

## Appendix 12 Construction Period

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### 12A Instructions for Approval of Initial / Interim Advances

Insurance of advances is the process of releasing FHA-insured mortgage proceeds and other funds necessary for the construction, acquisition and/or refinancing of the project. Chapter 12 Section 12.7 *Insurance of Advances and Related Matters* explains the general criteria to advance the mortgage proceeds and other funds. Appendix 12A and Appendix 12B provide the procedures and the HUD Forms (HUD-92403 and HUD-92448) required to request the initial and interim monthly advances of mortgage proceeds by the MAP Lender, borrower, and the general contractor.

#### A. Approving Initial/Interim Advances – Form HUD-92403 Application for Advance of Mortgage Proceeds

1. Before any FHA-insured mortgage proceeds are advanced, funds provided by the Borrower must be disbursed in full for project work, material, and incidental charges, and expenses from other available funding sources in the following order:
  - a. All funds from the cash escrow established by the Borrower for: onsite construction, fees, carrying charges (e.g. taxes, insurance MIP, exam fee, inspection fee, GNMA fee, title and recording), and financing (front money escrow).
  - b. Grant/loan proceeds furnished by a national, regional, or local community service organization or a private source.
  - c. Grant/loan proceeds furnished by a government agency or instrumentality or low-income housing tax credit syndication proceeds, or historic tax credits syndication proceeds, or new market tax credit proceeds, need not be fully disbursed before the disbursement of mortgage proceeds as long as the Regional or Satellite Office Director has previously approved a pro-rata agreement for governmental source funds and tax credits per 24 CFR 200.54. In the case of mortgage insurance for construction or rehabilitation, (purchase or refinancing) of a multifamily tax credit project, HUD may not require the escrowing of tax credit equity or any other form of security, such as a letter of credit.

2. The amount approved for a requested item cannot exceed the amount claimed by the Borrower. Release of the front money cash escrow may not be targeted to the completion of specific on-site improvements.
3. The MAP Lender will state on Form HUD-92403 the cumulative total of all advances made to the Borrower, including the advance under consideration. Reconcile any discrepancies before recommending approval of the advance.
4. MAP Lender-approved disbursement amounts shall not exceed the sum of the amounts approved:
  - a. For mortgage insurance,
  - b. For funding from the Borrower's cash escrow; and
  - c. For funding from available grant/loan proceeds.
5. Project Completion Funding and Disbursement of Tax Credits at Initial Endorsement  
The Housing and Economic Development Recovery Act of 2008 (HERA) provides that if the project will receive the benefit of equity from the sale of low-income housing tax credits (LIHTC) syndication proceeds, historic tax credits syndication proceeds, or new markets tax credit proceeds, HUD may not require the escrowing of the equity, or accept any form of security in place thereof, such as a letter of credit. Therefore, the Borrower will deposit with the MAP Lender cash that is sufficient, when added to the proceeds of the insured mortgage, to assure completion of the project and to pay the initial service charge, carrying charges, and legal and organizational expenses incident to the construction of the project. The Lender may accept a lesser cash deposit or an alternative to a cash deposit, where the required funding is to be provided by a grant or loan from a Federal, State, or local government agency or instrumentality.
  - a. As a special condition to the firm commitment, the lender is required to provide HUD with the most recently updated Equity Contribution Schedule. A Disbursement Agreement that reflects the terms of the Limited Partnership Agreement or Operating Agreement for the remaining outlay of tax credit equity contributions must also be provided prior to Initial Closing.
  - b. The Borrower's minimum initial equity installment is twenty percent (20%) of the total tax credit equity allocated for mortgageable and nonmortgageable costs (10% may be funded with an equity bridge loan). The initial installment shall be disbursed in accordance to the amounts approved by the Regional or Satellite Office Director per the pro-rata agreement for governmental sources funds and tax credits per 24 CFR 200.54".

- c. Subsequent contributions should be made at a time and in a manner during construction to ensure that the statutory limitations based on actual costs for the applicable FHA mortgage program are maintained during construction.
- d. Tax credit equity pay-ins related to Investor/Syndicator required reserves and/or escrows may be made after construction completion pursuant to benchmarks established in the partnership or operating agreement.

B. Architect's Fees

1. The Architect's cash fee is in AIA Document B108, Standard Form of Agreement Between Owner and Architect for a Federally Funded or Federally Insured Project.
2. The Architect's design cash fee may be released with the initial advance.
3. Design services provided by others as detailed in the B108 must be supported by contracts approved by HUD during commitment processing before any funds may be advanced.
4. The Mortgagor's and Architect's Certificate, Form HUD-92403.01, must accompany any request or partial request for advance of the design fee.
5. The Architect's supervisory cash fee is advanced based on a percentage of completion method. The maximum amount that may be approved is computed by multiplying the Architect's supervisory cash fee by the percentage of work completed and approved on Form HUD-92448, then deducting the total of installments previously paid.
6. There is no "holdback" applied to the disbursements approved from the Architect's Cash Fee.

- C. Interim Insurance of Advances, the Carrying Charges, Financing, Legal, and Audit Expense must not exceed their allocations in the Building Loan Agreement. Approve items due or already paid by the mortgagor that are supported by bills and/or paid invoices/ receipts on the initial advance. Do not approve costs for interest, taxes and insurance incurred during early start period.

Note: At cost certification, certify to the actual cost without regard to release limitations imposed by the Building Loan Agreement during the Construction period.

1. Interest is advanced only when and as earned. The MAP Lender must specify on Form HUD-92403, the period(s) for which interest is requested and the amount for each period.
  - a. At initial closing, check each interest request for accuracy, i.e. 360-factor, and the

annual interest rate approved at Initial Endorsement.

- b. The MAP Lender is prohibited from drawing down interest and refunding a portion of the money to the borrower. Such practice constitutes a kickback and is not acceptable to HUD and will be treated as a direct mortgage reduction. It is appropriate to allow amounts for fire, windstorm, extended coverage, liability, and other risk insurance customarily insured against in the community.
  - c. Do not allow amounts that accrued before Initial Endorsement.
  - d. Do not approve bills, invoices/receipts for workmen's compensation and/or public liability insurance that are included in the cost estimate.
2. Taxes.
- a. Do not allow amounts that accrued before Initial Endorsement.
  - b. Approve invoices that are payable during construction, even if a portion of the billing period will be after an allowable cutoff date. Necessary adjustments will be made at the time of cost certification.
3. Insurance. Allow amounts for fire, windstorm, extended coverage, liability, and other risk insurance customarily insured against in the community.
- a. Do not allow amounts that accrued before Initial Endorsement.
  - b. Do not approve invoices/receipts for workmen's compensation and/or public liability insurance that are included in the cost estimate.
4. Mortgage Insurance Premium may not exceed the amount due for 1 year.
5. Initial service charge and permanent lender fees are limited to:
- a. The actual amount paid, or the amount stipulated in the Lender's Certificate, Form HUD-92434M, whichever is less.
  - b. The initial service fee cannot exceed 2 percent.
  - c. The combined amount may not exceed 3.5 percent of the mortgage.

**NOTE:** If the 3.5% included in processing exceeds the financing fee charged by the mortgagee, identify the excess as restricted funds. For bond financed projects it is capped at 5.5%. Amounts in excess of 5.5% are not mortgageable.

6. Legal fees may be allowed for:

- a. Borrower's Counsel to create the Borrower entity; however, do not allow the cost

- of legal services to create tax shelters, trusts, etc.
- b. Costs associated with a counsel's review of initial and final closing documents.
- c. Normal interim activities in creating a project.
- d. Documented costs for items in paragraphs 6.a, b, and c above that are due and payable before or at final closing may be approved in the initial advance, provided the limitation in paragraph 6.e below is not exceeded.
- e. Seventy-five percent may be disbursed at initial closing or during construction. The remaining 25 percent may not be released before final endorsement.

**NOTE:** Do not allow legal expenses of the MAP Lender or legal services connected with land acquisition, title and recording charges and/or obtaining zoning as they are reflected in the land value. Amounts included in Form HUD-92264 for legal and audit expenses are not blanket allowances, but ordinarily set an upper limit on allowable amounts. Non-typical fees must be borne by the Borrower, unless in an exceptionally complex case, a higher fee is proven by the Borrower to be necessary and reasonable. Detailed invoices and/or other documentation is required as to the reasonableness, purpose, necessity, and proper classification of all items in the category.

7. Organizational Fees:

- a. The amount included in the replacement cost estimate for organizational fees is an allowance to reimburse the borrower for costs incurred to:
  - 1. Initiate a project;
  - 2. Organize the Borrower entity;
  - 3. Organize its planning, financing, and construction, and
  - 4. Control and manage construction by a hired third party, through endorsement.
  - 5. Third Party costs (Appraiser, Environmentalist etc.)
- b. Release based upon the following:
  - 1. Disburse 65 percent at initial closing.
  - 2. Disburse the remaining 35 percent at final endorsement.

Note: MAP Lender's Third-Party Costs, reflected in Organization Costs are exempted from the 65% rule. The rule applies only to the Borrower's organizational costs.

- c. This allowance may not be used to subordinate the cash requirements for closing.
- d. At cost certification allow only the amount included in Section G of Form HUD-92264 for organizational fees, unless fully supporting documentation is submitted by the Borrower that justifies the need for and reasonableness of the additional

expenditure. Any costs incurred in excess of this allowance are not eligible for recognition in processing a mortgage increase or the equity computation on Form HUD-2580, Maximum Insurable Mortgage.

8. Audit fees associated with obtaining an accountant's opinion of the Borrower's cost certification may not be advanced until final endorsement.
9. Title and Recording. Approve amounts typically incurred for:
  - a. Title search and policy at the time of Initial Endorsement;
  - b. Recording fees at Initial Endorsement;
  - c. Mortgage and stamp taxes;
  - d. Survey recording fees;
  - e. Updating title policy during construction;
  - f. Final title policy and recording charges; and
  - g. Legal fees incurred with any of the above.
  - \*\* Do not fully disburse these funds at Initial Endorsement. Ensure that sufficient funds are maintained in the account to cover title and recording costs required at final endorsement. This may require the approval of an amount less than that requested in the initial draw.
  - \*\* Do not disburse funds for title and recording cost associated with acquisition of the land or property.
  - \*\* Legal, organizational, title, recording costs and taxes incurred in connection with the site purchase may be added to the cost of the land in establishing the latest arms' length purchase price.
10. Developer's fee is provided in the estimated replacement cost of Sections 220, 221, 231 projects involving non-profit Borrower. A portion of the fee may be used to pay for transactional costs associated with developing the project including but not limited to:
  - a. Reduction of the estimated closing costs of the project;
  - b. Staff salaries;
  - c. Non-profit working capital deposit;
  - d. Relocation expenses;
  - e. Operating deficit escrow;
  - f. Financing fees over and above the 3.5 percent included in the estimated replacement cost of the project;
  - g. Environment studies; and
  - h. Housing Consultant services provided by either in-house staff or contractor.

11. Tap fees, soil testing and other fees. Approved disbursement must be fully supported and is not to exceed the amount estimated in the general contractor's or Borrower's list of other fees for requested items. Approve disbursement only for items actually due.
12. The contingency reserve is included in the replacement cost of substantial rehabilitation projects.
  - a. Use the contingency reserve for:
    1. Unforeseen costs of necessary changes approved by the HUD Office.
    2. Unanticipated soft costs associated with extension of time change orders approved by the HUD Office.
  - b. Changes classified as betterments by Architectural and Cost staff is ineligible for funding.
13. Third-Party MAP Lender Expenses: Fees to be paid for third-party review costs of the MAP Lender including but not limited to Architectural reviews, Cost reviews, appraisals, and market studies.
14. At Initial Endorsement, HUD fees for examination and inspection.
15. Sums allocated to acquisition cost of land or existing building.

D. Allocation of Cash Available to the Borrower:

1. Allocation of cash available to the Borrower listed on line 42 of Form HUD-2283, Financial Requirements for Closing (excess mortgage proceeds) may be allocated to the following items:
  - a. New Construction.
    1. Land value equity can be applied to fund operating deficit or working capital escrows, or other cash requirements at Initial Endorsement. After Initial Endorsement, additional draws from mortgage proceeds associated with the excess land value will be considered only after the designated escrow accounts have been fully exhausted. The land value is HUD's estimate of the "as-is" value of land or the actual latest arms' length purchase price, whichever is less. The latest arms' length purchase price may include the following costs incurred in connection with the site purchase:
      - (1) Legal fees associated with negotiations for acquisition of land, zoning, and

examination of title on the purchase or defense of title after purchase.

- (2) Prepaid special assessments.
  - (3) Interest on bridge loans to purchase property after the date of submission of the initial application for mortgage insurance.
  - (4) Taxes.
  - (5) Cost of improvements made to the project site by the sponsor/Borrower.
2. Cash escrow to cover offsite construction cost.
  3. Cost of any demolition reflected in the Fair Market Value of Land. Payment is approved as demolition progresses.
  4. Construction and/or permanent loan discounts required to be paid at initial closing.
  5. Cash to cover interest shortfall escrow, working capital deposit(s) (i.e. 2% escrow and 2% construction contingency), initial operating deficit, non-realty items, and any permanent loan discounts not required to be paid at initial closing.
  6. Remaining balance may be used to fund any approved change orders or held until final endorsement.

b. Rehabilitation of Existing Construction.

1. HUD's estimate of the "as-is" value by market comparison or the Borrower's acquisition cost/existing indebtedness, whichever is less.
2. Items a (i) through (vi) above.

E. Restricted Excess Mortgage Proceeds:

1. Restricted excess mortgage proceeds are those excess mortgage proceeds determined not to be available to the Borrower during construction, i.e., difference by which the HUD estimate exceeds contract amounts.
  - a. These funds cannot be used to satisfy any escrow requirements and must be held until final endorsement.
  - b. Identify these funds in an unused column of Form HUD-92451, Financial Record of Mortgage Loan Transaction as restricted funds.

F. MAP Lender Duties for Processing Form HUD-92403, Application for Insurance of Advance of Mortgage Proceeds. The Lender must review and approve Form HUD-92403 conducting the following major responsibilities:

1. Reconcile any discrepancies between the cumulative total for all advances, including the advance under consideration, and conclusions reached in the processing before recommending the advance for approval.

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- a. Enter any required adjustments in Column B and note, “No Adjustment Necessary, Except as Indicated,” or “No Adjustment Necessary,” as appropriate.
    - b. Enter the approved amount in the “Certificate of Mortgage Insurance” on the face of the form, and where the request is reduced; explain the disallowance on the form’s reverse side.
  2. Determine monthly that advances are proportionate to construction progress.
    - a. Require the MAP Lender’s underwriter to advise you where advances for “soft costs”, i.e., financing and carrying charges, are in excess of work progress as shown by the most current Progress Schedule accepted by the HUD and the percentage of project completion reflected on Form HUD-92448.
    - b. Take action where the mortgage is not in balance due to the fault of the contractor.
  3. The amount advanced for construction retainage items must be adjusted for a 10 percent holdback of the construction contract amount from each advance. The standard 10% retainage will be required until 50% completion. After the project is 50% complete, the retainage will be reduced to 5% until 75% completion, and further reduced to 2.5% until the loan reaches the Final Endorsement. The following conditions must be met to permit these reductions in retainage:
    - a. The Contractor has no identity-of-interest with the owner greater than a 5 percent equity interest,
    - b. If applicable, prior written consent from the surety company must be attached to the request for release, and
    - c. There are no questions regarding the contractor’s performance concerning the quality of work, compliance with the contract and any change orders or work in progress.
  4. Secure approval from HUD for any advance requesting release of any portion of the contractor’s 10 percent holdback.
  5. Maintain a record of approved disbursements on Form HUD-92451, Financial Record of Mortgage Loan Transaction (or similar format in an Excel worksheet).
- G. Certificate of Mortgage Insurance: (Prepare when the advance is eligible for approval.)
1. The approved sum is the total for the Contractor’s Requisition and other eligible line items.
  2. The total approved for any item must not exceed the amount allocated to the item unless the MAP Lender submits a written request to HUD for permission to reallocate funds between

line items.

3. The sum approved for mortgage insurance is the amount approved for advance less any funds remaining in the front money escrow and any grant/loan proceeds.
  4. For interim advances, the Lender is to prepare this Certificate and sign for HUD, to increase the amount of mortgage insurance.
  5. After signing Form HUD-92403 in the space for the Authorized HUD Official, and signing Form HUD-92448 for the Regional or Satellite Office Director, the MAP Lender sends a copy of Forms HUD-92403, HUD-92448, HUD-92451 (or similar format in an Excel worksheet), and supporting documentation to HUD.
- H. HUD Monitoring of Interim Draws. The HUD Single Underwriter will monitor interim draws. If a problem is encountered during an interim draw, the HUD Underwriter will bring the problem to the, Regional or Satellite Office Director's attention in order to:
1. Modify the next draw, or
  2. Withdraw the MAP Lender's authority to approve advances.

## **12B Instructions for Contractor's Monthly Requisition and Related Matters**

- A. Contractor's Monthly Requisition must be made on Form HUD-92448. The Contractor's Prevailing Wage Certificate on the form's reverse side must be signed. (The HUD Construction Manager should contact HUD Labor Standards and Enforcement staff if there are any outstanding questions regarding Davis-Bacon weekly payrolls and/or possible underpayment of Davis-Bacon prevailing wages.) The HUD Inspector reviews for acceptability. If acceptable, forward to MAP Lender's mortgage credit analyst for further processing.
1. Eligible items for inclusion on Form HUD-92448.
    - a. Acceptably completed onsite work, i.e. in full compliance with contract documents;
    - b. Materials acceptably stored onsite itemized by quantity and cost with supporting invoices;
    - c. Components acceptably stored offsite, where provisions are made at initial closing in accordance with Chapter 12, and requirements of Paragraph B below are met.
    - d. The Architect determines amounts due by job site observation of acceptable work. (The HUD Inspector makes the determination if there is no Architect.)

- e. The HUD Inspector:
  1. Checks the Architect's determination using Form HUD-2328, Schedule of Values, and trade item cost breakdowns (guides) to assure that amounts are reasonable for acceptable work and that funds remain for unacceptable and incomplete work;
  2. Spot checks the count of stored onsite items, determines that storage is acceptable, and assures that amounts are reasonable for approval;
  3. Checks the invoice and certificate for stored onsite items and approves payment after assuring that funds remain for transportation to the site and erection.
  
2. Ineligible items for inclusion on Form HUD-92448.
  - a. Noncompliant work and work supported or dependent upon noncompliant work. Work changes completed in anticipation of future change order approvals are noncompliant work.
  - b. Additive change orders. Refer all change orders to HUD for processing and payment.
  - c. Offsite work. See Paragraph C below for the contractor's requisition of payment, and release of funds to the Borrower for acceptably completed offsite work.
  
3. Modification of Contractor's Requested Amount.

Where there is disagreement with the requisition, the HUD inspector may modify the contractor's requested amount by:

  - a. Entering trade item modification(s) on Form HUD-92448;
  - b. Explaining the modification(s) in the HUD Representative's Trip Report, Form HUD-95379.
  - c. Completion of Form HUD-92448, Items (1) through (13) are made by the MAP Lender.
  
4. Supporting Documentation.
  - a. In order to help the HUD Inspector, reconcile differences with contractor claims, the contractor will submit receipts, bills of lading for onsite deliveries, billings for onsite work, evidence of onsite payrolls, etc.

previously shown on a survey, especially regarding:

1. Where the siting of structures or setting of finished floor elevations are questioned;
2. Location of materials stored onsite.

c. A survey is required for the next to last advance.

B. Components Stored Offsite.

1. Eligible Building Components. Only “building components” qualify for insurance of advances when stored offsite.

a. An “eligible building component” is a manufactured or pre-assembled building element which, by reason of bulk, size or weight, vulnerability to weather conditions or lack of space at the site, is impractical to store at the site.

b. Eligible building components comprise, but are not limited to:

1. Precast concrete floor, wall, and roof panels;
2. Assembled bath and/or kitchen core units;
3. Fully fabricated structural steel beams and columns.

c. Items that are not eligible “building components” are (but not limited to): kitchen appliances, carpeting, wood roof trusses, etc.

2. Basic Requirements for insured advances.

a. The MAP Lender must have agreed to the necessary provisions at initial closing. See Chapter 12 Sections 12.5 and 12.7.

b. The Construction Contract must include the rider “Amendment to the Construction Contract for Components Stored Offsite.” See Forms Appendix.

c. Payments are limited to the invoice value of the components.

d. The contractor and its surety bear full responsibility for fraudulent claims for payment and fraudulent disposition of such payments. Safeguards are to protect against premature payments, against materials that do not meet contract requirements and against losses not covered by insurance.

- e. The construction contract must be secured by a 100 percent performance and payment bond or a cash deposit or Letter of Credit in the amount of 15% or 25% of the HUD estimated cost of construction or rehabilitation for projects with four stories or less or five stories or more, respectively.
  - f. Components must be stored at a location approved by the Lender and HUD.
3. MAP Lender's Responsibilities.
- a. File Uniform Commercial Code (UCC)-1, financing statements with the proper office in the proper jurisdiction.
  - b. Make whatever additional filings are necessary to maintain a first lien on the components until they are incorporated into the building(s).
  - c. Release the financing statement filings as appropriate.
  - d. Unconditionally certify by letter to HUD that the security instrument(s) is (are) a "first lien" on the components covered by the instrument(s). The MAP Lender's certification must be supported by an opinion from the Lender's counsel.
  - e. In the event of default under the mortgage, either assign its security interest to HUD or acquire title through foreclosure to the components intended for use or incorporation into the building(s) and convey title to HUD.
4. General Contractors' Responsibilities.
- a. All direct and indirect costs associated with the storage and transportation of components stored offsite;
  - b. Obtaining a risk of loss insurance policy which covers the components. Evidence of this policy must be submitted to the MAP Lender prior to approval of any advance for components stored offsite;
  - c. Assurance that there is a valid security agreement that is a first lien on the components.
5. Contractor's Requisition. All requests for payment for components stored offsite must be submitted on Form HUD-92448, Contractor's Requisition, accompanied by the following:

- a. A statement from the Borrower's Architect certifying that:
    1. He/she has visited the storage site and inspected the components for which payment has been requested;
    2. The components are in good condition and they comply with the contract requirements;
    3. The components are properly stored and protected;
    4. The components are segregated, in an easily identified manner from other materials stored at the same site and are marked for identification;
  - b. A bill of sale accompanied by an itemized invoice transferring title of the components to the Borrower;
  - c. A copy of the security agreement provided to the mortgagee by the Borrower;
  - d. A copy of the financing statement or statements filed by the MAP Lender in accordance with the Uniform Commercial Code;
  - e. A warrantee from the MAP Lender that the security instruments represent a first lien on the building components;
  - f. An opinion from the MAP Lender's attorney that he/she has reviewed the security agreement and associated documents relative to the building components and that the security agreement creates a valid security interest in the collateral and that when the financing statement or statements is (are) duly filed, the secured party will have a first lien.
- C. Offsite Construction. Separate from work done under the Construction Contract for the project. Where offsite work is completed by the Borrower, rather than by a municipality or utility company, a separate construction contract is required, even if completed by the project contractor. Offsite work must also be funded from sources outside the mortgage, except that an escrow for its completion may be funded from available excess mortgage proceeds.
1. Completion Monitoring is performed by the HUD inspector and reported on the Trip Report, Form HUD-95379. See HUD Procedures.

2. Contractor's Requisition is by letter to the Borrower. Do not use Form HUD-92448 to

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reflect the value of acceptably completed offsite work, even if completed by the project contractor. Request for Approval of Advance of Escrowed Funds, Form HUD-92464, is used.

4. Construction Changes for offsite work must be requested by letter. Form HUD-92437, Request for Construction Changes, may be used as a guide, but the form itself must not be used for offsite change orders.

**12C Amendment to the Construction Contract for Payment for Components Stored Offsite**

- A. The undersigned as Contractor and as Owner will abide by the following conditions to induce the Commissioner to release mortgage proceeds for the payment of components stored offsite:
1. The components stored offsite that will be recognized for payment under Article 5 of the contract are those listed and approved by HUD as an appendix to the Contractor's and/or Mortgagor's Cost Breakdown, Form HUD-2328, attached to the Contract as Exhibit "A". The appendix must provide an inventory of the "stored components" and a breakdown of the line item of which the stored components are a part. The breakdown must state:
    - a. Cost of Components (Invoice Value),
    - b. Cost of transportation form the offsite storage location to the construction site,
    - c. Cost of Installation, and
    - d. Costs of any other items included in the line item.
  2. The Contractor is responsible for:
    - a. All direct and indirect costs associated with the storage and transportation of components stored offsite.
    - b. Obtaining a risk of loss insurance policy which covers the components during storage, in transit and until installed at the project site. The policy must name the Borrower, the Mortgagee and the Commissioner as their interest may appear. Evidence of the existence of this insurance must be submitted to HUD prior to the approval of any advance for components stored offsite.

- c. Assuring to the satisfaction of HUD proper identification and segregation of components while in storage and protection of components while in storage and transportation.
  - d. Securing from the Borrower or mortgagee all necessary security agreements, copies of financing statement, and documentation pertaining to first lien warranties, and submitting them with the request for payment.
  - e. Providing corporate surety bonds for on-site improvements on Form HUD-92452M for payment and performance bonds, each equaling 100 percent of the HUD estimate of construction or rehabilitation cost.
3. All requests for payment for components stored offsite must be submitted by the Contractor on Form HUD-92448, Contractor's Requisition, accompanied by the following:
- a. A statement from the Architect certifying that:
    - 1. He/she has visited the storage site and inspected the components for which payment has been requested,
    - 2. The components are in good condition and they comply with the contract requirement,
    - 3. The components are properly stored and protected,
    - 4. The components are segregated, in an easily identified manner from other materials stored at the same site and are marked for identification.
  - b. A bill of sale accompanied by an itemized invoice transferring title of the components to the Borrower.
  - c. A copy of the security agreement provided to the mortgagee by the Borrower.
  - d. A copy of the financing statement filled by the mortgagee in accordance with the Uniform Commercial Code.
  - e. A warranty from the mortgagee that the security instruments requested a first lien on the building components.
  - f. An opinion from the mortgagee's attorney that he/she has reviewed the security agreement and associated documents relative to the components for which advance are sought and that the security agreement creates a valid security interest in the collateral and that when the financing statement is duly filed, the secured party will

have first lien.

4. Restrictions.

- a. Payments for components stored offsite shall be limited to the cost of components (Invoice Value) identified in the HUD approved appendix to the Contractor's and/or Mortgagor's Cost Breakdown, Form HUD-2328, attached to the Contract as Exhibit "A," and shall be subject to a 10 percent holdback.
- b. In no case shall a payment be approved for components stored offsite to a contractor whose performance, in the judgment of the Regional or Satellite Office Director, is marked by serious deviations from the contract documents.
- c. At no time may the outstanding amount of insured advances for components stored offsite exceed 50 percent of the total estimated construction costs specified in the construction contract.
- d. The minimum amount for any single advance is \$10,000.

OWNER

CONTRACTOR

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\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

DATE: \_\_\_\_\_

DATE: \_\_\_\_\_

## **12D Instructions for Projects in Difficulty Before Final Closing**

### A. General.

1. Additional attention must be given to projects that are experiencing difficulties that may lead to default before reaching final closing. Diagnose problems and take immediate actions during critical periods of project construction to avoid foreclosure or assignment, and to avoid serious hardship to Borrowers, contractors and mortgagees. See Chapter 19 for final closing procedures when the Borrower and general contractor are in dispute and closing without full participation of the contractor.
2. Prompt action must be taken to correct problems as they arise. Where requested relief cannot be granted for statutory, regulatory or administrative reasons, however, a prompt and final disapproval must be given.

### B. Problems leading to default include:

1. Construction problems due to:
  - a. Work stoppage,
  - b. Contractor abandonment of job,
  - c. A change in the contractor, owner or architect during construction,
  - d. Construction defects untreated for 30 days, and
  - e. Extended periods of bad weather, strikes, etc.
2. Financing problems due to:
  - a. Contractor's inability to complete construction because of under financing.
  - b. Cost overruns in carrying charges due to circumstances beyond the contractor's and Borrower's control.
  - c. Cost overruns in construction hard costs caused by:
    1. Mandatory changes,
    2. Voluntary changes, and
    3. Price escalation.
3. Inadequate project income due to:
  - a. Underestimated operating expenses,

- b. Overestimated rents and long-term occupancy levels, and
  - c. Inadequate or lack of initial operating deficit.
- C. Defaults during construction. HUD Construction Manager will consider alternative actions that can be offered to avoid foreclosure and hardship to all concerned parties regardless of the cause.
- 1. Request field counsel to provide legal guidance and participate in meetings to discuss the consequences of default and possible preventive actions.
  - 2. Contact MAP Lender.
    - a. Speak to a responsible official and obtain an opinion on the cause of default, methods of cure and probability of cure.
    - b. Advise the Lender:
      - 1. To preserve its rights against the surety by giving prompt oral and written notification of the contractor's lack of performance or default, and by demanding performance under the contract of surety (see Paragraph 3. below), and
      - 2. To consult with its attorney and to secure HUD approval before entering into any formal or informal agreement with the surety.
  - 3. Notification of Surety. The MAP Lender must send a notice to the bonding company with a copy to the general contractor for all conditions affecting the bonding company's interests. The notice should be sent to the bonding company's principal office, and its regional or branch office, attention: Claims Department.
    - a. Conditions requiring notification include:
      - 1. A sustained work stoppage,
      - 2. Nonpayment of subcontractors, suppliers, workmen, etc., and
      - 3. Failure to maintain satisfactory progress.
    - b. Conditions that require obtaining surety's approval in advance include:
      - 1. Approving a change order or aggregate of change orders that exceed 10 percent of the contract price, and
      - 2. Extension of the bond by surety where there is a compelling reason why the contractor cannot remedy a latent defect before the bond's expiration date.
    - c. The Borrower is responsible for requesting the surety's performance, the MAP Lender must act to protect its and HUD's interests, and HUD must take the final action to protect its interests under conditions in paragraph 3.a. above.

## OMB REVIEW READY

4. Advise the Borrower of the contractor's violation, and/or lack of performance by the architect or Borrower and give 30 days for correction.
5. Assess the situation by considering:
  - a. Percentage of construction complete,
  - b. Occupancy (including current estimates of income, expenses and occupancy projections),
  - c. Type of assurance of completion (bonds, cash escrow),
  - d. Status of escrow deposits,
  - e. Undrawn dollar amount of letters of credit (including working capital), and
  - f. Any other pertinent information.
6. HUD staff should meet to assess available options and prepare a position to present to interested parties. The meeting should include the Regional or Satellite Office Director, Field Counsel, and a representative from Asset Management. Separate meetings by staff with one or more of the non-HUD parties may be helpful before holding a general meeting with all interested parties.
7. Convene a general meeting of all interested parties with either a direct or indirect interest in the project to explain the consequences of default. Hold such meetings even where there is no possibility of HUD granting a mortgage increase or other form of relief.
  - a. Emphasize that all non-HUD participants must make a meaningful contribution before HUD will assume any additional risk. Such contributions include:
    1. Infusion of new capital through adding partners, syndication or other investments, and/or
    2. Concessions by the MAP Lender to avoid a loss (e.g., deferral or forgiveness of interest, taking a partial assignment of the partnership interest, etc.).
  - b. State firmly and unequivocally that the non-HUD parties must work out the remedy if the default is to be cured.
  - c. Clarify that unless a written firm proposal for a workout is developed; assignment or foreclosure of the mortgage will be the consequence.
  - d. Address the remedies covered in paragraph D below, as appropriate.
8. Extension of MAP Lender's election period to assign a loan for insurance benefits should not be granted where a workout proposal is not developed. Thirty days should be the maximum extension in most cases.

### D. Remedies to avoid/cure defaults.

1. Call on the Bonding Company to perform, where applicable.
  - a. Request field counsel to communicate with surety where it fails to perform to terms of the bond, and
  - b. Where the Surety refuses to honor its obligations after communications by field counsel, request the Department of Treasury to initiate procedures for removal of the surety from the Treasury Circular 570. List the surety, contractor, and project; describe the particulars, including nature of the problem, length of delays and actions taken by Borrower, mortgagee and HUD to secure surety's performance; and attach a copy of the bond(s). Mail to:
    - U.S. Department of Treasury
    - Surety Bond Branch
    - Financial Management Service
    - Washington, D.C. 20227
  - c. Distribute copies of the letter to the Washington Docket, Field Office Docket and the Regional or Satellite Office Director.
2. MAP Lender or Title Company control payments through issuance of two- or three-party checks to assure that disbursed mortgage proceeds are applied for the intended purpose and not diverted to other uses.
  - a. All money drawn for construction must be paid to subcontractors, suppliers, and workers on the job.
  - b. Money drawn for specified purposes, e.g., architect's fees, insurance premiums, taxes, etc., must not be diverted to other uses.
3. Transfer construction funds to soft cost expenses, i.e., keep the mortgage in balance. The liquidated damages clause in the construction contract provides a source of funds for overruns in interest, taxes, MIP and insurance (soft costs) that are due to construction delays that are the general contractor's fault.
  - a. Authorize the transfer of funds from the construction contract for payment of soft cost overruns, where it becomes apparent that the scheduled date for completion cannot be met due to the fault of the contractor. The amount of transferred funds must be reflected on subsequent Forms HUD-92448, as a decrease to item 7, Sum of Cost Breakdown Items Plus Inventories of Materials.
    1. The transfer of funds will get the attention of the contractor, Surety (if any), Borrower and mortgagee, as well as address any financial necessity.
    2. Notify the contractor, Surety (if any), Borrower and mortgagee by certified mail of the amount and the reason for the transfer.
    3. Require written acknowledgement of the notification from the mortgagee and Surety, if any.

- b. Computation for funds transfer from the construction budget. When the amount originally allocated to interest on Form HUD-92451, Financial Record of Mortgage Loan Transaction (or similar format in an Excel worksheet) is exhausted or near exhaustion, request the Architect and HUD representative to estimate the earliest date of construction completion. Use this date to:
  1. Set an assumed completion date.
  2. Compute the minimum liquidated damages for the period between the completion date specified in the construction contract, as adjusted by approved change orders, and the assumed completion date.
  3. Transfer the computed amount from Column J, Construction, to Column G, Carrying Charges and Financing, on Form HUD-92451 (or similar format in an Excel worksheet).
    - (a) Allocate full amount to interest, initially.
    - (b) Only use funds for MIP, taxes and insurance after funds for these line items, and the working capital escrow have been exhausted.
4. Use of contractor's holdback, subject to provisions of paragraph 2 above.
5. Release assurance of completion cash escrow where used in place of a performance and completion bond for the construction contract.
  - a. The Regional or Satellite Office Director may authorize such release, where:
    1. The project is nearly complete,
    2. Project completion and final closing may not be attainable with the remaining mortgage proceeds alone or in combination with the Borrower other available assets, and
    3. Release of the funds will offer an excellent chance for project completion and final closing with clear title.
  - b. The entire escrow may be released under such circumstances except for 2-1/2 percent of the contract, which amount is needed to fund the latent defects escrow, subject to:
    1. The MAP Lender must take steps to assure that all required payments by the contractor have been made or will be met to preclude uncovered liens, and
    2. Disbursement of such funds and Borrower's additional contributions must be under strict control of the mortgagee or a title company.
  - c. Distribute the Regional or Satellite Office Director's written authorization for release of the funds as follows: original to the Washington Docket with copies to the Field Office Docket, Closing Attorney, and Mortgage Credit Control File.
6. Infusion of new money. See Paragraph C.7.a above.
7. Deferment of principal payments where the project is complete and ready for occupancy

but cannot go to final closing.

8. Mortgage increase may be provided as discussed in MAP Chapter 13 Section 13.23, where economically feasible. Where the contractor is changed because the original contractor becomes bankrupt, abandons the job, or the contract is terminated due to inadequate contractor performance, any mortgage increase must also be processed in accordance with the following:
  - a. Reprocess the project.
    1. Use rents, expenses, and occupancy ratios current as of the date of reprocessing.
    2. Consider the new builder's cost to complete, amounts expended to date, and any increase in carrying charges, financing, etc., due to increased mortgage amount and/or extra construction time over the original estimate.
  - b. Mortgage increase conditions.
    1. The Borrower provides any required front money.
    2. Any recovery from the original contractor or surety must be applied first to reduction of the mortgage on a mandatory basis,
    3. The balance of the net recovery after legal expense, if any, may be used to indemnify the Borrower, MAP Lender, and others, and
    4. A legal document providing for paragraphs (2) and (3) above must be included as a rider to the Regulatory Agreement and Lender's Certificate at final closing, where such recovery has not been made before and considered in the cost certification.
9. Reanalyze the Cost Certification for inclusion of all allowable costs where final closing has not occurred.
10. Working capital deposit balance.
- E. Default report before final closing, Form HUD-58047. Report monthly on the default and describe the plan for curing it.
  1. If default cannot be promptly cured, provide a current estimate of income, expenses and occupancy projections.
  2. Report distribution:
    - a. Regional or Satellite Office Director, and the Director of the Office of Asset Management and Portfolio Oversight Division, within two weeks of default.
    - b. Asset Management's Account Executive staff for use with the Multifamily Default Status Report, Form HUD-92426.

- F. Decision to foreclose where the contractor becomes bankrupt, abandons the job or the contractor is terminated due to inadequate contractor performance. Encourage the MAP Lender to consider foreclosure and tender of the unfinished property to HUD, where the Regional or Satellite Office Director agrees in writing that it would be advantageous to the insurance fund, e.g., instances where interruption of construction occurs at an early stage and market and/or economic conditions have worsened to preclude attaining project viability. Consider surety's position in reaching this determination.
1. MAP Lender tenders unfinished property. Where the Regional or Satellite Office Director agrees in writing that accepting conveyance of such unfinished property would be more advantage to the insurance fund than pursuing project completion:
    - a. Promptly convey the decision to all interested parties.
    - b. Request field counsel to maintain close communication with the Lender's and Borrower's counsel and seek advice from the Office of General Counsel as necessary.
  2. Estimate completion cost for the unfinished project to support a subsequent damage claim against the surety for damages due to contractor's failure to perform.
  3. Document distribution. Original documents, including the Regional or Satellite Office Director's authorization to accept the unfinished project, in the Washington Docket with one copy to the Field Office Docket, Field Counsel and Mortgage Credit Control File.
- G. Recovery of mortgage proceeds. In the event of a mortgage insurance claim before final closing instruct the MAP Lender's to establish communications with the Office of the FHA Comptroller regarding the surcharge of insurance benefits.
- H. Tax-exempt bond funded project default before final closing. See Chapter 11 for additional information and riders included in the "Note" and "Lender's Certificate" regarding a default.
1. Prepayment lock-out and/or penalty override. Consider exercising HUD authority to override Lender's prepayment lock-out and/or penalty provisions only where:
    - a. The project mortgage has defaulted, and HUD has received notice of such default, in accordance with 24 CFR Section 207.256,
    - b. HUD determines that the project is experiencing a net income deficiency that is attributable to more than management inadequacy or lack of owner interest, and that the deficiency's magnitude leaves the Borrower unable to make required debt service payments, pay all project operating expenses and fund all required HUD reserves,
    - c. HUD finds that there is a reasonable likelihood that the Borrower can arrange to refinance the defaulted loan at a lower interest rate or otherwise reduce the debt

- service payments through partial prepayment, and
  - d. HUD determines that refinancing the defaulted loan at a lower rate or partial prepayment is necessary to restore the project to a financially viable condition and to avoid an insurance claim.
2. Deadline extension for filing claim intentions. MAP Lender must request a three-month extension of the election notice filing deadline in the event of a default within the term of the prepayment lock-out and/or penalty. See Chapter 11 and the Lender's Certificate.
- a. Analyze the project's financial condition and assess the feasibility of arranging a successful refinancing.
  - b. Recommend that the Regional Center or Satellite Office Director grant the 3-month extension or a shorter extension of the election notice filing deadline, based upon positive conclusions reached by the analysis in paragraph a. above.
  - c. Do not consider additional extensions of the election notice filing deadline, unless specifically requested by the MAP Lender.
- I. Grant/loan project with a pro rata disbursement agreement that defaults before completion of construction. The governmental entity must disburse the remaining funds where the request for funds remains in the same ratio as previously authorized.