


**DEPARTMENT OF HOUSING AND COMMUNITY DEVELOPMENT****DIVISION OF FINANCIAL ASSISTANCE**

1800 Third Street, Suite 390  
P. O. Box 952054  
Sacramento, CA 94252-2054  
(916) 322-1560  
FAX (916) 327-6660

**ASSET MANAGEMENT AND COMPLIANCE (AMC) ADMINISTRATIVE NOTICE****Notice Number: 07-03**

Date: December 14, 2007

To: HCD-Assisted Rental Project Borrowers and Management Agents

From: Chris Westlake, Deputy Director  
Division of Financial Assistance 

Subject: Updated Guidance for Loan Extensions and Use of Reserve Funds in the  
RHCP-Bond and CHRP-R Portfolios

**Administrative Note:** This Administrative Notice establishes a formal written notification of administrative guidelines which affect the operation of Department programs. This format is used to identify, clarify and record administrative guidelines and interpretations of public interest.

This notice supersedes Administrative Notice #07-01 dated April 19, 2007 regarding projects financed by HCD's CHRP-R and RHCP-Bond programs extending, resyndicating and/or subordinating the loans received under these programs, and using reserve funds to defray or minimize the cost of buying out the sponsors' limited partners. This notice summarizes the conclusions of HCD's Legal Affairs Division (LAD) on the legal permissibility of the actions requested by these sponsors. This updated notice modifies the provisions for the use of reserves for buying out the limited partner's interests in these projects. It also updates the requirements for HCD loan extensions and loan subordinations where there is a leasehold interest in the property.

The sponsors specifically requested the ability to: 1) extend the HCD loans well before their due date, and, in most cases, for more than ten years, to facilitate new tax credit syndications; 2) subordinate the HCD loans to new debt, also to facilitate new syndications or pay the costs of buying out the limited partners; 3) use funds in HCD-controlled project operating and replacement reserve accounts to cover the cost of buying out limited

partners; and 4) spend down operating and replacement reserves, to avoid the cost of buying them from limited partners.

## **HCD Loan Extensions and Subordinations**

### **Extensions to Facilitate New Syndications or Resyndication**

HCD currently has sufficient legal authority to grant the requested loan extensions for CHRP-R and RHCP-Bond so long as a project is operated consistently with the regulatory agreement and the extension is necessary to continue operations consistent with the statute and regulations. LAD found no statutory barrier to granting multiple ten-year extensions, or to granting these extensions well before the loan due dates. HCD would have to make a finding, every ten years, that the project was still in compliance with the HCD regulatory agreement, and that the extension was necessary to continue operating the property under the program regulations.

### **Subordination**

HCD currently has authority to subordinate its loans. The program regulations permit refinancing of existing liens or additional financing necessary to maintain or improve the fiscal integrity of the project or to maintain affordable rents. In CHRP-R, this authority is constrained by the loan-to-value limit in the CHRP-R regulations. Subordination must meet the policy parameters listed below. An increase in senior debt will be allowed only for purposes of rehabilitation, related costs and the cost of the transaction including limited partner buyout, subject to HCD approval.

### **Extension and Subordination Policy Parameters**

HCD approval of extensions and subordinations will be conditioned on meeting the following:

- No loss of project financial integrity (it must cash flow).
- No increase in rents on HCD assisted units and no reduction in number of HCD assisted units.
- Maintain or improve physical condition/useful life of property.
- Maintain or improve HCD loan security. Maximum senior permanent debt plus HCD loan less than or equal to unrestricted value of property after any physical improvements at time of restructure, subject to the limit on the use of funds in excess of existing permitted senior debt set forth above.
- Deferred developer fees paid only through distributions.
- Deferred developer fees do not impact future repayment of HCD interest.
- No increase to allowable sponsor distribution.
- The Department will not defer payment of interest equal to the percentage charged in the Multifamily Housing Program (Chapter 6.7 commencing with Section 50675) for

the Department's ongoing monitoring and management responsibilities. Payment of .42 percent annual interest on the HCD loan will be required.

- Project and sponsor are in compliance with all HCD program and regulatory requirements.
- Sponsor must hold fee title to the development property or a leasehold or other possessory interest sufficient to meet the sponsor's obligations under the Department's loan documents. The status and nature of the sponsor's title and interest in the property shall be subject to the Department's approval.
- If the sponsor's interest in the property is a leasehold, the lease must provide adequate security for the Department's loan. In general, meeting the requirements of the Uniform Multifamily Regulations, Section 8316, will provide adequate leasehold security. The lessor and lessee will be required to sign the Department's standard form Lease Rider, unless the lessor will sign the Department's Deed of Trust. Where the lessee and the lessor are affiliated or related private parties, both the lessee and the lessor must execute the Department's loan documents so as to encumber both the leasehold and fee interests in the development.
- The sponsor must obtain the consent of the junior lienholders to the amended regulatory agreement.

## **Reserves**

### **Replacement Reserves**

Since the use of replacement reserves generally offsets potential project losses due to physical plant failures, HCD is willing to allow (not require) the release of replacement reserves prior to the end-of-tax-credit compliance period restructuring, provided that:

- All such capital expenditures benefit the project,
- The funds are not used to prematurely replace items which have significant remaining useful life,
- HCD approves the use of these funds, and
- HCD approves a plan to bring the reserve up to an adequate level over time.

Replacement reserves may not be used for costs related to the limited partner buyout.

### **Operating Reserves**

HCD is willing to allow a substantial drawdown of operating reserves, down to one month's operating reserve requirement, for capital costs that would normally be paid out of the replacement reserves provided that the financial well-being of the project is not jeopardized. HCD will need to provide prior approval for the use of these funds. Sponsors will be required to fund operating reserves up to the HCD-required level prior to taking any future distributions.

In addition to using operating reserves for capital costs as described above, HCD will allow the use of operating reserves for third party costs related to limited partner buyouts. Allowable buyout costs include appraisal, legal, and consulting fees; title and escrow fees; transfer taxes; and payoff of the limited partners. HCD may approve other fees or costs on a case-by-case basis. In addition to having approval from other lenders that require operating reserves, use of the operating reserve funds for these costs is subject to the following conditions:

1. Sponsor must be in substantial compliance with program requirements for all its projects within the HCD portfolio;
2. Current year sponsor distributions and any funds available from refinancing must be used to pay buyout costs prior to using funds from the operating reserve account;
3. Funds from one project may not be used for another project;
4. The residential portion of the project must have had a positive cash flow for the last three years. Exceptions will be considered on a case-by-case basis;
5. A minimum of one month's operating costs, non-contingent debt service, and replacement reserve deposit must remain in the operating reserve account;
6. The operating reserve account balance must be brought up to the required amount (4 months of operating costs, non-contingent debt service, and replacement reserve deposit) within two (2) years from the date of the initial withdrawal of funds for this purpose from the reserves. Information from the Annual Report or Audit for that year will be used to determine compliance. The sponsor will submit its request using the Department's Operating Budget Request for Limited Partner Buyout Costs Excel worksheet, which can be accessed on the Department's website, at: <http://www.hcd.ca.gov/fa/amc/mmemo.html>
7. Prior to withdrawing funds from the operating reserves for buyout-related costs, the following documentation must be provided to HCD for approval of operating reserve withdrawals:
  - The most recent bank statement showing the Operating Reserve Account balance;
  - Details and documentation of the cost of the buyout;
  - An Amendment to the Regulatory Agreement accepting HCD's conditions for using the Operating Reserve funds for this purpose (see Attachment), and
  - Junior lienholders consent to the Amendment to the Regulatory Agreement.

Once we receive this information, HCD will use the most recent Audit or Annual Report information to determine the amount of Operating Reserves that could reasonably be

expected to be replenished within the two year period in order to achieve the required operating reserve balance. In determining this amount, HCD will evaluate the total project cash flow (excluding HCD required interest payments) including residential and commercial income. This will be the maximum amount that can be withdrawn to pay for limited partner buyout costs.

8. All project cash flow (excluding HCD required interest payments but including all distributions and commercial cash flow) must be used to replenish the operating reserves until they reach the required four month level which must be maintained for the life of the HCD loan.

9. Sponsors may not take any distributions until the replacement reserves are adequately funded. HCD will determine the required annual replacement reserve deposits based on an HCD-approved physical needs assessment and reserve study. This study must be submitted within two (2) years of the release of operating reserve funds; and

10. For purposes of calculating rent increases for HCD-assisted units, increased reserve deposits will not be used in the rent increase formula until HCD has formally approved updated reserve deposit requirements.

HCD reserves the right to deny the use of reserves for limited partner buyout costs if, in its sole discretion, it determines the financial or physical integrity of the project or HCD's interest in the property would be jeopardized.

Attachment

ATTACHMENT

Free recording in accordance  
with California Government  
Code sections 6103 and 27383

RECORDING REQUESTED BY, AND  
WHEN RECORDED, MAIL TO:

State of California  
Department of Housing and  
Community Development  
P. O. Box 952052  
Sacramento, CA 94252-2052  
Attn: Multifamily Housing Program

AMENDMENT NUMBER \_\_\_\_  
TO  
REGULATORY AGREEMENT NUMBER \_\_\_\_\_

(FOR USE OF OPERATING RESERVE FUNDS FOR  
LIMITED PARTNER BUYOUT COSTS)

**Borrower Name:**  
**Project Name:**  
**Contract Number:**

This Amendment to Regulatory Agreement number \_\_\_\_ (the "Amendment") is made and entered into by and between \_\_\_\_\_, a California \_\_\_\_ [form of organization] \_\_\_\_\_, (the "Borrower") and the Department of Housing and Community Development, a public agency of the State of California (the "Department"), dated as of \_\_\_\_\_. It amends the Regulatory Agreement by and between Borrower and the Department dated \_\_\_\_\_ (as amended by amendment(s) numbered [LIST PREVIOUS AMENDMENTS AND DATES], the "Regulatory Agreement").

Recitals

A. Whereas Borrower is the owner of a rental housing development located in \_\_\_\_\_, California (the "Project") which has been assisted with a

below-market interest rate loan provided by the Department. As a condition of the financial assistance, Borrower and Department have entered into the Regulatory Agreement which governs the use, rents, occupancy, management, income, expenses and operation of the Project.

- B. Whereas Borrower, pursuant to the provisions of the Regulatory Agreement, has funded and maintained an Operating Reserve Account ("Account") for the Project. Withdrawals from the Account are subject to the review and approval by the Department. The balance of the Account as of date of this Amendment is \$ \_\_\_\_\_.
- C. Whereas Borrower has requested that the Department approve the withdrawal of funds from the Account to be applied to the Limited Partner Buyout Costs for the Project (the "Transactional Costs").
- D. Whereas the Department approves of the requested withdrawal subject to the terms and conditions of this Amendment.

**NOW, THEREFORE**, the parties agree as follows:

- 1. The forgoing Recitals are true and correct and included as part of this Amendment.
- 2. Borrower asserts, warrants and agrees as follows:
  - a. Borrower is in substantial compliance with the terms and conditions of the Regulatory Agreement.
  - b. All information, data, documentation and material submitted to the Department by Borrower in connection with its request to withdraw funds from the Account is accurate, true and correct to the best of Borrower's knowledge.
  - c. Borrower has sufficient funds in addition to the withdrawal authorized by this Amendment to complete the transaction for which the Transaction Costs have been approved by the Department. Borrower will use all due diligence and make best efforts to complete said transaction as submitted to and approved by the Department.
  - d. All amounts withdrawn from the Account pursuant to this agreement will be applied toward the Transaction Costs approved by the Department.

3. The Department approves a withdrawal from the Account in the amount of \$ \_\_\_\_\_ to be applied toward Transactional Costs. Notwithstanding anything in this Amendment or the Regulatory Agreement, Borrower shall at all times retain in the Account an amount equal to the sum of one month of operating expenses, required deposits into the replacement reserve account and mandatory debt service pursuant to the last Department-approved Annual Report or Audit as required by the Regulatory Agreement.
4. Borrower shall ensure that the amount in the Account shall equal or exceed \$ \_\_\_\_\_ (the "Required Account Amount"), which is deemed to be the sum of 4 months of approved operating expenses, required deposits into the replacement reserve account and mandatory debt service, pursuant to the last Annual Report or Audit approved by the Department, by \_\_\_\_\_, 20\_\_\_. After payment of any Department-required interest, all residual receipts or surplus cash, as defined in the Regulatory Agreement shall be deposited into the Account, and Borrower shall not receive or pay any distribution as defined in the Regulatory Agreement, until the Required Account Amount is reached. In the event that cash flow from the Project is insufficient to achieve the Required Account Amount by the date set forth above, Borrower shall deposit the deficiency from another source of funds so as to guarantee the Required Account Amount is achieved by said date.
5. The Required Account Amount shall be maintained for the term of the Regulatory Agreement and any amendments thereto. If the Department approves any withdrawals from the Account, Borrower agrees to replenish these funds prior to the end of the fiscal year in which the withdrawal is made. Once the amount in the Account equals or exceeds the Required Account Amount, annual deposits to the Account will no longer be required.
6. By \_\_\_\_\_, 20\_\_\_, Borrower shall submit a physical needs assessment and reserve study that details the Project's physical needs and the amount of annual replacement reserve deposits (adjusted for inflation) necessary to meet those needs. Based on this information, the Department will reset the required annual replacement reserve deposit for the Project. Borrower agrees to deposit this amount annually prior to taking any sponsor distributions.
7. The provisions of this Amendment shall supersede any conflicting provisions of the Regulatory Agreement but only to the extent of such conflict. All other terms and conditions of the Regulatory Agreement shall remain in full force and effect.



**IN WITNESS HEREOF**, Borrower and Department execute and enter into this Amendment as of the date first set forth above and agree to be bound hereby:

**DEPARTMENT**

**BORROWER**

**Department of Housing and  
Community Development,  
an Agency of the State of California**

**(insert name of Borrower)**

**By:** \_\_\_\_\_  
**Name:** \_\_\_\_\_  
**Its:** \_\_\_\_\_

**By:** \_\_\_\_\_  
**Name:** \_\_\_\_\_  
**Its:** \_\_\_\_\_

**SPONSOR**

**(insert name of Sponsor)**

**By:** \_\_\_\_\_  
**Name:** \_\_\_\_\_  
**Its:** \_\_\_\_\_

Signatory below agrees to be bound by and agrees to the terms, conditions, and provisions:

**(insert name of Borrower)**

**By:** \_\_\_\_\_  
**Name:** \_\_\_\_\_  
**Its:** \_\_\_\_\_