

## Chapter 12 Construction Period

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### 12.1 HUD Construction Administration Roles and Responsibilities

For new construction and substantial rehabilitation projects the HUD construction administration period begins at initial endorsement and extends to final closing. For refinance transactions with repairs and alterations, the construction administration period begins at endorsement and ends at the closing of the Repair Escrow. Construction administration involves managing risks during construction and ensuring compliance with all contractual obligations upon completion. HUD's personnel tasked with construction administration roles and related duties are as follows:

- A. HUD Construction Analyst (CA). HUD regional production chiefs or designated technical branch chiefs will assign HUD construction analysts to administer construction for each project. The assigned construction analyst (CA) serves as a single point of contact on behalf of HUD to the lenders and the external development team (e.g., owner, general contractor, architect, etc.) during the construction administration period. In general, the CA is responsible for overseeing construction progress and the development team's performance during construction and the contractor's warranty period. The HUD CA must be familiar with all program and contractual requirements particular to the project. Where existing HUD forms (e.g. the Trip Report, HUD form 95379) refer to the HUD "construction manager" or "CM" the reference is to the HUD construction analyst designated as the HUD point of contact for construction administration of the project.
- B. HUD Inspector. The HUD inspector monitors construction on HUD's behalf by visiting the site, participating in progress meetings, and generating inspection reports based on observations and interviews of the project development team. The purpose is to protect HUD's interests during construction. As HUD's agent, the inspector ensures that the construction conforms to the drawings, specifications, and sound construction practice within the scope of the contract.
  - 1. The HUD inspector is typically an independent third-party contracted by HUD to serve as HUD's agent managed by HUD CA.

2. The HUD CA or another designated HUD construction analyst may act as HUD inspectors on a project-by-project basis.

## **12.2 Pre-Construction Conference**

A pre-construction conference is required for every new construction and substantial rehabilitation project and must precede the initial start of construction, including early start of construction. A pre-construction conference is optional for Section 223(f) projects depending upon the size and scope of the project, complexity of the repairs and experience of the development team. A pre-construction conference is not required for refinance projects where work is limited to repairs and level 1 alterations but is recommended when the cost and/or classification of work requires a project architect, except when the architect's task is limited to design of accessibility remedies. The HUD Inspector or the HUD CA conducts the pre-construction conference as the HUD representative and the conference should be held at initial endorsement or early start approval where feasible but may be scheduled shortly before or after endorsement if necessary. The necessary attendees and the topics to be covered are set forth below:

A. Expected attendees:

1. Borrower's representative;
2. Borrower's supervisory Architect;
3. General contractor;
4. Major subcontractor(s), i.e., principal trades, MEP, site, structural, finish or any with 15% or more of the work measured in hard cost;
5. HUD representative (HUD CA or HUD Inspector);
6. HUD's Underwriter;
7. Lender's representative; and,
8. Representative from the Office of Davis-Bacon and Labor Standards for Davis-Bacon Wage related issues.

B. For new construction and substantial rehabilitation projects, the HUD representative should review the Supplementary Conditions of the Contract for Construction, Form HUD-92554M, covering Davis-Bacon wage rates, special environmental conditions related to construction including issues regarding lead-based paint, asbestos, site contamination or the need for archaeological monitoring on site during excavation, Federal labor standards and equal

employment provisions-related issues, including contract obligations of the general contractor and all subcontractors as follows:

1. Certification of compliance with Davis-Bacon wage rates with each request for advances;
  2. That Davis-Bacon wage rates are applicable to a second mortgage securing a governmental loan.
  3. Statement of sanctions that may be imposed for not complying with the supplemental conditions.
  4. Applicable Davis-Bacon wage decision and the Form HUD-92554M must be made part of the subcontracts for all tiers.
  5. Importance of Federal wage payments, prompt certified payroll submissions and proper recordkeeping. A copy of the applicable Davis-Bacon wage decision and Form WH-1321, Notice to Employees, must be conspicuously posted at the job site.
  6. Identifying HUD Labor Standards and Enforcement staff that will review labor standards compliance and answer any further inquiries concerning Davis-Bacon wage and reporting requirements.
  7. The URL for Universal Source Locator to obtain the Equal Opportunity poster with instructions to post conspicuously at the job site.
  8. Contractor's Guide to Davis-Bacon.
  9. Contractor's registration with Elation Systems for Davis-Bacon prevailing wage payroll certification.
- C. Contract Administration. The HUD representative should describe the contract provisions for administering the work, including:
1. General contract administration responsibilities of the lender, borrower, borrower's Architect and/or supervising architect, general contractor, and HUD representative.
  2. Procedures for:
    - a. Change orders;
    - b. Requesting clarification of construction documents;
    - c. Reporting and correcting non-compliant work;
    - d. Requesting periodic payments and release of escrowed funds;
    - e. Substantial completion of work or portions thereof; and,
    - f. Permissions to occupy, including management plans and rent rolls.

3. Work changes completed in anticipation of a future change order will be regarded as non-compliant. There will be no insured advances for such work or other work dependent on it.
4. Periodic advances:
  - a. Borrower's and general contractor's required preparation of requests, including the field approval and subsequent processing;
  - b. Provisions for submitting surveys, title reports, and other documentation in support of construction advances;
  - c. Requirements for contractor's retainage and its release.
5. Stored materials and procedures to request payment for materials stored onsite, and components stored offsite where applicable (see Appendices 12B and 12C).
6. Offsite work and procedures to request payment for completed offsite work, the required retainage and its release.
7. Termination of contract(s). Provisions for terminating the construction contract and/or Architect's contract, and the lender's responsibilities during the construction stage and in the event of a default.

#### D. Cost Certification

1. Cost certification requirements for the mortgagor and (if applicable) the general contractor, subcontractors, equipment lessors and suppliers, industrialized housing manufacturers and relocation-related costs. Where there is a second mortgage securing a Governmental loan, the cost certification also applies to the second mortgage.
2. Inform all parties that HUD will initiate a pre-cost certification conference to be held when construction is 90% complete and that detailed instructions will be provided at that point. (See Chapter 13 for cost certification procedures.)
3. Matters concerning identity of interest:
  - a. Identities of interest that develop or become known after initial closing must be reported to the lender and to HUD within 5 working days of having such knowledge;
  - b. HUD must give prior approval for all identity of interest subcontractors and apply penalties where this is not done;
  - c. Self-owned equipment must be certified; and
  - d. Shell companies are prohibited. In this context a shell company is a firm organized for the apparent purpose of acting as a general contractor but in practice subcontracts the preponderance of its responsibility measured both in the substance of the work as well as in monetary value to one or two other de facto general contractors, collecting

a fee but performing little or no commensurate service. See the 50/75 percent rule in Chapter 13.16.

## **12.3 HUD Construction Inspection and Monitoring**

### **A. Purpose of Inspection.**

1. Inspection means periodic observations made of construction activity at the site by a HUD Inspector for the purpose of protecting HUD's interests. Inspections are conducted to:
  - a. Evaluate the contractor's and Architect's performance;
  - b. Confirm construction is in accordance with the contract documents; and,
  - c. Report on conformance with prevailing wages and other contract requirements.
2. The inspection instructions are the same for projects involving the insurance of advances and those to be insured upon completion, except for those variations specifically stated to be applicable to one or the other.

**B. Access.** At all times, HUD has the right of access to the property and the right to inspect all work performed and materials furnished to complete the project.

### **C. HUD Construction Analyst's Duties:**

1. Assignment. HUD CA will assign a third-party inspector to conduct inspections for the project. Upon assignment, the CA will issue the following to the inspector:
  - a. Set No. 3 of the contract drawings and specifications. This set will be HUD's "As-Built" document for the inspector to redline throughout construction to conform it to the contractor's "Record Set."
  - b. Copy of the Construction Contract, HUD-92442M for insured advances projects and other acceptable construction contract for Insurance Upon Completion projects (see Chapter 5.5) or AIA A104 when applicable for certain refinance or acquisition transactions.
  - c. Owner-Architect Agreement (AIA Document B108 or B104) when an Architect is required to administer the construction contract (see Chapter 5.2.C.1.c).
  - d. Contractor's and/or borrower's cost breakdown. Schedule of Values, Form HUD-2328 when insured advances are involved or list of repairs and alterations with costs summary as applicable for certain refinance or acquisition transactions.

- e. Drawings and specifications pertaining to off-site improvements.
  - f. Agreements or contracts providing for off-site construction.
  - g. Construction Schedule.
  - h. Other construction-related documents such as repairs lists, relocation plans, etc.
2. Offsite Fabricated Construction. HUD will not conduct inspections of construction progress for modular or panelized products fabricated in off-site manufacturing facilities. (See Chapter 5.7.D.4)
3. Trip Report Review. The CA shall review and evaluate all HUD-95379 Trip Reports completed by the HUD Inspectors and initiate appropriate actions as necessary.
- a. The CA should be aware of progress, trends, new or uncorrected non-compliance, unusual conditions, etc., in order to be familiar with the work and to initiate any required corrective action immediately (see Section 12.3.F).
  - b. The CA shall review Trip Reports for quality and identify any absence of significant facts, findings, and evaluation comments.
    - i. The CA shall advise the HUD Inspector of any unsatisfactory action or detail in the report, or any error in its preparation to prevent repeat of similar errors.
    - ii. A field review inspection by the CA may be necessary to evaluate the quality of the reports.
    - iii. Any differences of opinion or findings between the HUD Inspector and other technical specialists involved during inspection must be resolved by the CA prior to the official submission of the Trip Report to the Architect and the lender.
4. HUD Inspector Oversight. The CA shall keep informed of the general quality of the performance of HUD Inspectors. A protocol for supervising HUD Inspector's field operations is established in the Inspection Contract and is followed for each project.
- D. HUD Inspector's Duties. The inspector is to observe and report on construction activities for compliance with the contract documents. The inspector must be factual and specific in all statements in reporting and recording significant construction developments observed.
- 1. Orientation. Upon assignment to a project, the inspector will study the drawings and specifications and become familiar with the conditions at the site.

2. Facilities. The contractor must furnish the inspector with enclosed working space that is acceptable to HUD. Adequate (but not elaborate) facilities should be required as soon as actual construction begins at the site.
3. Inspections.
  - a. The major functions during inspection are to:
    - i. Evaluate the performance of the contractor and construction administration of the supervisory Architect;
    - ii. Report on the contractor's conformance with construction schedule;
    - iii. Report on occupancy, delays, disputes, and changes;
    - iv. Conduct inspections of periodic construction progress and of critical phases of the work;
    - v. Report noncompliance with the contract documents observed by the inspector and/or the supervisory Architect;
    - vi. Determine that the amounts requested by the contractor and recommended by the Architect for payment are reasonable;
    - vii. Conduct employee wage interviews using Form HUD-11; and,
    - viii. Report on labor and EEO compliance.
    - ix. Review completed units and execute the Form HUD-92485 Permission to Occupy as required;
    - x. Report on compliance with a relocation plan, when applicable (see Chapter 3.1.KK and Appendix 3E for applicability and requirements).
  - b. Frequency. The inspector shall make one job site visit each month for new construction and substantial rehabilitation projects, except when HUD determines no inspection is necessary due to the progress of the work in a particular period. Additional visits may be necessary due to the nature of the project. The frequency of inspection should ensure reasonable continuity and be appropriately scheduled for the size and character of the project, the speed with which construction is progressing and the quality of work on the project. Visits should be scheduled to observe major construction operations without neglecting lesser operations. Enough time must be allotted to each visit to make a complete inspection. Inspection frequency for Section 223(f) transactions is described at Chapter 12.17.B.
  - c. Each inspection shall be recorded on a HUD Representative's Trip Report, Form HUD-95379.

- d. Reporting requirements. The following documents executed during inspection must be sent promptly to the CA, the project Architect and the lender's Construction Loan Administrator:
  - i. HUD Representative's Trip Report, Form HUD-95379: Original to the CA, with copies to the Architect and the lender's Construction Loan Administrator.
  - ii. Contractor's Requisition, Form HUD-92448: Original to the lender's Construction Loan Administrator for signature with copies of the signed documents to the CA, the Architect and the HUD Inspector.
  - iii. Change Order Form HUD-92437: Original to the lender's Construction Loan Administrator for signature with copies of the signed document to the HUD CA, the Architect, and the HUD Inspector.
  - iv. Permission(s) to Occupy, Form HUD-92485: When all required signatures (mortgagor, architect, contractor, lender, and HUD Inspector) are affixed, the document will be sent to the HUD CA for approval. Upon signing by the FHA authorized agent, copies are sent to the lender's Construction Loan Administrator, the Architect, and the HUD Inspector.
  - v. If any nonconformity with HUD requirements or site conditions not considered in the design is found at any point, they are to be reported by memorandum to the CA and to the Regional Center Director.
4. Start of Construction Date. The inspector will report the date of initial construction start and the date of the start of permanent construction on Form HUD-95379.
  - a. The date of the initial construction start, used for recording and reporting purposes, is the "start of construction" as used in connection with labor standards and prevailing wage requirements. This is defined as the beginning of initial site clearance and preparation, provided these activities are pursued diligently and are followed, without appreciable delay, by other construction activities.
  - b. The date recorded as the start of permanent construction, used for the purpose of determining the earning of the inspection fee, will correspond to the first day that permanent on-site building elements were put into place, such as footings and/or foundations, pilings, utility lines, etc.
  - c. While excavation is an integral part of foundation work, it does not constitute a start of permanent construction.
5. Shop Drawings and Other Data. During the construction period, the inspector must check whether shop drawings are being submitted by the contractor for approval by the Architect as required by the AIA General Conditions of the Contract. Upon request by the Architect or the inspector, the contractor will keep copies



of tests, certifications and any other data required by the contract documents onsite for review.

6. Work Stoppage. The HUD inspector will report to the CA on Form HUD-95379 any work stoppage unless such stoppage is due to inclement weather or similar reasons. If known to the inspector, the reason for the work stoppage should be stated and when resumption of construction is anticipated.

7. Occupancy. The HUD inspector will complete the portion, "FHA Inspection Report," of Form HUD-92485, Permission to Occupy, when submitted, to request permission to rent or occupy specific living units, commercial or other space. The Form is to be submitted when the inspector reports safe ingress and egress to the units and/or building, as evidenced by a certificate of occupancy from the locality. In the event that scheduling does not permit the inspector to inspect the completed units on a timely basis, then the CA may authorize the Architect to issue a phased Permission to Occupy on condition that the HUD Inspector will inspect the completed units at the next regularly scheduled site visit. Units and spaces should not be occupied prior to approval by HUD. The Regional Center Director should determine who in the Regional Center or Satellite Office will approve the permission to occupy.

- a. Occupancy prior to the execution of Form HUD-92485 will be reported to the Regional Center Director by written memorandum.
- b. The inspector will also include on the Form HUD-95379, the number of units occupied prior to approval, as well as the date occupancy took place.

8. Additional duties of the Inspector:

- a. Advises the Architect administering the construction contract on HUD requirements;
- b. Reviews the Architect's job log;
- c. Reviews copies of the Architect's decisions;
- d. Reports on project construction progress to the CA on Form HUD-95379;
- e. Notifies the Architect and the contractor if an identity of interest exists between the owner and the contractor, or if it is determined that there are any essential variations in the cost of the work installed, materials stored and the request for construction advances recommended by the Architect; and
- f. Conducts interviews with an appropriate sampling of the laborers and mechanics engaged and records interview information on Record of Employee Interview, Form HUD-11, in connection with wage and labor compliance in the construction of the project.

9. Construction record. From the initial construction start through final inspection, the HUD Inspector shall be responsible for maintaining a record of construction that includes minutes of the pre-construction conference as well as reports of required guarantee inspections. The Inspector shall keep a record binder when the CA

first assigns the project or may elect to expand the project record binder to include inspection reports. All forms, reports, decisions, and documents relevant to construction or inspection reporting shall be recorded in the binder in chronological order. The forms and documents listed below shall be included in the Construction Inspection Record Binder, when applicable.

- a. Drawings and specifications: Set 1, 2, and 3 referenced in journals though filed elsewhere (record the storage location of set 1 and use of 2 and 3).
- b. Off-site drawings and specifications (referenced in journal).
- c. Construction Contract, Forms HUD-92442M.
- d. Owner-Architect Agreement.
- e. Progress schedule (Form HUD 5372) and construction schedule (See Chapter 5.3.A.4 and 5.3.B.3).
- f. Contractor's and/or borrower's Cost Breakdown, Form HUD-2328.
- g. HUD Representative's Trip Report, Form HUD-95379.
- h. Contractor's Requisition, Form HUD-92448.
- i. Change Orders Form HUD-92437, AIA G710, and Architect's supplemental instruction or equivalent.
- j. Letters, memoranda, notes, and worksheets.
- k. Journal of Architectural Actions (if separate binder).
- l. Surveyor's Report, Form HUD-91073M (final and others, if requested).
- m. Permission(s) to Occupy, Form HUD-92485.
- n. Record of established escrows including amounts escrowed and a complete list of unfinished construction items, record of call-back inspections and recommendations for monies to be released.

10. Projects Insured upon Completion. The inspector will report the percentage of completion of the project on Form HUD-95379 at the end of each month. This percentage is an approximation for general information and is not used for disbursement.

11. Off-site inspection. The inspector checks all off-site construction for conformity with the terms of the contract and reports work progress by percentages on Form HUD-95379. Completion is reported on Form HUD-92464.

E. Construction progress meetings (monthly meetings). During construction the contractor, mortgagor, mortgagor's supervisory Architect and HUD Inspector must attend monthly job meetings at the job site when monthly requests for advances are prepared. The project architect is responsible for conducting and keeping official written records of the meetings.

1. The owner's representative must be a member of the borrower entity, usually a general partner or managing member with authority to make decisions. Non-profit organizations may be represented by an executive officer or member of the Board of Directors.

2. The MAP lender's representative must attend whenever the project is out of compliance, such as when construction has fallen more than 10% behind schedule according to the Construction Progress Schedule (HUD-5372), when work has stopped for more than 10 business days, contractors are not timely paid, the general contractor or any prime sub-contractor abandons the job, identified construction deficiencies are not timely addressed or the architect or general contractor are changed or other problems arise that jeopardize the completion of the project.

3. During the meeting, the HUD Inspector must:

a. Comment to the group on the quality of construction and of the Architect's observations and the contractor's supervision.

b. Comment on all known construction defects and deficiencies (non-compliance) and methods of correction.

c. Explain that changes in the work from the contract documents (non-compliance) must be resolved by approved change order requests or the work done in accordance with the contract documents. All change orders must receive prior approval before work subject to the change order is commenced.

d. Inform parties of HUD policy for holdback of construction advances until non-compliance is corrected.

e. Record on Form HUD-95379 the issues raised at the meeting. Significant concerns of any party should be presented by memorandum through the CA to the Regional Center Director.

f. Monthly meetings may also be used to resolve equal opportunity and labor disputes. When such disputes are known, the HUD Labor Standards and Enforcement and Equal Employment officers must be invited to attend.

g. Address any tenant relocation concerns, including any URA compliance-related issues.

F. Reporting and dealing with serious construction problems.

1. HUD Role: HUD Offices must identify and report, by electronic mail, to the Regional Center Director and Multifamily Asset and Counterparty Oversight Division (MACOD) all insured multifamily projects under construction or in the guarantee period that have serious construction defects or other serious construction-related problems. This information will be used to reply to inquiries, as an "early warning system" on troubled projects, and to determine if assistance by the HUD Office is necessary. The Production Division Director or designee will work with the lender, owner, contractor and other related parties to resolve the noncompliance.

a. HUD Inspector must identify all construction problems that may delay completion or lead to foreclosure or assignment of the mortgage to HUD by using Form HUD-95379, HUD Representative's Trip Report.

b. The CA must prepare a referral memorandum to the Regional Center Director when defects or construction-related problems occur such as:

1. Work stops for 20 calendar days;

2. There are slow payments or non-payments to the general contractor and/or subcontractors;

3. Contractor abandons the job;

4. Contractor, owner or Architect changes during construction;

5. Correction of any construction deficiency is not started within 30 days of the first notification to the contractor; or

6. Contractor can't or won't correct any construction defect or latent defect.

c. The referral memorandum must include full details of the construction-related problem, including:

1. A copy of Form HUD-95379, which identifies the problem.

2. The inspector's opinion of the cause and recommendation for correction.

3. A report of action by the CA and/or other HUD Office staff.

4. A report of actions by the owner, Architect, contractor, mortgagee, and bonding company (when appropriate).

5. A plan of action to be undertaken by the HUD Office if the mortgage is assigned to HUD during construction or foreclosure is initiated by the lender.

c. Only the initial report is required unless the Regional Center Director requests further action or follow-up by the HUD Office.

2. MAP Lender's Role: It is the lender's responsibility to work with the borrower, general contractor, and architect to get projects back on schedule and in compliance with the contract documents. The lender should take the lead in initiating appropriate measures and coordinate efforts by the development team. The borrower, lender, and general contractor must develop

an action plan and submit to HUD to get projects back in compliance when construction is 60 or more days behind schedule and/or the project is at risk of not reaching completion.

a. The MAP Lender shall prepare a written plan when the project is at risk before the project goes into default. This plan should include:

1. A description of the circumstances that led to the project being at risk of default
2. A listing of the issues needing resolution
3. An identification of which party has which role in the resolution
4. Action items needed and the responsible party/parties
5. A list of resources required and identification of those available for resolution
6. A timeline of projected deliverables and milestones toward resolution

3. For complete instructions on handling problems before final closing, see Appendix 12D.

## **12.4 Architect's Duties in Administering Construction**

The Architect administering construction (Supervisory Architect) shall:

- A. Provide services in accordance with the Owner-Architect Agreement.
- B. Have no identity of interest with the owner or contractor. An identity of interest is defined in the HUD Amendment to the B108, Owner-Architect Agreement.
- C. Ensure that construction is carried out in accordance with the contract documents, including:
  1. Restrict materials, products and equipment to those specified.
  2. Restrict all deviations to those substantially consistent with the original design concept including form, color, and texture.
  3. When arriving at the net amount due on every requisition, compare the cost of the work and materials with the cost to complete the project. Current and previous payment must relate to the total cost for completion.
  4. Restrict substitution of items of a different design or size from those specified to those that are equivalent in utility (i.e., durability, quality, and ease of maintenance).
  5. Restrict substitution of any material differing in composition or appearance from the one specified to one which is equivalent in its attributes (i.e., character, quality, durability and ease of maintenance).

6. Keep a log on the site that is readily available to the mortgagor and HUD representatives.
- D. Architect's supplemental instructions. The architect administering the construction contract may issue field orders using AIA Document G710, Architect's Supplemental Instructions, or a similar form.
1. The architect must send a copy of each supplemental instruction to HUD, although prior approval by the lender and HUD is not required.
  2. Supplemental instructions must not involve a change in contract sum or contract time.
  3. Supplemental instructions may be used to:
    - a. Direct the contractor to bring construction into compliance with the contract documents.
    - b. Interpret or clarify the contract drawings and specifications.
    - c. Order minor changes in the work, not involving cost.
    - d. Accept specified equivalents.
    - e. Record other "field orders" that are not construction changes.
- E. The Architect administering the construction contract is responsible for reporting in writing the results of periodic visits to the construction site. The Architect's log should provide information regarding assessment of the progress of the work and a record of the actions taken to ensure that the work is being accomplished in the best interests of all the parties.
1. The American Institute of Architects (AIA) Document G711, Architect's Field Report, may be used for the log.
  2. A log of each visit should show, at a minimum, the following:
    - a. Date of inspection.
    - b. HUD project identification and location.
    - c. Time, weather, and temperature range.
    - d. Estimated percent of completion.
    - e. Work in progress and conformance with the contractor's progress schedule.
    - f. Persons present at work site.
    - g. Observations and items to verify.
    - h. Information or action required.
    - i. Firm name and signature.

## **12.5 Architect's Adequacy**

The Architect's administration of the construction contract is covered by the Owner-Architect Agreement and by the General Conditions of the Contract for Construction. The HUD inspector is responsible for determining the adequacy of the Architect's administration.

- A. Deficient administration. The Architect's administration of the construction contract will be considered deficient when: 1) the Architect does not report all observed non-compliance with contract documents; 2) does not report instances of unacceptable performances; and, 3) fails to actively pursue remedies. The Architect will not be responsible for actual construction, construction means, methods, techniques or other related responsibilities of the contractor. However, based on on-site observation as the owner's agent the Architect must keep the lender, owner and HUD informed of the progress of the work and endeavor to protect the owner and HUD against defects, deficiencies, and delays in the construction.
- B. Reasons for termination of services. Inadequate performance, undue delay, misrepresentation or failure to act on the part of the Architect or the Architect's associates and employees shall be reason for the termination of the Architect's services on the project and may adversely affect the firm's acceptability on future projects.
- C. HUD office actions. The HUD inspector shall bring to the attention of the Architect specific areas in which services are considered deficient. Sufficient time and appropriate assistance shall be given to obtain necessary compliance.
  - 1. When the Architect's performance is first observed as deficient, in addition to the HUD Representative's Trip Report, Form HUD-95379, the inspector shall also prepare a written memorandum to the CA of the deficiency and advise of any planned actions or assistance. The memorandum should recommend that future requests for Architectural inspection fees be disallowed until performance improves to an acceptable level.
  - 2. An immediate follow-up by the CA is always required. Conferences with the inspector and the Architect should be arranged and a target date established for the Architect to comply. The CA shall inform the Regional Center Director of current problems and of established target dates for corrections. Deficiencies related to misrepresentation, undisclosed identity of interest and known illegal kick-backs should be immediately referred to the local HUD Office of General Counsel with a copy to the Regional Center Director. The local HUD Office should clearly document all actions.
- D. Request for contract termination. When compliance with the contract cannot be obtained within 30 days, the Regional Center Director shall request termination of the Architect's contract in accordance with the provisions of the AIA Owner-Architect Agreement. Upon termination, the Architect shall be entitled to only the prescribed portion of the fee determined by the percentage to which construction was completed on the date that the

Architect was removed from the project. The Regional Center Director has full authority to secure acceptable performance.

- E. Contract termination. The owner will hire an independent Architect who is acceptable to all parties to continue the administration of the project construction documents. The HUD inspector does not assume the Architect's responsibility.

## **12.6 Completion Inspections for New Construction and Substantial Rehabilitation**

- A. Substantial completion. The Architect will date and sign the certification on Form HUD-92485 Request for Permission to Occupy, for that part or for all the work that is sufficiently complete, in accordance with the contract documents, and may be occupied for the use intended.
  1. The contractor must submit a punch-list of items to be completed or corrected to the Architect when the work is ready for occupancy. (See Article 9.8, AIA Document A201.)
  2. The Architect will inspect, check the punch list and modify it if necessary, and determine when the work is substantially complete. (Dwelling units containing punch list items will not be accepted for occupancy. However, punch list items in interior common areas and on the exterior do not preclude occupancy.)
  3. Certificate of Substantial Completion: The Architect and HUD Inspector will verify on Form HUD-92485 Request for Permission to Occupy the date that the work, or a portion of the work, is substantially complete and suitable for occupancy. Where the Owner-Architect Agreement and the General Conditions of the Construction Contract, AIA Document A201, refer to a Certificate of Substantial Completion, it confirms that the Permission to Occupy Project Mortgages, Form HUD-92485, was executed. The date of substantial completion of a portion(s) of the project is the date that the HUD Inspector signs the Permission to Occupy for the portion(s) of the work completed. This is contrasted with the final completion date, which is the date the HUD Inspector signs the final HUD Representative's Trip Report, Form HUD-95379 evidencing that construction is 100% complete.
  4. The Contractor's Warranty Period commences with Substantial Completion of the Project as defined in Article 3.D of the Construction Contract, HUD-92442M which takes



precedence over AIA Document A201, Article 9.8.4, and stipulates that warranties commence with the substantial completion of each portion of the work.

- B. Final 100% draw completion inspection. The Architect and HUD inspector will make the final inspection upon written request of the contractor for 100% draw request requiring no modifications.
1. The Architect must determine that all punch-list items have been completed unless they are beyond the control of the contractor (i.e.: items of delayed completion).
  2. The inspector must prepare the final inspection report on Form HUD-95379 which includes:
    - a. Reports onsite construction completion, although there may be items of delayed completion.
    - b. Lists and describes any items of delayed completion.
    - c. Lists any offsite work and reports the percentage of completion for each.
  3. The HUD Construction Manager will check the final inspection report to determine:
    - a. If unacceptable and, requires re-inspection (i.e.: the report is not considered final).
    - b. If acceptable, the report will be endorsed as follows:
      - i. "Construction acceptably completed." (If there are items of delayed completion, add, "subject to escrow of funds to assure completion of listed items of delayed completion.")
      - ii. "All offsite sewer, water, electrical and gas facilities are completed, connected and operable, and safe, adequate, all-weather ingress and egress provided." (If offsite item incomplete, add, "except as stated at the time of inspection.")
      - iii. Date and sign the report.
    - c. CA will prepare a memorandum for signature by the Regional Center Director transmitting the final inspection report, which:
      - i. States the date of final completion (i.e.: the date of final inspection);
      - ii. Lists incomplete offsite work; and
      - iii. Lists items of delayed completion and the estimated of cost of completion for each item.

**NOTE:** The escrow for items of delayed completion must not be less than 150% of the estimate to complete and must not exceed 2% of the mortgage. Work must be completed within the time specified in Form HUD-92456M, Escrow Agreement for Incomplete Construction, but not more than 12 months from the date of the final HUD inspector's trip report.

C. Warranty inspections. Inspections to ensure correction of latent defects (defective or nonconforming work not observed during construction) or to check any item of delayed completion will generally not be required or expected to be performed by the HUD Inspector. HUD has the option of requiring such inspections on particular transactions. For those transactions where such inspections are requested by HUD, they should be performed within 1 year of the date of final completion and the following requirements will apply:

1. The CA will schedule guarantee inspections as follows:
  - a. If required, the first inspection must be within 9 months of final completion and should provide for inspection of the entire project.
  - b. Other inspections may be necessary to assure inspection of seasonal items such as heating and landscaping.
  - c. The last inspection must be not later than the 10th day of the 12th month after the final endorsement date to check previously reported defects and their correction, and to identify any additional defects.
  - d. The ninth- and twelfth-month warranty inspections are to be attended by the Architect, Owner and General Contractor. Copies of the Architect's Field Reports for these inspections are to be forwarded to both HUD and the Lender.
2. The Architect must report each guarantee inspection on Form HUD-95379, including:
  - a. If work is acceptable, state, "All observable work acceptable at the time of this inspection."
  - b. If unacceptable, list latent defects.
    - i. Describe each item.
    - ii. Recommend method of correction.
    - iii. Estimate current cost of correction.
  - c. Check any item of delayed completion and list complete and uncompleted items under a separate heading.
  - d. Note any improper maintenance or casualty damage under a separate heading.

## **12.7 Insurance of Advances and Related Matters**

A. General.

Insurance of advances is the process of releasing insured mortgage funds and other funds necessary for the construction, acquisition and/or refinancing of the project. The following general criteria apply to the advancing of such funds.

1. All escrowed funds for on-site improvements (with the possible exception of grant/loan proceeds furnished by a government agency or instrumentality or tax credit equity proceeds) must be disbursed before mortgage proceeds. See Chapter 14 for instructions on the pro-rata disbursement of tax credit equity proceeds. EB-5 Investments must be funded in advance, in the same way as other equity sources, and are not eligible to be disbursed on a pro-rata basis.
2. The amount of construction funds approved and advanced for insurance must be consistent with construction progress as approved by the HUD Inspector, except in the case of the initial and final advance which must be approved by the Regional Office Production Director, See Chapter 12.7.A.6 below.
3. Other mortgageable items must be adequately documented with bills and/or receipts before funds can be approved and advanced for insurance.
4. The amount advanced for construction items must be adjusted for a 10% holdback until 50% completion then reduced per Section 12.15.A.3 below.
5. The final amount approved for insurance must be supported by certified costs recognized in the cost certification review. Projects that are exempt from the cost certification process can submit for HUD's review a copy of their final Sources and Uses Statement prepared by the allocating State Housing Finance Agency or in the alternative, a statement of the final sources and uses amounts prepared by the title insurance company providing services for the project.
6. The Application for Insurance of Advance of Mortgage Proceeds, Form HUD-92403, is initiated by the mortgagor. The initial and final advances must be submitted by the mortgagee to HUD for review and approval. Interim advances are approved by the mortgagee, based upon the HUD Inspector's approval of the construction amount. The approved lender's construction loan administrator must sign forms HUD-92403 and HUD-92448 in the Authorized HUD Official signature block.
  - a. For the initial and final advances, the Regional Production Director must sign Forms HUD-92403 and HUD-92448, in the following spaces:
    - i. Under Authorized HUD Official for Form HUD-92403, and
    - ii. Under Director, Housing Production for Form HUD-92448.
  - b. For other interim advances, the lender (i.e., either the lender's underwriter or construction loan administrator) must sign Forms HUD-92403 and HUD-92448 for HUD, in the same spaces as described for signatures by the Regional Production Director for initial and final advances in the immediately preceding sub-paragraph 6.a.

7. Requests for funds must be supported with relevant evidence attached to Form HUD-92403 and Form HUD-92448, Contractor's Requisition, such as bills and receipts.
8. Please see Chapter 19, Closings for additional requirements related to title and survey matters.

B. Lender's role in processing HUD-92403 Application for Insurance of Advance includes:

1. Complete the application indicating:
  - a. In Column B, amounts approved by the lender/HUD;
  - b. Lender's approval date;
  - c. Amount to be advanced from mortgage proceeds;
  - d. Amount disbursed from mortgagee's front money escrow, if any; and
  - e. Total loan proceeds disbursed including the current request.
2. Submit the initial and final application to HUD for review and approval.
3. Process and approve interim advances.
4. Ensure clear title before advancing the approved disbursement.
5. Notify HUD in writing when clear title does not exist or is impaired by reason of mechanics liens unresolved for more than 60 days or other impairments appearing since initial endorsement without Lender and HUD consent.

C. Stages of Advances.

In cases involving insurance of advances, HUD and the lender's processing of advances is divided into the following stages:

1. Initial advance. Refers to the first application and coincides with the initial endorsement of the HUD-insured Note. The initial advance will be reviewed and executed by the HUD mortgage credit analyst. The lender should submit Form HUD-92403, Application for Insurance of Advance of Mortgage Proceeds, with supporting documentation for HUD approval.
2. Interim advances. Interim advances are subsequent applications up to completion of the project and will be processed and approved by the lender.
3. Next to Final Advance. When HUD is in receipt of the contractor's certification and the consent from both the mortgagor and surety, if any, the final 2.5% of the construction holdback is released.

Note: This procedure applies only to non-identity of interest contractors or where the contractor's identity of interest in the project ownership is not greater than 5%.

4. Final Advance. This refers to any remaining balance of mortgage proceeds at final endorsement and takes into consideration funds necessary to set up the escrows for

“Items of Delayed Completion” and “To Be Paid in Cash Items” and will be processed by HUD. In addition to the Form HUD-92403, the lender must submit a copy of Form HUD-92451 Financial Record of Mortgage Loan Transaction (or similar format in an Excel worksheet), which reflects payments to the various participants during the construction period.

- D. Instructions for Approval of Initial/Interim Advances can be found in **Appendix 12A**.
- E. Contractor’s Monthly Requisition and Related Matters. See Appendix 12B for instructions on completing Contractor’s Requisition, Form HUD-92448, and related matters.
- F. Next to Final Advance. The lender may request the next to final advance when construction is acceptably complete, even if there are items of delayed completion.
  - 1. It may provide for the release of the contractor’s holdback provided the conditions in Section 12.15.E have been met. The amount approved for release will be based on the cost certification review and HUD-approved amount (or where the cost certification is exempt, an operating statement is reviewed instead). The amount approved for release will also consider items of delayed completion. A special condition will be included in the Firm Commitment in the event that the cost certification is exempt, and an operating statement will be reviewed instead.
  - 2. The balance of the off-site escrow may be released upon HUD approval provided:
    - a. The off-site sewer, water, electrical and gas facilities are completely installed and connected for a period not less than 30 days; and safe and adequate all-weather facilities for ingress and egress are provided.
    - b. All other required off-site construction, if any, is completed.
    - c. There is no event of default on the mortgage or failure to comply with program obligations.
    - d. The mortgagor has provided a latent defects assurance consistent with the requirements of form HUD 91073M.
- G. Final Advance. The Application for Insurance of the Final Advance will request any remaining balance of mortgage proceeds and ensures that:
  - 1. The mortgagor’s cost certification has been approved and the maximum insurable mortgage amount determined using Form HUD-92580, Maximum Insurable Mortgage.
  - 2. Form HUD-92403 is accompanied by a completed Form HUD-92448, with required Contractor’s Prevailing Wage Certificate, if the contractor’s holdback has not been previously disbursed. Refer to Section 12.15.E for instructions on releasing the contractor’s holdback.

3. The sum to be approved for the advance is the balance of the mortgage proceeds, based on the maximum insurable mortgage on Form HUD-92580. Refer to Section 13.12 for instructions on an advanced amortization adjustment, if any.
4. An escrow is established for incomplete or delayed construction items under the provisions of Form HUD-92456M, Escrow Agreement for Incomplete Construction.
5. Form HUD-92023M, Request for Final Endorsement of Credit Instrument, or Form FHA-2453, Commitment to Insure upon Completion, must have been submitted and reviewed.
6. Set up the escrow for the mortgagor's unpaid construction costs under the provisions of Form HUD-92456M, Escrow Agreement for Incomplete Construction.

H. Keeping the mortgage in balance.

Soft cost overruns (such as interest, taxes, mortgage insurance premium [MIP], and property or liability insurance) that result from a construction delay before completion of the project and is the fault of the general contractor, (i.e. due to poor performance), are funded according to the liquidated/actual damages clause in the construction contract. This clause is not intended to penalize the contractor, but to provide a source of funds for the increased soft cost. When the interest allocation is over expended (*i.e. when the percent of the interest allocation expended exceeds by 10% or more the percentage of completion indicated by the Construction Progress Schedule, form HUD-5372 or the budgeted interest allocation remaining is demonstrably insufficient to carry the loan through Final Endorsement*) the lender must notify HUD immediately, and HUD will advise the lender of the following procedures:

1. When the interest allocation is insufficient, have the Architect and the HUD inspector estimate an expected completion date.
  - a. 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 estimated completion date.
  - b. When the interest allocation has been exhausted, the non-profit developer's fee, if applicable, or the working capital escrow should be used to keep interest current.
  - c. Transfer the computed liquidated damages amount from column I, Construction, to Column G, Carrying Charges and Financing, on Form HUD-92451 (or similar format in an Excel worksheet) and:
    - i. Allocate the full amount to interest, initially.
    - ii. Funds may be used for MIP, taxes, or insurance payments, if requested, after the funds for these line items and non-profit developer's fee, if applicable and working capital escrow are exhausted. However, funds transferred from the construction account may be used to cover only the cost of those items attributable to the period between the completion date specified

in the construction contract as adjusted by any approved change orders, and the estimated completion date.

2. Notify the borrower, contractor, HUD and the surety, if any, by certified mail of the amount and the reason for the transfer.
3. Require written acknowledgment from HUD and surety, if any, before transferring funds.
4. 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*.
5. After review of the cost certification documents, if the full amount of transferred funds was not needed to cover the cost of interest, MIP, taxes, and insurance attributable to the period identified, the balance will be transferred back to the construction account.
6. In processing Form HUD-92448, before releasing the general contractor's holdback, make adjustment for the lesser of actual or liquidated damages determined in the cost certification review.
7. This procedure should be used only if, in consultation with the Regional Center Director, it is determined that the problems causing the delay will be remedied within the near future.

In the event the project continues to sustain an imbalance between sources and uses of funds, the Regional Production Office will inform the Regional office of Asset Management about the issues and the status of any release of IOD funds.

## **12.8 Construction Change Orders – General HUD Duties**

- A. General instructions. Construction contract changes to the scope of contract work, contract price or contract time must be requested by the mortgagor through the lender on Form HUD-92437, Request for Construction Changes and must be signed by the mortgagor's Architect, the mortgagor, the general contractor and the lender before HUD reviews the change order for approval.
  1. HUD review and approval. The HUD CA will review each change order and describe the substance and consequence of the change to the HUD underwriter who will consult the respective Technical and/or Underwriting Branch Chief on any consequential change.
  2. Change orders will be approved only when they are necessary, or are for betterment or an equivalent. The following information should appear on the face of the change order:
    - a. Classification (necessary, betterment, etc.);
    - b. Qualification for payment from the contingency reserve and from the developer's fee for non-profit borrowers; and

- c. Whether the change order results from error, omission or negligence on the part of the Architect, contractor or mortgagor.
3. Change orders submitted after the final HUD Representative's Trip Report will not be approved, except where:
  - a. The change order pertains to "Items of Delayed Completion," or
  - b. Written approval is given by the Regional Production Director.
4. Surety approval must be secured in writing before approving any change order for time extension (see Chapter 12.8.G.1.c). Surety consent is not required where the project's assurance of completion is by a cash escrow or letter of credit.
5. Working capital new construction contingency. The working capital escrow requirement for new construction transactions is 4% of the mortgage amount, half of which (or 2%) is used as new construction contingency to fund HUD approved change orders, construction cost overruns and other cost overruns not caused by the General Contractor. For eligible uses and procedure for release of the working capital escrow see Chapter 12.15. C.

B. Other change order policies.

1. Changes must be accurately reported and accounted for pursuant to U.S. Criminal Code, Section 1010, Title 18, U.S.C.
2. Procedures for changes outlined here are not to be used to alter the intent of the contract documents or to lower the quality or value of a project.
3. HUD does not initiate any change but may require it as a condition of approval in connection with a change proposed by the Architect, mortgagor or contractor.
4. All changes must be approved in writing by the lender and HUD before they are made.
5. Any change that is made without formal approval, even though tentatively agreed to as technically acceptable, must be recorded by the HUD Inspector as a noncompliance until the Form HUD-92437, Request for Construction Changes - Project Mortgages, is approved. The payment of future insured advances may be affected until corrected.
6. Change orders that include a physical alteration such as change of materials, change of building plans, or change of site plans must not have any negative impact on the approved environmental review or any mitigation conditions. If the change order will have an impact, HUD will either reject the change order request or require an updated environmental review consistent with Chapter 9 requirements.

C. Change order classification.

1. Necessary changes (which the CA or designee must document) are those that arise from:
  - a. Latent conditions that differ from conditions defined by the construction documents;
  - b. Changes in the applicable state or local codes, ordinances, etc. after:



- i. Initial closing for insured advances; or
      - ii. Firm Commitment for insurance upon completion.
    - c. The Architect's errors or omissions.
    - d. Damage to completed construction.
  2. Betterment changes are those that are economically justified. They must either:
    - a. Increase net income;
    - b. Reduce long-term project maintenance and/or operating expenses; or
    - c. Otherwise enhance the mortgage security.
  3. Equivalent changes are those proposed because:
    - a. A specified item is not readily available, and the substitution provides equivalent or better utility and performance, or
    - b. The proposed substitution reduces the contract price but provides equivalent or better utility and performance.
- D. Additive change orders. The lender must not give any explicit or implied assurance to the borrower or the contractor that an increase in the insured mortgage amount will be granted when construction changes are approved.
1. Except for "necessary" change orders, the lender must require the borrower to escrow funds with the lender for any additive change order where HUD first estimates that the aggregated change orders equal or exceed a \$5,000 increase in the construction contract price, and for all subsequent additive change orders. The lender may submit to HUD a letter of confirmation from the contractor stating that the borrower has fully paid for the approved change order instead of escrowing the funds. Non-profit borrowers may use the developer's fee to fund additive change orders. After 75% completion is achieved and if construction is on schedule and without findings of non-compliance, the CA may allow any HUD approved additive change order to be funded from the 2% contingency.
    - a. Excess mortgage proceeds, if available, may be used to fund the escrow for necessary and betterment change orders. However, any excess mortgage proceeds used to fund the escrow for contractor estimated costs in excess of HUD estimated costs, or HUD estimated costs in excess of contractor estimated costs, may not be disbursed until final closing. [See Cross References at Chapter 8.14.K and Appendix 12A paragraph D]
    - b. The lender may accept a third-party letter of credit instead of a cash deposit, subject to the lender agreeing to provide the cash equivalent, where the letter of credit is not immediately honored.
    - c. The lender may recognize the cost of third party paid change orders at cost certification, where there are available mortgage savings.

2. For substantial rehabilitation projects the lender must approve disbursements from the established contingency reserve in an amount not to exceed the HUD cost estimate for necessary or betterment change orders.
  - a. The lender must require an escrow for any amount that the contractor's cost estimate exceeds the HUD estimate.
  - b. The lender may authorize the use of excess mortgage proceeds, if available, to satisfy the escrow requirement, subject to the disbursement limitations in Chapter 12.8.D.1.a above.
  - c. After substantial rehabilitation work is complete and approved by the HUD Inspector and subject to lender and HUD approval, the borrower may elect to apply funds remaining in the contingency reserve line item to do:
    - i. necessary, further improvements, betterments or upgrades to the property,
    - ii. an initial deposit to the Reserve for Replacement account, or
    - iii. a reduction to the principal mortgage balance.
3. The lender must approve the following forms for mortgagor's application for funds for completed additive change orders:
  - a. Form HUD-92464M, Request for Approval of Advance of Escrow Funds, where an escrow is used, which must be submitted to HUD for approval.
  - b. Form HUD-92403, Application for Insurance of Advance of Mortgage Proceeds, where a rehabilitation project's contingency funds or a non-profit's Developer's fee or excess mortgage proceeds are to be used.
- E. Deductive change orders. Where the HUD estimated decrease in contract price for any aggregation of change orders:
  1. Remains less than 2-1/2% of the contract price, the lender must reduce the Contractor's "Final" Requisition, Form HUD-92448, by the appropriate amount.
  2. Equals or exceeds 2-1/2% of the contract price and for all subsequent deductive change orders regardless of the amount, the lender must:
    - a. Reflect the decrease in the Contractor's Requisition, Form HUD-92448, item 8.
    - b. Reduce the original mortgage amount at cost certification, where required.
- F. Changes that adversely affect property income are a basis for change order rejection, except where it is a necessary change order and the situation is unavoidable. HUD staff must adequately document the analysis and decision showing that the change resulted in less property income. If the estimated reduction in property income would result in a reduced mortgage amount, the change order must be submitted to the Regional Production Director for review and approval. (See Chapter 12.10 and 12.11 below.)
- G. Extension of contract time.

1. The MAP Lender may approve an extension only where:
    - a. The delay is beyond the contractor's control (e.g. strikes, adverse and unknown site conditions, bad weather exceeding the average for the season, etc.) and the delay is documented or associated with an approved change order,
    - b. The extension request is submitted within the limit provided by the contract and the general conditions for delays beyond the contractor's control, and submitted concurrently with any requested changes in the work, and
    - c. The request is accompanied by a Surety's written consent. There is no consent requirement where the project's assurance of completion is by a cash escrow or letter of credit.
  2. The lender may require funding for the increased cost for interest, taxes, insurance, MIP and contractor's general requirements by use of a cash escrow, excess mortgage proceeds, or non-profit's developer's fee, if applicable, or from contingency reserve.
  3. HUD may enforce liquidated damages in accordance with the terms of the construction contract (Form HUD-92442M).
  4. Required documentation. Within 21 days of the date a construction delay occurs, the contractor must document the delay with the Architect and include:
    - a. Date of occurrence and number of calendar days it covered;
    - b. Effect on construction progress;
    - c. Cause of the delay. If the cause is of a continuing nature, submit the extension request when the cause ceases, but still record the initial date of occurrence and its effects on construction; and
    - d. The extension request must include the written consent of the Surety and conform to AIA Document A201, Article 8.3.
- H. Changes to items of delayed completion are the only construction contract changes that the HUD CA may approve after project completion. All others require the Regional Center Director's consent.
- I. Emergency changes.
- The only time a change can be made without prior written approval of the lender and HUD is in emergencies that:
- a. Endanger life or property; or
  - b. Halt construction.
- However, even then, the Architect must notify the lender and HUD and as soon as possible, submit a Form HUD-92437.

- J. Insurance Upon Completion: Construction Contract Changes, Form HUD-92437, are to be processed in the same way as Insurance of Advance cases, except as modified below:
  - 1. An escrow is not required for additive change orders. The borrower:
    - a. Must be able to provide the additional funds required, and,
    - b. Must not have any outstanding obligation in connection with construction other than the insured mortgage at the time the mortgage is presented to HUD for insurance upon completion.
  - 2. Surety approval is not required for the approval of additive change orders regardless of the percentage of contract increase.
- K. Changes to offsite construction must be requested by letter or other acceptable format with the information required by Form HUD-92437 used as a general guide, although the actual form must not be used.
- L. Other changes. Changes necessitated by error, omission or negligence of the Architect, owner, or contractor must be recorded by the HUD CA or HUD inspector, on Form HUD-92437, including.
  - 1. The reason for the determination; and
  - 2. Confirmation that the cost of the changes must not be included in the mortgage amount.

## **12.9 Change Orders – Inspection Instructions**

### **A. General procedure.**

**NOTE:** For projects involving insurance upon completion, references here to "contract requirements" or "contract documents" include the conditions and provisions of the commitment if there is no construction contract.

- 1. Any contemplated changes are first discussed among the Architect, contractor, owner, and HUD inspector.
- 2. The HUD inspector may assist the general contractor and owner by reviewing potential change order packages as desired to make a preliminary determination of technical acceptability before the change is submitted for approval to the lender and the HUD Office. (This neither commits HUD to the change, nor relieves the Architect or the contractor of having to submit Form HUD-92437.)
- 3. All onsite changes to construction documents and requests for time extensions must be submitted for approval on Form HUD-92437, Request for Construction Changes - Project Mortgages.

- a. Required attachments for physical changes are:
  - i. Appropriate modifications to the contract drawings and specifications;
  - ii. Architect's statement that the change:
    - (1) Conforms to the original intent of the contract drawings and specifications;
    - (2) Is necessary to overcome an impediment to construction, or is an addition desired by the owner.
  - iii. Backup documentation from the contractor of the amount requested consisting of itemized quantities and costs including a breakdown of labor and materials, as well as any requisite general requirements and eligible allowances for overhead and profit.
- b. The form must be signed by the:
  - i. Borrower,
  - ii. Contractor,
  - iii. Architect; and,
  - iv. Authorized representative of the lender.
4. All offsite changes to construction documents and requests for time extensions must be:
  - a. Requested in a letter or other format acceptable to the CA, but not on Form HUD-92437.
  - b. Documented and processed the same as on-site changes.
5. HUD will promptly review all requests submitted so delays will not affect construction or contractor requisitions.
  - a. Processing should normally take no more than 5 workdays and is directed by the CA.
  - b. All construction change requests must be reviewed, signed, and dated by the CA.
6. Voiding changes. If an approved change is not made, it must be nullified by a Form HUD-92437 restoring the drawings and specifications to the status prior to the change request or to a status acceptable to HUD.
7. Unapproved changes. When there are unapproved changes in the construction, the HUD inspector must modify the amount of the contractor's requisition to cover:
  - a. The non-compliance (any change that has not formally been approved on Form HUD-92437), and
  - b. Construction removal that may be required if the unapproved change does not receive approval.

## **12.10 Change Orders – HUD Architectural and Cost Instructions**

A. Architectural. The HUD CA will review all requested changes for technical acceptability.

B. Cost.

1. Construction changes:

- a. The HUD CA will produce a cost estimate for each construction change request submitted by the mortgagor by applying current data to accepted or amended change order quantities; include amounts for general requirements and builder's overhead and profit using the percentage of each from Section G of Form HUD-92264 that was approved at Firm Commitment.
- b. Compare the estimate with the mortgagor's estimate and, if reasonable, use the mortgagor's figure. Otherwise use the HUD estimate.
- c. Complete the cost entries on Form HUD-92437 and forward the completed form to the HUD underwriter.

2. Approved time extensions:

- a. Calculate the additional general requirements cost due to the extension of time.
  - i. Divide the cost of general requirements from the contractor's approved Form HUD-2328 by the number of months estimated for construction from Section G of Form HUD-92264 approved at Firm commitment. Sixty-five percent of this amount is the estimate per month of additional general requirements.
  - ii. Use one quarter of the monthly estimate per week.
  - iii. There is no cost effect for extensions of time for less than one week.
- b. Complete the cost entries on Form HUD-92437 and forward the completed form to the HUD Underwriter.

## **12.11 Change Orders – HUD Underwriter Instructions**

A. Appraisal Reconsideration, When Required.

1. The HUD underwriter must determine if a requested change is likely to reduce project marketability or income by reducing rents or revenue and/or increasing operating expense. The HUD underwriter or the assigned HUD appraiser must identify and explain any estimated increase or decrease in net project income on the reverse of Form HUD-92437.

2. The HUD underwriter or assigned appraiser must prepare a Trial Form HUD-92264 and Trial Form HUD-92264-A reflecting the new data for the HUD underwriter to re-determine the maximum insurable mortgage.

B. HUD underwriter tasks

1. Processing.

- a. If the borrower's or contractor's estimate for the change order exceeds HUD's estimate, the difference must be escrowed with the lender. Excess mortgage proceeds, if available, may be used to satisfy this requirement. Conversely, that portion of HUD's estimate that exceeds the borrower's or contractor's estimate must be restricted and held until final endorsement to ensure funds to complete the project.
- b. Process the cost and appraisal findings and show the cumulative effect on cost of all approved change items.
- c. Use Chapter 12.8.D and 12.8.E for additive and deductive change orders.
- d. Recalculate the maximum insurable mortgage when any approved construction change or changes adversely affect net income, e.g., a change that causes an increase in project operating costs or a reduction in project income.
  - i. The HUD underwriter or assigned appraiser completes a Trial Form HUD-92264 with an updated income and expense analysis.
  - ii. Re-determine the maximum insurable mortgage.
  - iii. If the re-determined mortgage is lower than the original mortgage amount, as a condition of approval of the change order, indicate in item 3b of Form HUD-92437 that subsequent Contractor's Requisitions, Form HUD-92448, must be reduced by the greater of:
    - (1) The difference in mortgage amounts;
    - (2) The net increase in costs resulting from acceptable construction changes.
- e. Extensions of time.
  - i. The HUD CA is responsible for determining whether the delay was beyond the contractor's control and, if so, the length of the approved time extension.
  - ii. Calculate the cost increase due to the extension:
    - (1) Compute pro-rata daily rate for interest, taxes and insurance by using estimates in Section G of Form HUD-92264 and

multiply these rates by the approved time extension measured in days.

(2) An additional year of MIP will be required if the approved time extension, when added to the estimated construction term plus the two months included in Section G of Form HUD-92264 plus previously approved time extensions, would extend the term past twelve, twenty four or thirty six months, as applicable.

(3) Add the additional general requirements, if any, noted by the HUD CA on the change order request.

NOTE: Only Item (3) above amends the construction contract price on Form HUD-92437.

- iii. Determine the source of funds for any increase due to the extension, e.g. cash, excess mortgage proceeds or non-profit's developer fee, or contingency reserve funds.
  - iv. Requests for release of excess mortgage proceeds or contingency reserve funds set aside to fund time extensions are submitted on Form HUD-92403.
  - v. Releases from a cash deposit are made using Form HUD-92464M.
  - vi. These funds may be released only after the account for the soft cost item(s) being requested has been exhausted on Form HUD-92451, Financial Record of Mortgage Loan Transaction (or similar format in an Excel worksheet).
2. Requests for disbursement of contingency reserve funds, working capital construction contingency funds and non-profit's developer fee for completed change order items, are made on Form HUD-92403. All requests:
- a. Must be accompanied by a certification by the borrower's supervisory Architect and the HUD Inspector that all the work covered by the change order was acceptably completed in accordance with contract documents.
  - b. Must include the authorization by the Depository Institution relative to payment to the contractor contained on Form HUD-92464M, Request for Approval of Advance of Escrow Funds.
  - c. Must include the criminal certification contained on Form HUD-92464M for certifications made in paragraphs a and b above.
  - d. Are subject to a holdback of retainage consistent with the construction contract.



3. Change orders funded from excess mortgage proceeds. Excess mortgage proceeds may be used to fund either necessary or betterment change orders.
  - a. These funds may be used to fund HUD's estimate of increased costs as well as any portion of the contractor's estimate that exceeds the HUD estimate. The portion that exceeds HUD's estimate must be restricted until final endorsement.
  - b. Funds are released in the same manner as contingency reserve funds.
4. Releasing Cash Deposit. The borrower must submit, through the lender, Form HUD-92464M when construction covered by a cash deposit is complete and acceptable to HUD.
  - a. The borrower's supervisory Architect and the HUD inspector must certify on Form HUD-92464M that all work and materials covered by the change order are satisfactory and consistent with contract drawings.
  - b. If construction costs were paid in full by other than the cash escrow or excess mortgage proceeds before submitting the disbursement request to HUD for approval, the borrower must submit a receipt of payment signed by the general contractor.
  - c. If construction costs will be paid after HUD's approval for the release of the funds deposited for the construction change, before the next Form HUD-92403 is submitted, the borrower must submit a receipt of payment signed by the general contractor.
5. Change Order Summary Sheet showing cumulative cost of all executed change orders should contain, at least:
  - a. The date the change order was signed by the borrower;
  - b. The date HUD received the change order;
  - c. The date the HUD underwriter completed review of the change order;
  - d. The borrower's or contractor's estimate of cost for the change order;
  - e. HUD's estimate of cost for the change order;
  - f. The amount of change orders to be funded from contingency reserve, working capital construction contingency, non-profit's developer fee, or excess mortgage proceeds;
  - g. The required cash escrow deposit, if any;
  - h. The HUD percentage of cost increase or decrease.

## **12.12 Labor, Fair Housing and Equal Opportunity (FHEO) and URA Compliance**

### **A. Wages**

1. Payrolls. Contractor payrolls are submitted directly to the HUD Labor Standards and Enforcement staff a minimum of once a month.
2. On-site interviews. The HUD inspector submits all original copies of Form HUD-11, Record of Employee Interview, to the HUD CA who forwards these to the HUD Labor Standards and Enforcement Staff.

B. Labor violations. The HUD CA must advise the Labor Standards and Enforcement Staff of continuing minor infractions that cannot be resolved or of any identified or suspected major violations. Labor standards enforcement staff shall provide written clearance to Housing and OGC in connection with final closing confirming either that there are no outstanding issues and the project may proceed to closing without condition, or that outstanding issues remain and the closing may proceed conditioned on the deposit to the U.S. Treasury of funds sufficient to meet any wage restitution and/or liquidated damages that have been or may be found due. Final closing may not occur without receipt of this written guidance from labor standards enforcement staff.

C. FHEO noncompliance. The HUD CA must advise the local HUD Director of FHEO of continuing minor noncompliance that cannot be resolved or of any identified or suspected major noncompliance.

D. Compliance with any applicable relocation plan. See Chapter 3.1. KK and Appendix 3E. If existing tenants are displaced by rehabilitation or repairs and alterations, a relocation plan should be in place and the borrower must be executing the plan. If the lender, the HUD inspector or the HUD CA observe relocation of existing tenants where no relocation plan is in place or observe an unmet need to relocate tenants, the Regional Production Director must be immediately advised and the borrower required to cease any construction activity that requires or should require (as prescribed in Chapter 3.1.KK) the borrower to relocate tenants. If the project is subject to the Uniform Relocation Act or Section 104(d) of the Housing and Community Development Act of 1974 as described in Chapter 3.1. KK, the HUD CA should promptly seek the assistance of the HUD Regional Relocation Specialist. Otherwise the HUD CA should advise the lender and the borrower that the HUD approved relocation plan must be followed, or if no such plan is approved, then a relocation plan consistent with Appendix 3E must be prepared, approved by HUD and implemented before any further construction that requires relocation may proceed.

### **12.13 Surveys**

Surveys must be by a licensed surveyor and show the exact location of on-site improvements, including utility lines and easements. Please see the FHA Multifamily Program Closing Guide for additional requirements related to survey matters.

- A. The contractor must give the owner and HUD surveys:
  - 1. At any time, the owner or HUD requires, and
  - 2. When construction is complete (“as-built” survey).
- B. The inspector, when uncertain of the location of construction or stored materials in relation to property lines or easements, may ask the Architect to require a survey with the next contractor's requisition.
- C. If encroachments are found, the inspector must notify the HUD CA by memorandum explaining the conditions. (Encroachments may jeopardize the entire property as security for an insured mortgage.)

### **12.14 Permission to Occupy**

Permission to Occupy Form HUD-92485 must be executed and dated by the Architect before the borrower permits occupancy of any phased dwelling unit and signed and dated by the HUD inspector on the same date as the Architect for the final Permission to Occupy.

- A. Physical completion. The work, or portion thereof for which Permission to Occupy is approved, must be sufficiently complete in accordance with the contract documents so the mortgagor can occupy or utilize the identified portion of the work for its intended use.
  - 1. Support facilities (utilities, disability access, vehicular access and parking, fire life-safety equipment, etc.) must be in place.
  - 2. The acceptability of each unit and facility for which Permission to Occupy is requested must be confirmed:
    - a. Property must be inspected and Form HUD-92485 signed by the borrower, supervisory Architect, contractor, and HUD Representative.
    - b. Minor items that do not preclude occupancy are permitted but must be listed as an attachment to Form HUD-92485.
    - c. The contractor is fully responsible for any incomplete or improperly performed contract work whether or not listed.

B. Signatures, Approval and Permission:

1. Form HUD-92485 must be signed by the borrower, supervisory Architect, contractor, lender, and HUD CA.
2. Approval: The HUD CA or a designated HUD Technical Branch Chief signs as Chief, Architecture and Engineering Section. The Underwriting Branch Chief signs as Chief Underwriter.
3. Permission to Occupy: The Regional Production Director will designate an FHA Authorized Agent in the Regional Center or Satellite Office to sign the Permission to Occupy.

C. Submission Documents. The lender must sign Form HUD-92485 agreeing with the request and stating that insurance risks have been covered for the project. The borrower must include the following documents with the completed Form HUD-92485:

1. A Certificate of Occupancy or equivalent permit from the governing municipal authority for all units and facilities listed on the Permission to Occupy; and any other required permits or authorizations;
2. An accord or certificate of property and liability insurance from the borrower's insurance company.

D. Partial Occupancy Approval.

1. Favorably consider partial occupancy of units as they become available, where vandalism could be minimized, needed project income is provided, an earlier rent-up date could be achieved, utility costs for occupied units can be metered separately from contractor's utilities, etc.
2. Approve a series of Permissions to Occupy as units or facilities become available, e.g. individual buildings on multi-building projects, or individual floors or wings on larger buildings.
3. Approve a single Permission to Occupy for all units where dictated by management considerations, e.g. very small projects.

## **12.15 Escrowed Funds, Letters of Credit, Deposits, Holdbacks and Related Matters**

A. Borrower's Application for Disbursement of Escrowed Funds, for HUD approval.

Form HUD-92464M, Request for Approval of Advance of Escrow Funds, must be used where the escrow is to ensure completion of offsite improvements, demolitions, additive change orders, Non-Critical repairs and accessibility-related Critical repairs approved for deferred completion (within 12 months of initial closing) under Section 223(f) program, temporary resident relocation, or borrower's unpaid construction items at final endorsement.

1. The borrower must initiate the process by completing Form HUD-92464M. The borrower must determine the amount of funds to request for release from the escrow that align with the completed work. The lender must complete the Form before submitting a disbursement request to HUD for approval.
2. The HUD Inspector is required to record the percentage of acceptably completed escrow work on the HUD Representative's Trip Report, Form HUD-95379, and should also sign page 5 of Form HUD-92464M in the space for the HUD Inspector if requested work is acceptably completed. The borrower will review the Trip Report to determine the amount of funds to request for release of escrow funds that align with the completed work. After the borrower has reviewed the Trip Report and entered information on the HUD-92464M, the borrower must forward a copy of both Forms to the lender for their review and completion before the disbursement request is submitted to HUD.
3. HUD will not authorize interim advances (HUD-92403) that exceed the documented percentage of completion less the applicable retainage. An interim advance is the difference between the percentage of completion times value of work currently complete previous payments that included a 10% retainage, until work is 50% complete. (This does not apply to the Section 223(f) program.)
4. Where excess mortgage proceeds are used to fund an escrow for completion of offsite improvements, additive change orders or mortgagor's unpaid construction items, return the original copy of Form HUD-92464M to the depositor and retain one copy.

B. Release of letters of credit. In the event of a claim:

1. Assignment. HUD will not accept an assignment of the letter of credit to HUD from the lender.
2. Undrawn Balance. HUD will treat any undrawn balance from a letter of credit or escrow agreement as cash held by the lender.
3. Cash equivalent. The lender must provide cash equal to the undrawn balance, if demand on a letter of credit is not met.

C. Working Capital Deposit (HUD-92412M) escrow is established at initial closing with the lender. It is the responsibility of the borrower to advise the lender how it plans to fund the escrow: either by cash, a letter of credit, excess mortgage proceeds, or excess land equity, if any.

1. Purpose. The deposit is used to:

- a. Defray the cost of initial marketing and rent-up including sales and advertising, model furnishing, and equipment and supplies essential to initial rent-up, etc.
  - b. Cover project expenses that are not covered by project income or the Initial Operating Deficit Escrow in the first operating year. The project expenses include real estate taxes, permanent property insurance premiums, mortgage insurance premium, ground rents and assessments.
  - c. Cover shortfalls in interest, taxes, property insurance premiums, mortgage insurance premiums, ground rents and assessments during construction after funds available under the Building Loan Agreement are exhausted.
  - d. Fund necessary change orders and construction cost overruns not caused by the contractor from the 2% new construction contingency portion of the working capital escrow.
2. Control and Release of Escrow. The lender controls disbursements from the escrow and, in conducting its due diligence during initial occupancy, is required to fully document all expenditures from the escrow. In reviewing a borrower's request to release a partial amount of escrow, the lender should consider the following.
- a. Borrower's request for the release of such escrow funds must be by letter to the lender, rather than on Form HUD-92403.
  - b. None of the escrow can be used to defray any of the hard costs of construction applicable to the Total for All Improvements, Section G of Form HUD-92264, Rental Housing Project Income Analysis and Appraisal (or other Firm Stage underwriting form applicable to the Section of Act the project is to be insured under).
  - c. Avoid premature disbursements and unnecessary expenditures.
  - d. As portions of a project are ready for occupancy, a partial disbursement may be permitted for reasonable opening expenses. However, the lender must not exhaust the escrow prior to project completion but should retain a reasonable amount to offset funding needs through the remainder of the construction period and thereafter.
  - e. The HUD Office may direct that the deposit be used to cover any shortfall in interest, taxes, property insurance mortgage insurance premiums, ground rent and assessments.
3. Final Release of Escrow.
- a. Subject to HUD approval, the lender may release any unused balance in the working capital portion of the escrow to the borrower if the project is not in default and when the operations of the project have demonstrated to the Regional Production Director's satisfaction that the project has achieved 6 consecutive months of sustaining occupancy (defined at Chapter 3.1.Yeven

- b. If the mortgage is in default, the lender must apply any balance of the escrow (either working capital or construction contingency portions) to cure a default, where a default occurs before its release.
  - c. At final endorsement any remaining balance of the new construction contingency portion of the escrow may be used to fund any latent defects assurance or escrow for delayed construction items or if these needs are otherwise met, refunded to the borrower.
- D. Initial Operating Deficit Deposit must be established with the lender at initial closing. The borrower must advise the lender how it plans to fund the escrow, by cash, a letter of credit, excess mortgage proceeds, or excess land equity, if any.
- 1. The purpose of the operating deficit escrow is to provide funding for operating expenses, non-capitalized property taxes, insurance and interest and principal payments when income is insufficient during the initial lease up period. This escrow is not mortgageable and the unused portion must be returned to the borrower.
  - 2. Release of the Initial Operating Deficit Escrow. HUD will consider lender's request using Form HUD-92464M, Request for Approval of Advance of Escrow, for all initial operating deficit draws during lease-up. The lender's request must be accompanied by:
    - a. A review and analysis of the monthly accounting reports detailing progress on lease up as compared to the lease up projections used in underwriting, and
    - b. An updated calculation of the sufficiency of the escrow. This analysis and calculation are particularly important if the project is experiencing substantial variations from its lease up projections.
    - c. Unused amounts will be released upon the lender's request when the project has demonstrated to the Regional Production Director's satisfaction that the project has achieved six consecutive months of sustaining occupancy (defined at Chapter 3.1.Y The HUD Underwriter will consult with Asset Management (AM) staff prior to approval of a release to obtain AM's approval. HUD offices should exercise caution to be certain that monthly results are not erratic or seasonal and that 1.0 or better debt service coverage will be sustainable after release of the escrow funds. For garden apartment projects consisting of separate buildings, each of which is leased up separately, HUD will consider partial releases of the operating deficit escrow as individual buildings achieve 6 consecutive months of break-even occupancy. It is the lender's responsibility to fully document all expenditures from the escrow fund to ensure that funds are used solely for project operating needs.
- E. Amount of contractor's retainage and release. Retainage provides an incentive for the general contractor and mortgagor to promptly complete the project, submit cost certification and reach final closing.

1. Amount of retainage. The Building Loan Agreement allows for the possibility of a reduced holdback amount as set forth in a retainage reduction rider when the project reaches 50% completion. The rider is not a HUD form. The owner and the general contractor will create a rider, to attach to the Building Loan Agreement, which describes how the retainage is reduced according to the guidance below. The construction contract also provides for a 10% holdback from the contractor's monthly payments for acceptably completed work, acceptably stored materials, and where applicable, components acceptably stored offsite. The requirements for reduction of the retainage after 50% completion are as follows:
  - a. The Contractor has no identity-of-interest with the owner that is greater than a 5% equity interest in the ownership entity,
  - b. Prior written consent from the Surety must be obtained and attached to the request for reduction, and
  - c. There can be no questions regarding the contractor's performance concerning the quality of work, compliance with the contract and with any change orders or work in progress. The Regional Production Director or his designee must make the decision to reduce the retainage based on the recommendation of the HUD CA and/or the HUD inspector.
  - d. Assuming the above conditions are met, 10% retainage will be required only until 50% completion. After 50% completion the retainage may be reduced from 10% to 5% until 75% completion, and then may be reduced further to 2.5% retainage until the loan reaches Final Endorsement.
2. Release of retainage for identity of interest contractors. Except as provided in paragraphs 4 and 5 below, the retainage may not be released, in whole or in part, until Final Endorsement for a contractor with an identity of interest that is greater than 5% equity interest in the ownership entity.
3. Release of retainage for non-identity of interest contractor. The contractor's retainage, or the remaining balance in the retainage, may be released at the next to last advance, when requisitioned on Form HUD-92403, Application for Insurance of Advance of Mortgage Proceeds, subject to compliance with the following:
  - a. Contractor's cost certification, where required, has been reviewed and the necessary adjustments made to Form HUD-92451, Financial Record and Mortgage Loan Transaction (or similar format in an Excel worksheet);
  - b. Contractor has disclosed its final obligations on Form HUD-92023M, Request for Final Endorsement of the Credit Instrument;
  - c. All work under the construction contract has been inspected and approved by the controlling jurisdictions and/or authorities;



- d. Certificates of occupancy or other required approvals for the dwelling units and non-dwelling facilities, where applicable, have been issued by governmental authorities having jurisdiction. (Separate buildings for community rooms, rental offices, laundry rooms, etc., commonly require separate certificates of occupancy.);
  - e. Permission to Occupy, Form HUD-92485 has been issued by HUD for all units;
  - f. All Davis-Bacon payroll requirements have been satisfied;
  - g. Surveyor's Certificate, Form HUD-91073M, and survey showing the location of all improvements, utility easements and site utility distribution lines have been submitted to HUD, and
  - h. Retain, where applicable, an adequate amount to cover the following:
    - i. Items of delayed completion in an amount equal to 150% of the HUD CA's cost estimate for completion,
    - ii. Any owed or contested amounts indicated by mechanics, subcontractor, supplier, or equipment lessor liens, etc.
    - iii. The lesser of the liquidated damages or actual damages computed at cost certification, and
    - iv. The net effect of all change orders if said effect is negative.
4. Early partial release of retainage.
- a. After 90% contract completion, the Regional Production Director may release part of the general contractor's retainage and suspend further withholding of retainage from payments due, where:
    - i. The contractor has no identity of interest or the contractor's only identity of interest in the project ownership is less than 5%;
    - ii. The contractor, mortgagor and mortgagee request the early release of the holdback and attach the request to Form HUD-92403, Application for Insurance of Advance of Mortgage Proceeds; and
    - iii. Prior written consent from the surety, if any, for the early release of holdback is provided with the request.
  - b. The Regional Production Director must determine that:
    - i. The contractor's general performance warrants partial release of the holdback without conditions, or
    - ii. A partial release of the holdback is appropriate with conditions, e.g., measures to assure immediate distributions to subcontractors or others, would be in the mutual interest of all participants, and
    - iii. The undisbursed holdback amount must equal or exceed 2.5% of the contract amount.

5. Projects in difficulty. Release of part of the contractor's holdback before 90% contract completion may be granted only to prevent a default of the construction loan and only if it would solve the project's problems and enable it to reach construction completion.
    - a. The contractor's performance must be considered, including:
      - i. The completed work must be satisfactory,
      - ii. The percentage of completed contract work must be sufficient to ensure project completion within the specified contract time, and
      - iii. The holdback may not be released if there are unresolved questions concerning:
        - (1) Quality of work,
        - (2) Compliance with the contract, including outstanding change orders, or
        - (3) Work is progressing behind the contractor's construction schedule, as amended by approved change orders.
    - b. Written consent for the early release of holdback must be obtained from the surety, if any, the mortgagor and the mortgagee.
- F. Cash-Out Escrow from Land Equity (or any balance remaining after funding all mortgage requirements.) See Section 8.14.K.
1. Cash out from the excess value of the land, or the "as is" property value for a substantial rehabilitation project, that was contributed to meet the sponsor's equity requirement at initial endorsement, above what was required at initial endorsement must be deferred and held by the lender. If any of the land equity was used to fund escrows at initial endorsement, the remaining balance is deferred and held by the lender. The lender will have discretion as to the form of escrow used for holding cash-out from land equity. Refer to Appendix 12A paragraph D about eligible uses of cash-out from land equity.
  2. The lender will hold the cash-out funds until project operations have demonstrated to the HUD field office's satisfaction that it has achieved 6 consecutive months of sustaining occupancy or 12 months of sustaining occupancy for transactions that meet the Large Loan parameters. (See Chapter 3.1.Y for definition of sustaining occupancy.) The HUD Underwriter will consult with Asset Management staff prior to approval of a release. HUD Offices should exercise caution to be certain that monthly results are not erratic or seasonal and that 1.0 or better debt service coverage will be sustainable after release of the escrow funds. HUD will approve a request for release of funds on Form HUD-92464M from the lender. The lender's file should contain the HUD approval and documentation supporting the release.

## **12.16 Insurance Upon Completion (IUC)**

- A. Basic requirements during construction stage are generally the same as for projects with FHA insured advances. However, IUC advances are not FHA insured. Therefore HUD does not monitor the lender's disbursements. Also, because HUD has no risk exposure until final endorsement, HUD does not become involved in the resolution of construction problems, even if those problems prevent or may prevent the borrower from meeting program obligations. The following are major variations from standard program requirements for insurance upon completion projects.
- B. Firm Commitment to Insure Upon Completion, completed on the HUD Commitment template by HUD staff, must contain special conditions defining requirements necessary to maintain the commitment until Final Endorsement of the permanent mortgage.
1. While there is no initial closing there should be a preconstruction meeting to advise the lender, borrower and contractors of requirements that must be met and the construction monitoring methods that will be followed from the date of the Firm Commitment through Final Endorsement. The construction stage starts after the issuance of the Firm Commitment.
  2. The Firm Commitment must specify the expected date of construction start and the expected date of construction completion, followed by a date for Final Endorsement. Construction/rehabilitation must start and be completed within the period provided by the Firm Commitment, subject to HUD's decision to amend the Firm Commitment pursuant to a request by the lender. Unless terminated, the Firm Commitment will endure until consummated at Final Endorsement. The lender may request or advise HUD of its termination of the Firm Commitment for the convenience of the borrower. HUD may terminate the Firm Commitment upon lender or borrower's failure to cure material non-performance of program requirements and/or requirements of the Firm Commitment after notice and opportunity to cure consistent with existing construction administration procedures defined in this Chapter 12. In the event of termination, the lender will not be entitled to any refund of application or inspection fees paid.
- C. Required documents include:
1. Construction contract, Form HUD-92442M. The following must be made a part of the contract:
    - a. General Conditions, AIA Document A201;
    - b. Supplementary General Conditions, Form HUD-92554M;
    - c. Davis-Bacon Wage Rates (supplied by HUD Labor Standards and Enforcement);

- d. AIA Document B108 with HUD 92408-M, HUD Amendment to AIA Document B108 attached identifying identities of interest between Owner, Contractor, Subcontractor and Architect;
    - e. Cost certification criteria from Form HUD-92442M, Article 13, where an identity of interest exists or a “cost plus” form of contract is used.
  2. A complete master set of drawings and specifications and two duplicate sets;
  3. The Agreement and Certification, Form HUD-93305M, executed by the borrower, lender, and the general contractor.
  4. A title policy or title evidence showing:
    - a. Insured property free of all encumbrances other than the mortgage and acceptable reservations of title;
    - b. Proof that no unpaid obligations exist except as previously approved by HUD;
    - c. Title policy continued to date of credit instrument endorsement.
  5. Survey and Surveyor’s Certificate, Form HUD-91073-M;
  6. Contractor’s Requisition Project Mortgages, Form HUD-92448. The Contractor’s Prevailing Wage Certificate must be submitted at the time the mortgage is presented to HUD for insurance.
  7. Assurance of funds to meet operating deficit. Completed Forms to assure funds are available to carry the project to a sustaining occupancy after final closing:
    - a. HUD-92476M, Agreement of Sponsor to Furnish Additional Funds,
    - b. HUD-92476a-M, Escrow Agreement for Operating Deficit, and
    - c. HUD-92477M, Bond Guaranteeing Sponsor’s Performance.
  8. Warranty against latent defects is required in accordance with Section 12.16.S.
- D. The pre-construction conference must precede the initial start of construction, see Section 12.2. However matters concerning insured advances of funds, and deposits to or disbursements from escrows for additive change orders are not relevant to insurance upon completion transactions.
- E. Construction monitoring and reporting must be done in accordance with Section 12.3 but only for the purpose of Labor and FHEO compliance and adherence to the approved plans and specifications subject to approved change orders.
- F. Labor and FHEO liaison, see Section 12.12.
- G. Contractor’s monthly requisitions are not applicable to projects insured upon completion.
- H. Off-site construction:
  1. Monitoring is recorded by the HUD inspector on Form HUD-95379.

2. Advance of funds monitoring is not applicable to projects insured upon completion.
- I. Construction contract changes and Architect's supplemental instructions (see Sections 12.8 to 12.11 and 12.4.D). Construction changes are processed in the same manner as insurance of advances, except as modified below:
    1. An escrow is not required for additive change orders, because HUD has no risk exposure until final closing. The mortgagor must be able to provide the additional funds required and must not have any outstanding obligation in connection with construction other than the insured mortgage at the time the mortgage is presented for insurance.
    2. Surety approval is not required for the approval of additive change orders regardless of the percentage of contract increase.
  - J. Permission to Occupy applies as in Section 12.14.
  - K. Final HUD CA or Inspector's Trip Report falls under HUD procedures above at Section 12.3.D.
  - L. Warranty period falls under HUD procedures above at Section 12.6.C.
  - M. Working capital deposit and operating deficit escrows are usually required for Insurance upon Completion projects. Therefore, to mitigate any risk, projects that apply for Insurance upon Completion must fully meet the operating deficit escrow and the working capital requirements contained in Section 8.13, except for the extra 2% new construction contingency portion of the working capital escrow which is not required. See Sections 12.15.C and 12.15.E for releasing escrowed funds.
  - N. Property insurance schedule and requirements. When onsite construction is 80% complete (before Final Endorsement of the mortgage), the lender must prepare:
    1. Property Insurance Schedule, Form HUD-92329, that:
      - a. Correctly shows the insurable value of the completed structures;
      - b. Reflects any changes in cost occurring after issuance of Firm Commitment.
    2. Property Insurance Requirements, Form HUD-92447.
  - O. MIP is not charged until final endorsement.
  - P. Cost certification (see Chapter 13).
  - Q. Closing must occur within the period provided in the commitment.
  - R. Extension of Firm Commitment instructions are in Chapter 11.

- S. Builder's warranty. The general contractor must enter into a latent defect agreement with the Owner and Lender for the benefit of HUD and provide one of the following at Final Endorsement to assure correction of any latent defects:
1. Cash escrow deposit of 2.5% of the total cost of construction, to be retained in an escrow held by the lender for a period of 15 months, or
  2. An irrevocable, unconditional letter of credit for 2.5% of the cost of construction issued to the lender by a banking institution.

## **12.17 Completion of Repairs and Alterations Pursuant to Section 223(a)(7) and 223(f)**

A. **Repairs and Alterations** are documented by the lender with a list that categorizes each work item as Critical or Non-Critical. (See Section 5.1.C and Appendix 5G Section II.B).

1. Completion of repairs and alterations.
  - a. All critical repairs completed before initial closing. A site visit(s) and report(s) by a HUD representative are required to confirm satisfactory completion of critical repairs before closing. The only exception is critical accessibility repairs that HUD approved for deferred completion based on the complexity of the repair (see Chapter 5.10.J). No other critical repairs may be deferred.
  - b. Non-critical repairs may be considered for deferred completion after closing at the request of the mortgagor. HUD will require the following schedules prior to approving the request:
    - i. Schedule of Values (see Section 12.17.C below) for payment of completed repairs;
    - ii. Progress Schedule. Repairs must begin immediately upon closing and, with limited possible exceptions, must be completed within 12 months of loan closing;
    - iii. Schedule of Delayed or Interrupted Occupancy or Income, must list:
      - (1) All facilities or units for which occupancy or income will be delayed or interrupted by repairs deferred until after closing;
      - (2) Estimated period of delayed or interrupted occupancy or income;
      - (3) Projected completion date;
      - (4) An additional deposit must be made to an operating deficit account for delayed repairs that interrupt

occupancy or income for any period. The amount of the additional deposit will be determined by HUD.

- iv. Temporary Resident Relocation Schedule, when required.
2. Payment for Repairs.
    - a. Critical repairs completed before closing: Mortgage proceeds may be advanced at Initial/Final Endorsement only upon verification that repairs have been completed.
    - b. Non-Critical repairs completed after closing are funded by a repair escrow:
      - i. A repair escrow account must be established for the full amount of the costs of deferred repairs and alterations plus an additional assurance of completion amount equal to 10% or 20% of the estimated cost of deferred repairs and alterations (see Section 5.10.L) depending upon program guidance.
      - ii. The Schedule of Values for deferred repairs and alterations will be provided to the HUD inspector, who will recommend progress payments based on this Schedule as a part of Form HUD-95379, HUD Representative's Trip Report following the inspection as described below.
    - c. Payments for repairs completed after closing when a Project Architect and/or General Contractor are involved:
      - i. The general contractor or architect initiates by completing and providing supporting documentation for form HUD-92464M, Requests for approval of advances of Repair Escrow Funds.
      - ii. Both the Project Architect and the HUD Inspector (when applicable) should have performed the inspection of the completed repairs and signed the HUD-92464 which the Architect submits to the owner who signs the form and forwards the request for advance of funds to the lender.
      - iii. Funds may be released for completed hard costs, i.e., repairs and alterations. Partial payment for a certain percentage of completion of a particular repair work item should only be allowed when such a progression is distinctly inspectable.
      - iv. Generally, deposits or down payments on materials should not be funded from the Escrow. The HUD CA may allow case-by-case exceptions for affordable properties or Section 202 refinancing projects.
      - v. For any completed repair work item, HUD will approve the release of funds up to, but not exceeding, the originally estimated amount for that item or an amended amount based on an approved change order(s).

- vi. Soft costs are payable pro-rata, based on the percentage of hard cost approved for disbursement.
  - vii. A non-prorata portion of the overall general requirements may be paid consistent with accomplishing a particular milestone or completing a relevant group of repairs and alterations that made necessary a particular item of cost classified as general requirements.
  - viii. When the entire work is executed by a General Contractor under the administration of a Project Architect with contractual relationships established by AIA Contract Documents (i.e., AIA B104 & A104), the release of Escrow funds may be based on AIA Document G702 and G703 submitted by the General Contractor at appropriate intervals of progress of the work.
3. Release of Cash-Out/ Equity from Loan Proceeds.
- a. Projects with a 50% cash-out holdback escrow, set up at Endorsement on Form HUD-92476.1M, Escrow Agreement for Deferred Repairs, may have escrowed funds released at the request of the Lender when all non-critical repairs and deferred accessibility repairs are successfully completed and evidence of clear title, lien satisfaction and latent defects coverage have been provided, even if this is after 12 months from endorsement.
4. Funds remaining in the repair escrow may be released to borrower when:
- a. All repairs have been satisfactorily completed as determined by HUD;
  - b. Evidence of clear title has been provided to HUD; and,
  - c. In cases where the cost of repairs and alterations exceeds \$400,000, the borrower (or the general contractor in cases where a construction contract was executed) has provided latent defect assurance with funded escrow. The escrow must be in the form of cash or letter of credit or surety bond (at the option of the lender) equal to 2½% (or a greater percentage as warranted) of the cost of repairs and alterations, to be maintained for fifteen months from completion of repairs. See Agreements 8 and 9 of HUD-92476.1M for further details.

**B. Inspection.** Unless HUD waives or delegates the non-critical repair escrow administration to Federal Housing Administration (FHA)-approved Multifamily Lenders and Servicers, inspections of completed repairs are performed by the HUD Inspector based upon the level of repairs and alterations set forth below:

1. Inspection Requirements.
- a. Projects insured under Section 223(a)(7) are limited to repairs which are routine maintenance. Accordingly, 223(a)(7) transactions and projects insured under 223(f) where work is limited to Repairs and



- Level 1 Alterations (as defined in Chapter 5 of the MAP Guide) will not require inspections and the owners may self-certify for lender and HUD's review.
- b. Those projects with Level 2 Alterations will require periodic inspections unless explicitly waived by the HUD CA based on the limited type and complexity of improvements. The waiver of HUD inspection must be clearly stated in the Firm Commitment.
  - c. Those projects with a level of work requiring a Project Architect (costs exceeding \$15,000 per dwelling and/or Level 2 and 3 Alterations) will require inspections at repair completion stages of 35%, 65% and 100%. The requests for release of funds from the Repair Escrow at these stages must be signed by the project architect and HUD Inspector prior to being reviewed and approved by the owner, lender and HUD. (See Chapter 12.17.A.2.c.ii, above.)
  - d. The owner may request inspections based on a schedule for projects where milestones based on completion of specific repairs and alterations or on time intervals is more appropriate than the percentage of completion (e.g., 4 months, 8 months and 12 months rather than 35%, 65% and 100%) for HUD CA's approval.
  - e. The agreed number and occasions for inspection should be reflected in the Escrow Agreement (form HUD-92476.1-M, as part of Exhibit "A" to the form) in alignment with the estimated amounts to be released at the established intervals.
  - f. For projects with no new tax credits, determine the monetary value of repairs and alterations satisfactorily completed based on full or partial completion of each work item appearing on the CNA eTool lists of repairs and alterations. Partial completion may be recognized only when the extent of completion is explicitly determinable by measurement or count, e.g. 3 of 8 similar buildings are re-roofed, therefore a quantity of 3 times the price per each may be reimbursed from the Repair Escrow.
  - g. For new LIHTC projects, the inspection must determine the percentage of completion of construction based on the Project Architect's plans and specifications and the General Contractor's approved form HUD-2328.
2. Inspections may be attended by the owner, architect, general contractor, consultants, and any other parties deemed necessary by HUD. HUD may also determine that construction progress meetings as described in Section 12.3.E be held in conjunction with the inspections. The inspection showing that all repairs covered by the repair escrow are completed shall be considered the 100% final inspection. Inspection Reports are filed on

Form HUD-95379, HUD Representative's Trip Report (Trip Report), for each monitoring visit.

The following are included in the Trip Report:

- a. Non-compliance with provisions of the commitment or closing, e.g. work write-up, drawings, specifications, etc., including changes made to the work without prior approval;
  - b. Adverse conditions e.g. slow work completion, destruction of work, new municipal requirements, disputes, etc.;
  - c. Borrower's performance of any applicable relocation plan.
  - d. Availability for use of facilities listed on the schedule of delayed or interrupted occupancy, when applicable;
  - e. Municipal authorizations. Permissions to occupy or use permits, etc. Where applicable, these must be issued before closing, unless related to work deferred until after closing;
  - f. Items to be completed within twelve months from initial/final endorsement. The HUD inspector must include in the Trip Reports:
    - i. A detailed list of the status of all required repair work with photos;
    - ii. Escrow amount requested on the HUD-92464M form; and
    - iii. For the final 100% Trip Report, the date of the completion of all the repairs.
3. Documents Required for HUD Construction Inspection and Monitoring. The HUD CA should assemble the following documents to monitor repairs and recommend payments during construction:
- a. Firm Commitment;
  - b. Escrow agreement;
  - c. Survey, surveyor's report and legal description;
  - d. List of required repairs (work write-up with clear and accurate scope cost and schedule of the work items);
  - e. Drawings and specifications (where required);
  - f. Schedule of Values;
  - g. Progress schedule;
  - h. Construction schedule (where required);

- i. Schedule of delayed or interrupted occupancy or income (required only for projects with repairs delayed after closing);
- j. Tenant relocation plan (where required);
- k. Construction contracts and Owner-Architect Agreement (where required); and
- l. Agreement and Certification.

**C. Schedule of Values for Reimbursement from the Repair Escrow.** The schedule of values is the itemized cost estimate for the proposed scope of construction work funded from the Repair Escrow.

1. For Section 223(f) applications with a scope of work described in the CNA e-Tool (see Chapter 5.3.C.4), schedule of values are the costs reported in Column B of the Lender's 223(f) Repairs & Alterations Cost Worksheet (see Chapter 5.3.C.5 and Appendix 5L) with hard costs itemized on the list(s) of repairs and alterations from the approved CNA.
2. For Section 223(f) applications with new tax credits, the schedule of values is the approved form HUD-2328.

**D. Final report.** Final HUD Trip Report must be made upon completion of all work prepared by the HUD Inspector. The final report must show that:

1. All work is acceptably completed in accordance with the firm commitment and/or closing escrow, as applicable, and approved changes.
2. Offsite work is completed or that the municipality has given written assurance for its completion;
3. Utilities are connected.
4. Permanent ingress and egress facilities are provided, and
5. Applicable municipal inspections, approvals, etc., have been issued.

**E. Change Orders.** Changes in the repairs and alterations work items, including associated cost changes, must be submitted to Lender and HUD for review and approval.

1. Changes prior to endorsement:
  - a. For non-LIHTC projects, a revised CNA eTool must be submitted to HUD for review and approval to issue an amendment to the Firm.
  - b. For new LIHTC projects, revised plans and specs and HUD-2328 must be submitted to HUD for review and approval to issue an amendment to the Firm.
  - c. In all cases, the changes must be reflected in a revised Repair Escrow Agreement (form HUD-92476.1M).
2. Changes after endorsement:

- a. Changes that result in increased costs must be funded by the borrower at the time the change order is approved and the Repair Escrow Agreement (form HUD-92476.1M) must be revised reflecting the addition of funds.
  - b. The Repair Escrow Agreement amount must not be reduced for change orders that result in cost reduction.
  - c. For non-LIHTC projects, approved changes after endorsement do not need an amended CNA eTool. The changes in cost and scope may be shown as annotated and initialed changes to the list(s) of repairs and alterations. A revised Lender's 223(f) repairs & Alterations Worksheet should reflect any cost changes.
  - d. For new LIHTC projects, approved changes should be reflected in a revised HUD-2328 and revised plans and/or specs to the extent required by the nature of the change.
  - e. The assurance of completion should not be used as a source of funding for change orders prior to completion of all repairs and alterations.
  - f. When an Architect is engaged and the changes are minor with no changes in cost and time, Architect's Supplementary Instructions (ASI) may be used without a Change Order Request submission to HUD. The Architect must forward a copy to the HUD Inspector and Lender after issuance for confirmation that the changes are not material.
  - g. In all cases, Lenders must ensure that any change order(s) or other addition to cost do not result in a total cost of repairs and alterations exceeding the cost threshold that defines substantial rehabilitation.
3. Acceptable format for change orders:
    - a. When a project architect is involved, AIA G701 is to be used;
    - b. When no architect is involved, a written request in a format similar to HUD-92437 Request for Construction Changes on Project Mortgages may be submitted. Form HUD-92437 may be used as a general guide, but the actual form must not be used.
  4. Contractor and project architect (if employed) must sign all change order requests.
  5. Borrower and Lender must review and sign the change order request and provide an updated list of repairs describing all changes to HUD for review and approval.
  6. Change order work may proceed once approved.
- F. **Warranty Inspections.** Where the owner uses a contractor, rather than its own staff, to carry out repairs, warranty inspections will be scheduled to discover and require correction of latent defects within 1 year of the date of substantial completion of all repairs. See Sections 12.6.C and 12.16. S.
- G. **Projects in difficulty.** Physical, financial, or management problems could be an indication that a default is imminent. For further explanation see Management Agent Handbook 4381.5

REV-2 Chapter 6 Exhibit 6-1, and Item 7 of the Form HUD-92476.1M, Escrow Agreement for Deferred Repairs.

1. If the borrower has not completed all deferred repairs by the end of the repair period the HUD Inspector will document all such non-completed repairs on Form HUD-95379, HUD Representative's Trip Report, and will submit the report to the lender and HUD Construction Manager.
2. The lender will complete the repairs using the repair escrow funds. The lender will submit a work schedule to HUD for the completion of all remaining repairs and will provide the borrower with a breakdown of these repairs and the cost(s) of completion (including administrative expenses).
3. Funds remaining in the repair escrow account after completion of the repair work by lender will be returned to the borrower, less reasonable administrative costs incurred by lender in completing the repairs.

## **12.18 Casualty Events During Construction**

A casualty claim may occur during construction that will require funding from a stakeholder's insurance coverage. If the claim is payable under the Builder's Risk policy the funds shall be applied toward a change order (HUD-92437) to correct the damage. For new construction or substantial rehabilitation projects, the amount to correct the damages must include the Davis-Bacon wage rate.

If the casualty claim is payable under the owner's casualty insurance, the owner may choose another contractor to correct the damages, provided however, if Davis-Bacon wage rates apply, the other contractor must execute a contract form providing enforcement provisions as required for general contractors in new construction transactions.