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**MARK-TO-MARKET ("MTM") ASSUMPTION
AND TRANSFER OF MTM DEBT TO A QUALIFIED NON-PROFIT ("QNP")
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OVERVIEW

Projects with debt restructured through HUD's MTM program generally have FHA insured first loans and one or two tranches of HUD-held subordinate debt (the "MTM Debt") payable out of a percentage (typically 75%) of surplus cash. The MTM Notes contain acceleration provisions making them due in the event the Project is sold (including transfer of certain ownership interests) or its senior debt is refinanced. HUD has discretion to waive these requirements in certain circumstances and also to agree to assign/forgive the MTM Debt to a "Qualified Non-Profit." The main HUD guidance is Notice H2012-10 and Appendix C to the Mark-to-Market Operating Procedures Guide. The Waiver Request is processed with HUD Headquarters Office of Recapitalization ("Recap") (formerly the Office of Affordable Housing Preservation – "OAHP") and a Full Transfer of Physical Assets ("TPA") is processed simultaneously with the applicable HUD field office.

MTM WAIVER REQUIREMENTS – OVERVIEW: HUD has the following general waiver requirements:

Maintain Property Viability

- 1.20 Debt Service Coverage required on new first loan.
- New first mortgage generally must be fixed rate and fully amortizing (i.e. no balloons)
- 7-10% operating expense cushion
- Review of adequacy of reserves, operating accounts and vacancy rates.

Maintain the Value of the Notes

- HUD looks at the present value of the MTM Notes as underwritten compared to the proposed transaction and as compared to the Project's recent performance (i.e. whether the Project is generating surplus cash at the projected rate from original underwriting).
- The criteria is satisfied if the first mortgage debt does not change.

Proceeds – Pay-down of the MTM Notes: If there are "Proceeds" in the transaction, HUD will require a portion be used to pay down the MTM Debt.

- Proceeds Definition: HUD has an expansive definition of "Proceeds" which includes any payments to Seller or affiliates, including payments to be made after closing and also includes any Seller retained reserves, residual receipts or escrows. Transaction costs, legal fees, broker fees, and principal portion of unpaid (post-closing) Capital Recovery Payment ("CRP") can be deducted from Proceeds. Developer fee is classified as Purchaser Proceeds.

- Pay-down Calculation: For MTM assumptions, HUD generally requires a pay-down of the MTM Debt in the amount of the greater of 50% of the Proceeds to the Seller or 33% (1/3) of the Proceeds in the deal, which includes developer fee.

- Strategic Community Property Eliminates Developer Fee: If the transaction qualifies as a "Strategic Community Property" transaction, regardless of whether it is also a QNP transaction, developer fee is *not* included in the pay-down calculation. Strategic Community Property criteria are discussed under the QNP section below.

Green Incentives: HUD provides incentives to owners to increase the Incentive Performance Fee ("IPF"), permitting more surplus cash to be distributed, if proposed rehab meets established green standards (i.e. LEED, Enterprise Green Communities).

QNP ELIGIBILITY: HUD also will assign the MTM Debt to a QNP or permit the MTM Debt to be forgiven.

Purchaser Requirements: The program requires a deed transfer of the Property.

As a threshold matter, the Purchaser "nonprofit" must be "independent", "tenant endorsed" and "community based" as follows:

- *Nonprofit:* The nonprofit buyer must be organized under the state law of its incorporation as a nonprofit; it can be a LLC or limited partnership if the nonprofit is the sole general partner or sole managing member.

- *Independent:* The purchaser cannot be "dependent" on any for-profit entity, including the seller. Safe Harbor criteria for qualifying are:
  - No for-profit has control over the nonprofit.
  - Seller and its affiliates have no control over the nonprofit.
  - For three years prior to sale, Seller has not provided any financial support, goods or services to the nonprofit or its affiliates.
  - Purchase and Sale Agreement describes all consideration to Seller.
  - After the sale, Seller does not retain any financial interest (equity, debt, any repayment from cash flow) in the property nor provides goods or services to property.
  - If the Purchaser does not meet the "safe harbor" requirements, it can make a showing of "independence."

- "*Tenant endorsed*": The nonprofit buyer must have the majority of tenant head of households of occupied units give endorsement in writing to the nonprofit buyer.

- "*Community based*": The nonprofit must have/be one of the following: (a) 1/3 of board are tenants or low income members of the community, (b) it must have established a "community advisory board" approved by HUD – which board has a substantive voice in project operations, or (c) it must be a CDBA, CHDA or CDFI [most NP's set up the "community advisory board"].

Nonprofit Issues: If the Seller is a nonprofit corporation or nonprofit controlled partnership, if the nonprofit stays in the deal the Purchaser may be a tax credit entity in which the nonprofit seller acts as the sole general partner or sole managing member"

Recapitalization: The transaction must be necessary to "recapitalize" the Property.

Use Restriction: The Purchaser must accept an extension of the MTM Use Agreement from 30 years to 50 years and a 10 year restriction on sale (i.e. the Purchaser can only sell the Project to another QNP for 10 years and sale approval is in HUD's sole discretion).

QNP - General Transaction Requirements

- Strategic Community Property -- long term preservation and affordability: the specific criteria are below. Note that Recap has recently started specifically emphasizing the kind of physical rehab likely to be found in an LIHTC transaction, and informally we have heard the target is $25,000/unit.
    - Demonstrate preservation need:
        - Physical/capital needs/obsolescence
        - Inadequate reserves
        - Market demand for affordable housing
        - Operating history
    - Demonstrate need for additional financing since restructuring.
        - Nonperformance or underperformance on MTM Note payments.
    - Showing that transaction achieves physical/financial stability; reasonable underwriting assumptions.
    - Community based support for the project (broad, financial and any other such support – local govt, housing authority).
    - Sizable non-HUD resources to support capital needs and operating stability
    - Ownership preservation experience and intent.
    - Substantial deferred developer fee (25% rule of thumb).
    - Extended affordability agreement – meaning an additional 20 years required for the Use Agreement, which is already a requirement of the QNP program and helpful if there are additional long-term affordability restrictions.
    - Other information HUD desires.

- Maintain Property Viability: The transaction must maintain property viability as described above (1.20 debt service coverage; 7-10% operating expense cushion) but new first mortgage debt does not generally have to be fixed rate/fully amortizing and HUD does not review the present value of the MTM Notes.

- Pay-downs: The same guidance applies, but the pay-down is only based on Seller Proceeds.

ADDITIONAL CONSIDERATIONS – ALL TRANSACTIONS

- Limited Distribution: While the MTM Debt is outstanding (either held by HUD or a QNP), any distribution limitation in the original HAP Contract is superseded. If the Project has a "new reg" HAP Contract, the original limited distribution applies when the MTM Debt is paid off..

- Reserves: If the Project has a New Reg HAP Contract, HUD continues to control the reserve for replacements even if the insured debt is paid off and the MTM Debt assigned to a QNP.

- Rent increases: Rent increases are OCAF only for the life of the MTM Use Agreement. The Project is ***not*** eligible for a budget based rent increase or to Mark-up-to-Market for the life of the MTM Use Agreement. Projects restructured with exception rents have additional limitations.

- Final Partial Year SCA: HUD will do a final partial years' surplus cash calculation to calculate the final seller payment owed to HUD on the MTM note and confirm all prior year SCAs are clear.