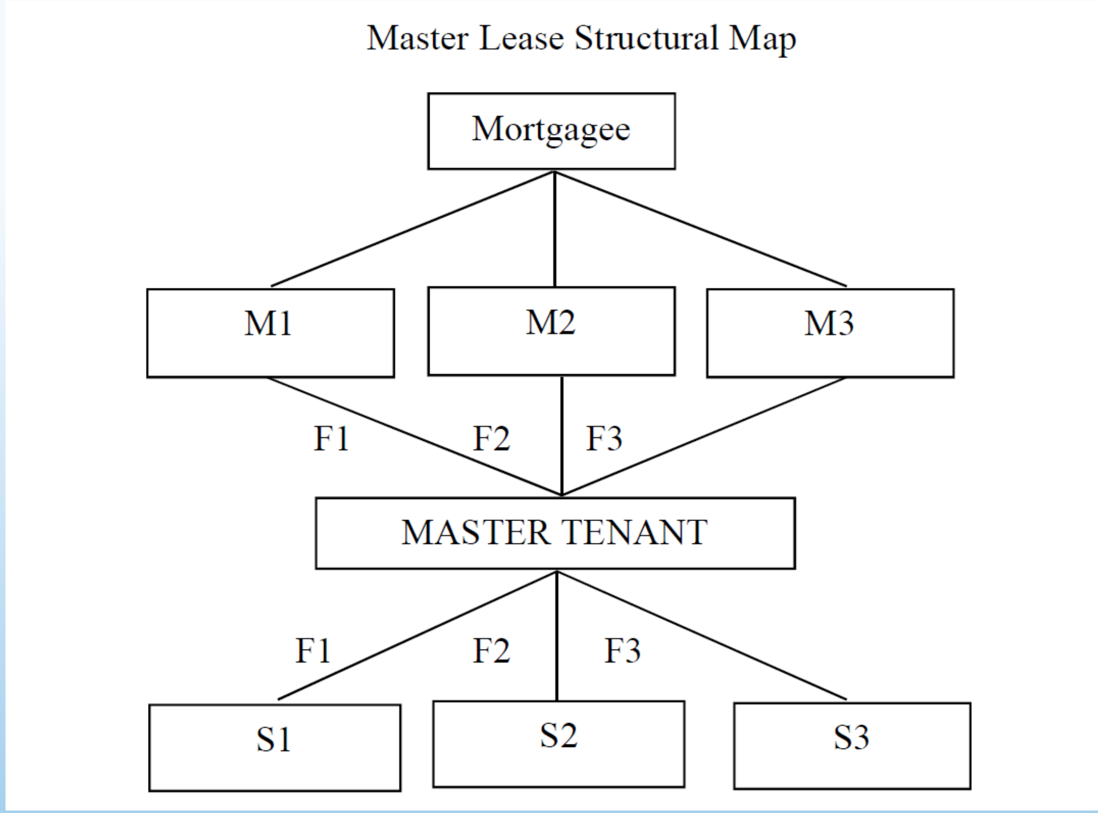
Overview of a Master Lease Requirements

- HUD requires a master lease for three or more properties and/or $15 million or more in aggregate loans to projects under common operator or borrower control.
- The master lease structure ties together the operating leases from each facility involved and requires each operator to use available funds from its project to pay rent for any other project subject to the master lease which is unable to generate adequate cash flow to make required lease payments.
- Each project has to be individually underwritten in accordance with HUD requirements. However, a master lease provides additional credit support by allowing better performing projects to support weaker performing projects which are controlled by common principals.

What is a Master Lease?

- A master lease is a single indivisible lease between the owners of multiple facilities, jointly acting as the landlord, and a master tenant.
- The master tenant agrees to pay rent to the owners in an aggregate amount required for each project and the owners have the right to allocate the rent as needed in order to make the payments required for all of the projects.
- The master tenant enters into operating leases, in this case, sub-leases, with the actual operators of each facility.
- See sample diagram on next slide

What does the Master Lease Structure Look Like?



Sublessee/Subtenant Roles

- The master tenant is NOT the actual operator of the facilities and does not hold the license to operate the facility. The master tenant enters into operating sub-leases with the actual operators of each facility.
- Each subtenant (operator) not only agrees to pay to the master tenant the amount of rent required and due under its sublease, each subtenant further agrees to guaranty the rent owed by all other subtenants who sublease from the master tenant by executing a Cross-Default Guaranty of Sub-Tenants (HUD-92331-ORCF).
- So, using the diagram above, if subtenant S1 is not able to make its full rent payment, subtenants S2 and S3 would make up the difference to extent that projects 2 and 3 have sufficient income to do so.

Bankruptcy Protections of a Master Lease

- In addition to providing additional credit support, the master lease structure is hoped in the case of a bankruptcy of the master tenant or subtenants to prevent "cherry picking." In other words, to lessen the ability of a master tenant or operators in bankruptcy to reject weaker performing subleases while retaining better performing subleases.
- Because the master lease is deemed under the Addendum to Master Lease (HUD-92211-ORCF) to be "an indivisible and non-severable lease" of all the facilities involved, including for purposes of 11 U.S.C. § 365 of the Bankruptcy Code, HUD hopes that a debtor master tenant or debtor operators will be forced to assume or reject the entire Master Lease and not be able to assume or reject the underlying subleases on a case-by-case basis.

Master Lease – Basic Terms

- Length of Master Lease – greater than longest mortgage maturity
  - Exceptions: unrelated parties and state law prohibitions or negative financial consequences
    - If shorter term:
      - subleases to be coterminous
      - Addendum to Regulatory Agreement will be required for a new Master Lease upon termination of current Master Lease
- Subleases
    - Minimum five (5) year term
    - Include responsibilities: payment of real estate taxes, maintenance, capital improvements, equipment replacement, property insurance, fidelity insurance

Master Lease – Basic Terms

- Minimum Lease Payment Requirements per Project referenced in Master Lease Schedule
- Minimum Lease Payment must be greater than 1.05 times sum of annual principal, interest, MIP, reserve for replacement deposit, property insurance and property taxes
- All Projects in the Master Lease must be subject to a HUD-insured loan
- Master Lease must be in place at the time of closing of the first loans in the portfolio

Master Lease Features

- Identity-of-Interest Borrower and Operator

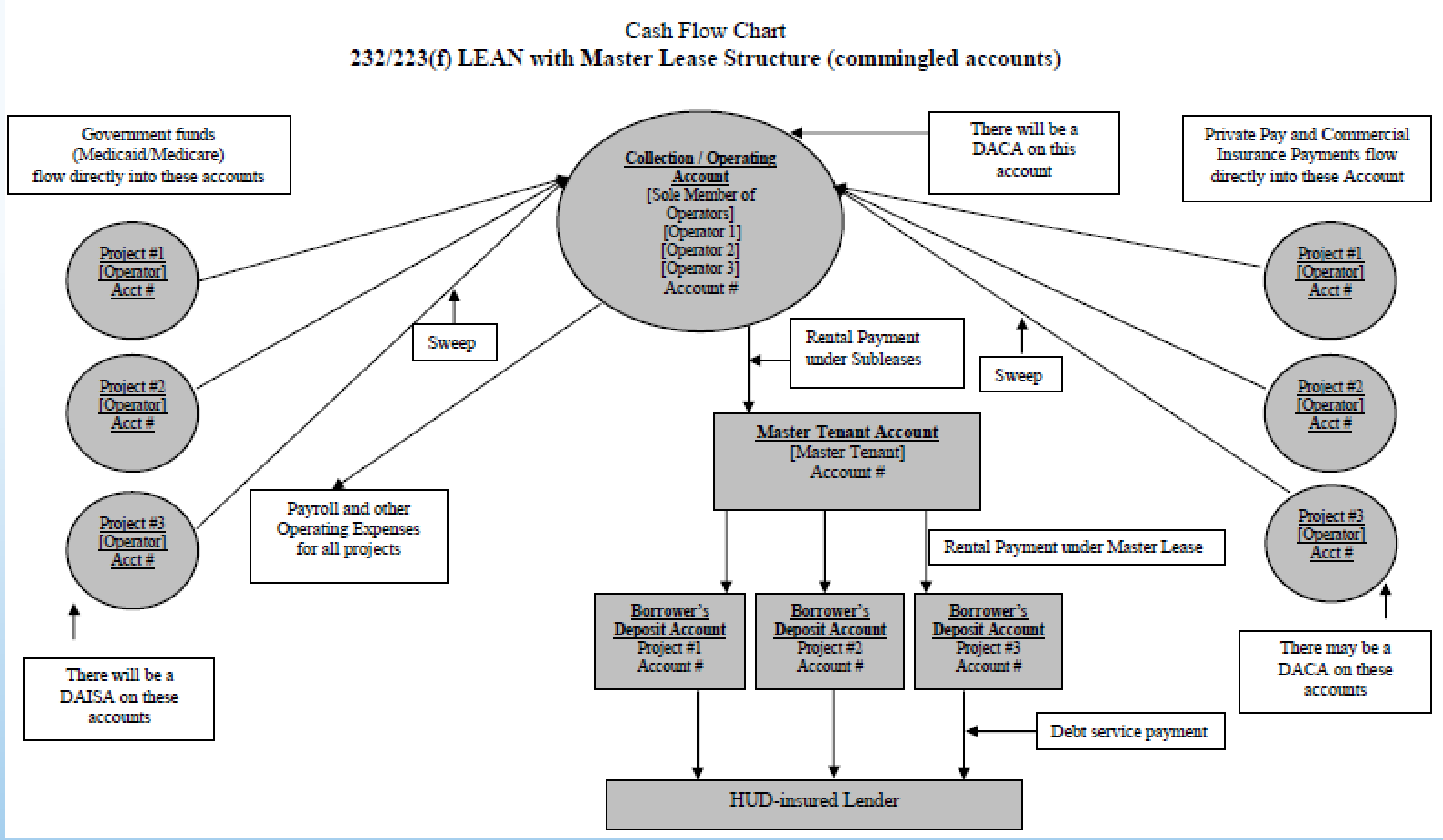
- Non Identity-of-Interest Borrower and Operator
  - Master Tenant can be controlled by either the Borrower or the Operator
  - Consider certain business terms (rent calculation, insurance, repairs, capital improvements, etc.)

- Multiple Joinders for large portfolios

Focus Points for Lenders

- Appropriate documentation for Application
  - Master Lease with Addendum and Estoppel
  - Sublease with Addendum and Estoppel
  - HUD Forms (SNDA, Cross Default Guaranty, Opinion, Regulatory Agreement, Security Agreement)
  - Master Tenant Organizational Documents
- Only Projects subject to HUD-insured loans can be part of the portfolio (no cross-default with other non HUD-insured Projects)
- Waivers (master lease term, professional liability insurance levels, etc.)
- Prohibited entity names ("HUD" can not be part of any entity's name)

Master Leases and Cash Flow Charts



Master Leases and Cash Flow Charts

Key Considerations:

- Each portfolio is unique and may have a different structure
- Master Lease Structure matches Cash Flow Chart
- Accounts subject to DACA and DAISA
- Upstream/Downstream Accounts
- All accounts that may hold Project funds need to be shown (including account numbers)
- If funds are commingled, need system to trace funds to each individual Project
- A/R Financing
- Debt Service Payments

Multiple Lenders and Multiple Master Leases

- Same Borrower sponsor and/or Operator across multiple Master Leases, each portfolio with a different Lender
- HUD will allow one Master Lease for each Lender
- Subordinate Cross-Default Guaranty of Subtenants to “tie-in” multiple portfolios with different Master Leases
- Allows for allocation of excess funds from one pool of projects (the performing projects) to another pool of projects under a different Master Lease (the non-performing projects) if funds are available after all obligations of the Master Lease and Operator are met

Limited Guaranty and Security Agreement

- What if HUD requires additional security in connection with a portfolio but the Projects are not subject to opco/propco structures? HUD may look for a Limited Guaranty and Security Agreement ("LGSA"). Remember, the LGSA is not really an alternative to a master lease in the sense that the parties can pick one or the other. If the Projects in a portfolio utilize an opco/propco structure, HUD will likely require a master lease. The LGSA is most often used when a master lease will not work.

LGSA: What It Accomplishes for HUD

- As with the master lease structure, the LGSA mitigates the concentration risk for HUD. The principals of the borrowers will provide the additional support required by HUD.

LGSA: How It Works

- Lender will identify the principals of the borrowers to provide a guaranty of the obligations of the borrowers within the portfolio under their respective loan documents. Guarantors will have direct or indirect ownership interest in the borrowers. Most often, the same Guarantors have ownership interest in all borrowers within the portfolio. The Guaranty covers payments due to lender under the loans and any costs incurred by lender as a result of an event of default.

LGSA: What Is Pledged

- Fortunately, the Guaranty is a limited guaranty. Guarantors pledge the cash equivalent of any cash distributions received by, or due to, the Guarantors within 180 days of an Event of Default.

LGSA: The Pledge

- Guarantors must grant a <u>first</u> security interest in the rights to cash. The security interest is released if within 180 days after the date of the distribution no event of default has occurred.

LGSA: Is a Limited Guaranty

- Guaranty is a limited guaranty. No other property or assets of Guarantor are at risk under the LGSA.

LGSA: Remedies of Guarantor

- If the Guarantor is required to advance cash to lender pursuant to the LGSA, can the Guarantor pursue the defaulting borrower? Yes, but any obligation of that borrower to the Guarantor must be evidenced and enforced pursuant to the HUD-Form of Surplus Cash Note ("SCN"). That means:

  - Maturity date of SCN on or after maturity date of loan to that borrower
  - SCN payable only from 75% of available surplus cash from that Project

LGSA: Possible Issues

- What if the Guarantor cannot grant a <u>first</u> security interest in the rights to cash to lender? Perhaps the Guarantor has already granted an interest in all rights to cash to some other creditor. Guarantor should keep this in mind when it delivers the LGSA, which includes a certification that the security interest granted to lender is a first security interest. The issue might also be revealed in connection with lender's due diligence. Likely, a creditor would perfect its security interest in the cash with a UCC Financing Statement.

Recent Developments - Master Leases

- Master Lease Policy - concentration risk mitigant
- Reallocation Rents
- Master lease and an operator bankruptcy
- Portfolio restructuring - releases from the master lease

Master Leases and Alternative Mitigation

Questions?