

WHEN YOUR CLIENT GETS FANCY FINANCING *REVENUE BOND LOANS AND HUD LOANS*

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Two kinds of closings add extra requirements to the borrower's usual tasks: revenue bond closings, in which private financing is funneled through a public agency for tax benefits; and HUD closings, in which the United States Department of Housing and Urban Development either acts as lender or as insurer of a loan for construction or development.

We will consider the implications of these two situations for title insurance coverage, as to the clearance requirements, closing procedures, and the forms of the title insurance policy and endorsements.

Revenue Bond Loans

I. Structure

The name "revenue bond closing" is a shorthand reference to a transaction designed to take advantage of a provision in the Internal Revenue Code exempting from federal taxation interest on bonds issued by municipalities and some other agencies.¹ Of course, there are many variations, but a prototype scenario starts with the agency (herein this term will include municipalities² and certain state agencies such as the Illinois Development Finance Authority³).

The agency issues a bond or a series of bonds—that is, a debt instrument with a defined rate of interest as its yield. The bond or bonds are sold to investors through a bond underwriter. Under the terms of a trust indenture, the agency turns over the bond proceeds to a trustee for the benefit of the

bondholders, and assigns to the trustee the right to collect repayment on behalf of the bondholders. The trust indenture empowers the trustee to administer the funds.

These funds are loaned to a borrower for a project of some sort: acquiring or building a factory or other enterprise, constructing or expanding a hospital, residential care facility, or an apartment building, for example. The funds are often used for construction but not necessarily so; disbursement by the trustee may be staged with construction draws or may be fully paid at the outset.

The borrower may sign a mortgage to secure repayment of a note, or a mortgage to secure repayment of the bonds. More frequently in recent years, bond underwriters require the borrower to obtain a letter of credit on which the trustee can draw in case of failure to repay the loan, avoiding for the investors the expense and delay of foreclosure proceedings. The bank issuing the letter of credit requires the borrower to execute a reimbursement agreement obligating it to repay the bank in the event the trustee draws on the letter of credit. The borrower secures performance of the reimbursement agreement by giving the bank a mortgage on the project property. It is this mortgage that is the subject of the title insurance policy.

II. Benefits

At this point, the obvious question may be: WHY? This tremendous barrage of paper, and funneling of funds through the various players has to have

reasons to justify itself.

Since the investors (buyers of the bonds) do not owe federal income tax on the bond interest they will receive, and many of the state authorizing statutes also exempt the interest from state income tax, the return can be lower than market rate but still be a profitable investment. This opportunity to pass along to the borrower at least some of the benefit of the lower-than-market borrowing rate is the essential driving force for bond transactions.

The agency accomplishes the public purpose of stimulating local business, creating local jobs, or meeting social needs without spending local tax dollars. Revenue bonds differ from ordinary municipal bonds in that public funds are not at risk to repay the bonds.⁴ The agency is a conduit between the investor and the borrower, and neither the terms of the loan documentation nor the authorizing statutes provide for any recourse to the agency or to public funds if the bondholders are not repaid out of the revenues from the project itself. Additionally the agency receives a fee for its participation.

III. Title Insurance Services

The mortgage securing the borrower's performance under the reimbursement agreement is insured usually by means of a regular ALTA loan title insurance policy rather than a construction loan policy. Many banks prefer this because the issuance of the letter of credit constitutes full disbursement of the loan, so long as the letter of credit is issued unconditionally and irrevocably to the order of the trustee, requiring only a draft in proper form to obtain the funds.

If the funds are being used for construction, an exception will be raised for mechanics liens arising from services, labor, or materials furnished after the date of the policy. This exception can be modified to reflect coverage at the time of each construction draw, as part of a date down endorsement; there will, however, be no exception for "pending disbursement." In this model the bank issuing the letter of credit (the mortgagee) is the named insured in the loan policy.

In another scenario, there is no letter of credit, and the mortgage secures the borrower's obligation to repay the bond indebtedness to the indenture trustee; in this case the trustee (as mortgagee or assignee of the mortgagee) is the named insured in the loan policy, as above, a regular ALTA loan policy.

The title insurer will need to be satisfied that the agency is acting with good authority, in the form of a resolution by a municipality⁵ or board resolutions by IDFA⁶ or any of the many authorities empowered by various statutes to issue revenue bonds. These authority documents commonly recite the specific public purpose for the bond issue and the conditions of issuance and performance.

If there is a letter of credit, the title insurer should examine it to see that it is irrevocable and unconditional. The title insurer must also ascertain that the letter of credit is delivered to the trustee, as this constitutes disbursement of the loan, and is necessary for insuring the lien of the mortgage. The reimbursement agreement should also be furnished to the title insurer. A "Letter of Credit Endorsement" is available, affirmatively insuring against invalidity or lack of priority of the mortgage as a result of its securing repayment of a letter of credit rather than an ordinary debt consisting of disbursed loan funds.

The endorsement also insures against avoidance by a trustee (on a preference or fraudulent conveyance theory) in any future bankruptcy of the debtor, if such avoidance is based on the fact that loan funds are found to be undisbursed. (See attached exhibit A). In addition, other documents comprising the transaction are useful to the title insurer to get an overview. The bond counsel's opinion letter, the trust indenture, and the loan agreement are examples.

Sometimes the insured requires construction date down endorsements for interim mechanics lien coverage at the times of draws. These endorsements can be issued in the usual construction escrow process in which the title insurer examines sworn statements and lien waivers and administers the



funds as directed, paying either the general contractor or the subcontractors and suppliers. Alternatively, the trustee may choose to make its own disbursements but wishes the title company to examine the statements and waivers. This service is known as “outside interim” coverage.

HUD Loans

In contrast to bond loans, which can take and over the years have taken as many forms as ingenious lawyers can concoct, HUD construction or development loans vary only according to their statutory authorization. They are governed by statutes, regulations, and the requirements of the HUD office administering the loans. (At present the HUD Chicago office is the only Illinois office.)

While the majority of HUD-related loans are for FHA insured single-family residences, this discussion will cover larger projects. Of the many HUD programs, some of the most commonly used are “multi-family” or “commercial” loans made by FHA-approved lenders for financing construction of apartment complexes, nursing homes, and hospitals. In these programs HUD insures the lender.

Also there is a widely used capital grant program in which HUD is the source of the funds and is the mortgagee in the insured mortgage. Section 202, for example, authorizes loans for construction or rehab of housing for low-income elderly; section 811 applies to housing for disabled persons.⁷ It is not unusual for a project to have “mixed financing,” in which there is an FHA-insured first loan and a junior loan from the City of Chicago or the Illinois Housing Development Authority, for example. Many of these “mixed financing” projects also involve bonds and low income housing tax credits, and the documentation can become very complex.

I. Documentation required by HUD

HUD mortgages come on printed government forms and normally are not varied. A separate regulatory agreement and a use agreement bind the borrower to conditions during the term of the loan

and sometimes include restrictions that survive the payment and release of the loan. Also, financing statements will be filed locally and at the office of the Secretary of State in Springfield. HUD requires certified copies of all documents affecting the property including, for example, easements created by grant or by plat of subdivision, as well as the newly recorded loan documents. A title company certification is acceptable.

HUD requires the borrower to establish an escrow for real estate taxes not yet billed—this is required even of tax-exempt organizations in the event the borrower does not secure or maintain its exemption. HUD has many other requirements including the building loan agreement, the projected budget, the housing assistance payment contract, and various guarantees and certifications from the borrower.

Additionally, a direct deposit procedure for successive disbursements of loan proceeds must be in place before the closing. A special HUD form must be completed by the borrower and the construction escrowee and accepted by the escrowee’s bank.

II. Title Services

HUD requires the 1992 ALTA loan policy adapted for construction loans and further adapted to its requirement of mechanics lien coverage through the date of disbursement of each draw rather than the customary coverage through the date of the general contractor’s sworn statement. (See Exhibit B for the HUD Date Down Endorsement 7(modified).)

Since the insurer relies on the contractor’s sworn statement as a basis for coverage, the extension to the date of disbursement (which is always later than the contractor’s statement) requires a backup personal undertaking from the borrower and sometimes the general contractor. This is in addition to the owner’s and general contractor’s sworn statements with all supporting waivers and affidavits routinely submitted for a construction draw.

If the survey reflects matters such as encroachments or utility lines lying outside a

recorded easement, HUD will require an endorsement to the title policy, insuring against loss or damage incurred as a result of the encroachment or adverse right reflected by the utility lines.

One source of difficulty occurs when a mechanics lien is recorded against the property. HUD does not accept a policy with a recorded lien, even with an endorsement insuring over the lien. This puts the borrower at a disadvantage in that the borrower must settle the lien and obtain a release. If the borrower could have the title company hold an indemnity to insure over the lien, this would leave the borrower in a position to negotiate with the lien claimant.

HUD sometimes requires the regulatory agreement and the use agreement to be shown on Schedule A, insured along with the mortgage itself.

At the initial closing the loan documents are recorded, and everything is signed up and in place

for work to begin. There may or may not be a partial disbursement at this time. However, the loan will be completely disbursed in successive construction draws. At the completion of construction, there is a second closing in which HUD receives a 1992 ALTA loan policy free of any exceptions for pending disbursement or mechanics liens.

Conclusion

We have presented information on these specialized types of loans as they relate to obtaining title insurance and escrow services. The common thread, of course, is that both categories, revenue bond loans and HUD loans, involve government cooperation in private projects. The benefit is direct and obvious in the case of HUD, and indirect in the case of the tax exemptions that drive bond loans. Regardless of one's view of the appropriateness of the statutory schemes supporting these transactions, it is clear that government assistance works for rich and poor alike.

BIBLIOGRAPHY

1. 26 U.S.C.A., 103 and 144(c).
2. 65 ILCS 5/11-7-1 et seq. "The Industrial Project Revenue Bond Act."
3. 20 ILCS 3505/1 et seq. "The Illinois Development Finance Authority Act. An act to create the Illinois Development Finance Authority for the purpose of creating and increasing job opportunities in labor surplus areas in the State of Illinois."
4. 65 ILCS 5/11-74-10 applies to municipalities, and 20 ILCS 3505/13 applies to the Illinois Development Finance Authority.
5. 50 ILCS 445/5.
6. 20 ILCS 3505.
7. Examples of the many authorizing titles are 42 U.S.C.A. 8012 , for capital grants for "Supportive Housing for Persons with Disabilities," and 12 U.S.C.A. 1701, authorizing capital grants for the 202 Program, and authorizing FHA insurance for apartment projects, nursing homes, and hospitals among others.



EXHIBIT "A"

ENDORSEMENT

Attached to and forming a part of
Title Insurance Policy No. _____.

LETTER OF CREDIT ENDORSEMENT

THE COMPANY INSURES THE INSURED AGAINST LOSS OR DAMAGE SUSTAINED BY THE INSURED BY REASON OF THE ENTRY OF A FINAL ORDER OF A COURT OF COMPETENT JURISDICTION DETERMINING:

1. THAT THE LIEN OF THE MORTGAGE DESCRIBED IN SCHEDULE A IS INVALID AS SECURITY FOR PAYMENTS THE INSURED IS LEGALLY OBLIGATED TO MAKE AND DOES MAKE UNDER THE TERMS OF THE (LETTER OF CREDIT, SURETY BOND) DESCRIBED IN SAID MORTGAGE;
2. THAT THE PAYMENTS DESCRIBED IN PARAGRAPH 1 ABOVE ARE NOT ENTITLED TO THE SAME LIEN PRIORITY OVER LIENS, ENCUMBRANCES, AND OTHER MATTERS DISCLOSED BY THE PUBLIC RECORDS SUBSEQUENT TO THE DATE OF POLICY AS WOULD BE AFFORDED TO PAYMENTS MADE AT THE DATE OF POLICY; OR
3. THAT THE LIEN SECURING THE PAYMENT DESCRIBED IN PARAGRAPH 1 ABOVE IS SUBJECT TO AVOIDANCE UNDER SECTIONS 544, 547, 548, OR 549 OF THE BANKRUPTCY CODE (AS SUCH SECTIONS EXIST AS OF THE DATE OF THIS POLICY) IN A PROCEEDING NAMING THE MORTGAGOR AS DEBTOR.

THIS ENDORSEMENT IS NOT TO BE CONSTRUED AS INSURING AGAINST LOSS RESULTING FROM ANY STAY OF ENFORCEMENT OR EFFECT OF THE BANKRUPTCY CODE WHICH COULD HAVE BEEN SUSTAINED BY THE INSURED IF ALL DISBURSEMENTS INTENDED TO BE SECURED BY THE MORTGAGE HAD BEEN MADE PRIOR TO THE FILING OF ANY PROCEEDING UNDER THE BANKRUPTCY CODE.

THIS ENDORSEMENT IS MADE A PART OF THE POLICY AND IS SUBJECT TO ALL OF THE TERMS AND PROVISIONS THEREOF AND OF ANY PRIOR ENDORSEMENTS THERETO. EXCEPT TO THE EXTENT EXPRESSLY STATED, IT NEITHER MODIFIES ANY OF THE TERMS AND PROVISIONS OF THE POLICY AND ANY PRIOR ENDORSEMENTS, NOR DOES IT EXTEND THE EFFECTIVE DATE OF THE POLICY AND ANY PRIOR ENDORSEMENTS, NOR DOES IT INCREASE THE FACE AMOUNT THEREOF.

EXHIBIT "B"

ENDORSEMENT

Attached to and forming a part of
Title Insurance Policy No. _____.

DATE DOWN ENDORSEMENT 7 (MODIFIED) (HUD)

SCHEDULE A OF THE ABOVE POLICY IS HEREBY AMENDED IN THE FOLLOWING PARTICULARS:

1. THE EFFECTIVE DATE OF THE POLICY IS HEREBY EXTENDED TO: (DATE OF DEPOSIT)
2. THE ESTATE OR INTEREST DESCRIBED IN SCHEDULE A IS AT THE EXTENDED EFFECTIVE DATE OF POLICY VESTED IN:

SCHEDULE B OF THE ABOVE POLICY IS HEREBY AMENDED IN THE FOLLOWING PARTICULARS:

1. THE FOLLOWING EXCEPTION NUMBERS ARE HEREBY ADDED:
2. THE FOLLOWING EXCEPTION NUMBERS ARE HEREBY DELETED:
3. THE FOLLOWING EXCEPTION NUMBERS ARE HEREBY AMENDED TO READ AS FOLLOWS:
 - (A) TAXES FOR THE YEARS:
4. THE EXCEPTIONS IN SCHEDULE B RELATING TO "ANY LIEN OR RIGHT TO A LIEN, FOR SERVICES, LABOR OR MATERIAL" ETC., AND TO THE "RIGHTS OF MECHANICS AND MATERIALMEN" ETC., ARE HEREBY DELETED AND THE FOLLOWING EXCEPTIONS ARE SUBSTITUTED THEREFOR

(A) ANY LIEN, OR RIGHT TO A LIEN FOR SERVICES, LABOR OR MATERIAL FURNISHED AFTER (DATE OF DEPOSIT)

(B) RIGHTS OF MECHANICS OR MATERIALMEN WHO ARE NAMED ON THE CONTRACTOR'S STATEMENT DATED ____ (G-C STATEMENT DATE) ____ AND OF MECHANICS OR MATERIALMEN CLAIMING BY, THROUGH OR UNDER THEM, TO THE EXTENT IF ANY, THAT THE AMOUNTS SHOWN IN SAID STATEMENT AS BEING UNPAID RELATE TO WORK, LABOR AND MATERIAL ACTUALLY IN PLACE ON SAID LAND ON (G-C STATEMENT DATE) ____



EXHIBIT "B" cont.

5. THE "PENDING DISBURSEMENT ENDORSEMENT" AND THE "INTERIM MECHANICS' LIEN ENDORSEMENT" APPEARING UNDER SCHEDULE B ARE HEREBY DELETED AND THE FOLLOWING ENDORSEMENTS ARE SUBSTITUTED THEREFOR:

(A) PENDING DISBURSEMENT ENDORSEMENT:

ANYTHING IN THIS POLICY AND ANY ENDORSEMENT THERETO NOTWITHSTANDING, THE LIABILITY OF THE COMPANY UNDER SAID POLICY SHALL NOT EXCEED THE SUM OF \$ (BEING THE AMOUNT ACTUALLY DISBURSED OF THE PROCEEDS OF THE LOAN SECURED BY THE MORTGAGE DESCRIBED IN SCHEDULE A AT THE DATE OF SAID POLICY) AND COSTS WHICH THE COMPANY IS OBLIGATED UNDER THE CONDITIONS AND STIPULATIONS TO PAY, BUT SUCH LIABILITY SHALL BE INCREASED BY THE SUM OF EACH SUBSEQUENT DISBURSEMENT MADE UNDER SAID MORTGAGE UP TO THE FACE AMOUNT OF THE POLICY; SUBJECT, HOWEVER, WITH RESPECT TO EACH SUCH INCREASE, TO ANY DEFECTS, LIENS, ENCUMBRANCES, ADVERSE CLAIMS OR OTHER MATTERS WHICH MAY BE DISCLOSED UPON AN EXAMINATION AND DOWN TO AND INCLUDING THE DATE OF EACH DISBURSEMENT;

(B) INTERIM MECHANICS' LIEN ENDORSEMENT:

THE COMPANY HEREBY INSURES THE INSURED AGAINST LOSS OR DAMAGE WHICH THE INSURED SHALL SUSTAIN BY REASON OF ANY INACCURACY IN THE FOLLOWING ASSURANCE:

THE LIEN OF THE MORTGAGE DESCRIBED IN SCHEDULE A IS FIRST, PRIOR AND SUPERIOR TO ANY OTHER LIENS (INCLUDING MECHANICS' AND MATERIALMEN'S LIENS) NOT SHOWN IN SCHEDULE B OF THE POLICY TO THE EXTENT OF \$, ADVANCED OUT OF THE PROCEEDS OF THE MORTGAGE.

THIS ENDORSEMENT IS MADE A PART OF THE POLICY AND IS SUBJECT TO ALL OF THE TERMS AND PROVISIONS THEREOF AND OF ANY PRIOR ENDORSEMENTS THERETO. EXCEPT TO THE EXTENT EXPRESSLY STATED, IT NEITHER MODIFIES ANY OF THE TERMS AND PROVISIONS OF THE POLICY AND ANY PRIOR ENDORSEMENTS, NOR DOES IT EXTEND THE EFFECTIVE DATE OF THE POLICY AND ANY PRIOR ENDORSEMENTS, NOR DOES IT INCREASE THE FACE AMOUNT THEREOF.

TITLE INSURANCE COMPANY
BY

AUTHORIZED SIGNATORY

NOTE: THIS ENDORSEMENT SHALL NOT BE VALID OR BINDING UNTIL COUNTERSIGNED BY AN AUTHORIZED SIGNATORY.

