B. Appendix 8, Section A.8.3 and Section A.8.7 sets forth the instructions and requirements for MAP Lenders to file a prior approval request. The Lender should deliver the prior approval submission to the HUD Regional Center most relevant to future application activity. The Regional Center will then forward this presentation to HUD Headquarters Office of Multifamily Housing Production for review.

8.7 Secondary Financing

A. The amount, form, terms and conditions of any permitted secondary financing must comply with the guidance herein and 24 CFR Sections 200.71 and 200.85. This section provides guidance when secondary funding is included in the project financing plan. Except as specifically noted in this section, the term of any subordinate loan may not mature before the term of the HUD-insured first mortgage. Additional secondary financing guidance for Low Income Housing Tax Credit projects is found in Chapter 14, Section 14.14. Identify all subordinate loan funds in Section III "Source of Funds to Meet Cash Requirements" form HUD-92264-A.

8.7.1 Public Sources

A. For all Sections of the Act (SOA), when secondary financing is funded by sources such as HOME funds, Affordable Housing Program, Federal Home Loan Banks (FHLB), Grants, or other quasi-public, federal, state, or local governmental sources, the following is applicable:

1. The subordinate loan must be documented by a promissory note (with terms similar to form HUD-92223M, Surplus Cash Note) and may be secured with a mortgage lien as prescribed by the governmental funding source and reviewed and approved by HUD and made subordinate to the HUD-insured first mortgage using form HUD-92420-M, entitled "Subordination Agreement - Public." At a minimum, the associated note will need to contain the following language from Section 8.7.5 below. Note that the parties will need to execute and record a Subordination Agreement and the note will need to conform to the terms in Section 3 of the Subordination Agreement.

2. Secondary financing (or grants lent to the property as a secondary loan) may be used to offset up to 100% of the applicable SOA equity requirements, and may also be used to finance non-mortgageable costs, which when added to the HUD mortgage and required equity contribution, may exceed 100% of the project's total cost. None of these sources may be substituted for Tax Credit Equity and all remain subject to the cumulative 75% limit on payments from surplus cash.

3. Non-mortgageable costs (i.e. replacement cost items, not eligible for inclusion in the HUD insured loan) to be financed by the secondary loan, must be certified by the funding source to be reasonable and necessary to complete the project. Documentation to this effect must be included with the application submission.

4. The term of a subordinate loan should generally be coterminous with the HUD insured first mortgage. However, the HUD Underwriter may consider exceptions on a case-by-case basis for public debt when other HUD programs (e.g., the HOME program, National Housing Trust Fund) require shorter amortizations and the risk is mitigated. Examples of mitigants include items such as significant additional public funds, low loan-to-value or loan-to-cost ratios, below market rents or higher than minimum debt service coverage.

5. Any restrictive covenants in the secondary financing must expire upon foreclosure of the HUD insured loan's mortgage or deed to trust. However, when the source of the secondary financing is HOME program funds, HUD will permit the Rider/Restrictive Covenant Agreement to be modified such that the restrictive covenants will survive foreclosure of the FHA insured security instrument. Additionally, state lending programs that provide secondary financing on terms similar to those under the HOME Program may also be considered under this policy on a case by case basis.

8.7.2 Private Sources – Section 223(f)

A. Secondary financing from a private lending source must be evidenced by a promissory note (form HUD-92223M Surplus Cash Note or form HUD-92908M Residual Receipts Note) that may not be modified or altered in any manner without the written consent of HUD. If secured by the Project, the private loan must be subordinated to HUD-insured loan with form HUD-92907M Subordination Agreement – Private.

B. Private secondary financing is permitted to offset mortgageable and nonmortgageable costs up to the difference between the loan-to-value percentage and a maximum combined debt of 92.5% of the fair market value (FMV), **except** in instances when private secondary financing is combined with federal, state or local governmental agency secondary financing. (In these instances, the governmental loan, in aggregate with the HUD first and private second, may exceed the property's FMV.) The 92.5% limitation on combined debt does not apply to Low Income Housing Tax Credit transactions, in which primary and secondary debt together may equal but not exceed 100% of total development costs. (See Chapter 14 for details.)

C. Private secondary financing up to 92.5% total LTV (including both HUD-insured and private secondary financing) may be secured by a lien encumbering the real property.

D. Mezzanine financing is a subordinate loan usually secured by a pledge of ownership interests, rather than by a secondary lien on the real estate or an obligation of the Single Asset Mortgagor Entity. Mezzanine debt terms must be fully disclosed to and approved in writing by HUD. Any mezzanine debt that remains from a previous financing of the property is subject to the secondary financing guidance in this section. Payments on mezzanine financing may be made only from surplus cash, and the debt may not mature before the FHA insured loan. Mezzanine loan interest rates will typically be higher than that of the first mortgage but must be reasonably consistent with market rates for mezzanine debt. Additionally, the interest rate must not be so high that it jeopardizes the ownership stability of the property, or that the interest due cannot reasonably be expected to be repaid from surplus cash. Interest due or accruing on the mezzanine loan must be approved as reasonable by HUD.

E. In the event of nonpayment or default on the mezzanine debt, any transfer of an ownership interest in the Borrower entity or in its principals to the mezzanine Lender must have prior written approval by HUD, through the Transfer of Physical Assets (TPA) process. The mezzanine Lender may exercise no enforcement remedies against the real estate or against the Borrower entity during the term of the mezzanine loan, nor may the mezzanine Lender take action that would trigger a Transfer of Physical Assets (TPA) without HUD approval.

NOTE: Project-specific exceptions or waivers to these policies for mezzanine financing must be approved in writing by HUD and documented in a HUD-2 waiver form.

8.7.3 Private Source – New Construction/Substantial Rehab

A. Private secondary financing is not permitted under Section 221(d)(4) or other new construction/substantial rehabilitation first mortgage programs. The only exception to this consideration is Seller-financed secondary debt (aka seller take-back note). The Seller-financed secondary debt must meet the follow criteria:

1. The FHA loan to replacement cost ratio is less than 50% (80% loan ratio for tax credit applications) of mortgageable cost; and
2. The Seller financed secondary debt is either:
    a. An arms-length transaction; or
    b. It involves an identity of interest transaction and the selling price of the land or building is not greater than the property's "as is" value."
3. Seller-financed secondary debt must also meet all of the following:
    a. It is an inferior cash flow debt, such that cumulative payments for that and any other subordinate debt must not exceed 75% of surplus cash, if available.
    b. It is documented in a promissory note that is not recorded and not secured with a lien against the property; this prohibition on a lien does not apply to LIHTC transactions (see Chapter 14).
    c. It does not contain any provision of foreclosure that would threaten the first mortgage.
    d. It is subject to automatic re-subordination in any subsequent refinancing of the first mortgage; and
    e. The subordinate debt does not have a balloon payment or maturity prior to maturity of the FHA-insured first mortgage.

8.7.4 Section 223(a)(7) Refinance Program

A. For Section 223(a)(7) applications, secondary financing terms are governed by the SOA of the underlying insured mortgage but shall not be used directly or indirectly to provide funds for an equity takeout or a Transfer of Physical Assets.

8.7.5 Condition for Repayment of Secondary Financing

A. (Subordination Agreement – Public (form HUD-92420M) and Subordination Agreement – Private form HUD-92907M). Required repayment of this and any other secondary debt, including interest, must be made solely payable cumulatively from up to 75% of available surplus cash. Consider using form HUD-92223M or including the following language in the secondary financing promissory note, or otherwise ensure the transaction provides for the following:

> *"So long as the Secretary of Housing and Urban Development or his/her successors or assigns, are the insurers or holders of the first mortgage on **(insert project name and FHA Project No.)**, the total payment(s) due under this Note, and all other secondary debt instruments shall be payable and shall not cumulatively exceed 75% of available surplus cash. Non-project sources that are outside the Mortgaged Property may also be used to repay subordinate financing. The term surplus cash is defined in the Regulatory Agreement dated **(insert date)** between HUD and **(insert name of Borrower)**. The restriction on payment(s) imposed by this*

paragraph shall not excuse any default caused by the failure of the maker to pay the indebtedness evidenced by this Note."

B. This language does not need to be added to the Subordination Agreement – Public (form HUD-92420M) or the Surplus Cash Note (form HUD-92223M)

8.7.6 Secured Public Secondary Financing Conditions

A. A publicly financed subordinate loan must be made subject to the Subordination Agreement Public, HUD-92420M, which includes, among other provisions, the following terms:

1. The Lender on the FHA-insured mortgage (first mortgage) consent to the placing of the subordinate lien and confirm that its existence does not create a basis for default on the insured first mortgage.
2. The subordinate lender certifies that the subordinate loan documents do not contain a cross default provision or any right of foreclosure before the termination of the FHA-insured mortgage.
3. The subordinate loan is assumable when a sale or transfer of physical assets occurs, and the insured first mortgage remains in place.
4. The subordinate loan automatically terminates if HUD acquires title to the project by a deed in lieu of foreclosure.
5. Repayment of the subordinate loan from Project Assets is limited to 75% Surplus Cash.
6. Subordinate lender agrees to extend the subordinate loan under certain circumstances (e.g., insufficient surplus cash for repayment when due and payable).

B. Both the subordinate lien, as modified by the Subordination Agreement Public, HUD-92420M, and the insured first mortgage loan documents must be recorded prior to or on the day of closing. Though recordable closing documents are frequently recorded in advance of actual closing, the subordinate loan may not be funded until closing. See Chapter 19, Section 19.1.3.4 for details on closing arrangements.

8.7.7 Unsecured Private Secondary Financing Conditions

A. Terms of unsecured private Promissory Notes must reflect those provisions found in: form HUD-91710M, Residual Receipts Note [Non-profit Borrower], or form HUD-91712, Residual Receipts Note [Limited Dividend Borrower], or form HUD-92223M, Surplus Cash Note [Profit Motivated Mortgagors] based upon the type of Borrower; or Form *Residual Receipts Note* (form HUD-92908M), when Borrower's distributions are restricted through a *Residual Receipts Rider* to the *Regulatory Agreement*. See the Closing Chapter 19, Section 19.4.8.2 for further details.

1. Form HUD-91710M, Residual Receipts Note (for Non-profit Mortgagors) and form HUD-91712M, Residual Receipts Note (for Limited Dividend Mortgagors).
    a. Principal and interest shall be due and payable on or after the maturity date of the HUD-insured mortgage.
    b. If the HUD-insured mortgage is prepaid in full, the holder of the residual receipts note has the right to declare the entire principal sum or any remaining balance including any accrued interest immediately due and payable.

c. Prepayments to principal and interest:

   1) may be made (a) from the residual receipts as defined in the Regulatory Agreement only after obtaining written approval from HUD or (b) from sources other than Project Income or Project Assets, e.g., syndication proceeds.

   2) may be made only after final endorsement of the insured mortgage and after the end of a semiannual or annual fiscal period.

d. if unauthorized prepayment is accepted, the funds shall be returned to the project immediately upon discovery.

e. The residual receipts note is nonnegotiable and may not be sold, transferred, assigned, or pledged by the payee.

f. Presentation, demand and notice of demand, nonpayment and protest of the residual receipts note are waived.

g. Interest on the note must not compound; however, for LIHTC projects, HUD will consider compounding of interest pursuant to the instructions in Chapter 14, Section 14.11.B.5 of the MAP Guide.

2. Form HUD-92223M, Surplus Cash Note (for all other mortgagor entities). The conditions and limitations are the same as form HUD-91710M, except that:

   a. Provisions may be made for interest payments annually or semiannually or at the end of a fiscal period. However, the Note should provide for interest to accrue and be payable in full at maturity.

   b. Prepayment of principal or any payment of interest must be limited to sources other than Project Income or Project Assets, e.g., syndication proceeds or surplus cash as defined in the Regulatory Agreement.

   c. Payments on promissory notes will be made only as permitted by the applicable Regulatory Agreement, but prepayment of the promissory notes from sources other than the project is permitted without HUD approval.

   d. Should any unauthorized prepayments be made, as determined by HUD, it shall be the responsibility of the Borrower to return them to the project.

   e. Interest on the Note must not be compounded, however for LIHTC and otherwise affordable projects, HUD will consider compounding of interest pursuant to the instructions in Chapter 14, Section 14.11.B.5 of the MAP Guide.

8.7.8 Tax Credit Equity Bridge Loans

A. Tax credit equity syndicators or investors (with or without an identity of interest with the MAP Lender) may make bridge loans to fund required equity contributions for LIHTC, Historic or New Market Tax Credits during the construction or substantial rehabilitation period as described in Chapter 14, Section 14.14.