
CHAPTER 1
CONSTRUCTION STAGE FOR PROJECTS WITH INSURED ADVANCES

- 1-1. GENERAL. The construction contract identifies the period within which construction must start after initial closing (typically 10 days), however, the construction stage starts with endorsement of the instrument to insure advances or approval for an early start.
- A. Start of Initial Construction is the date when contract work commences and is diligently pursued without appreciable delay between activities. It includes site clearance and other preparatory site work. The start of initial construction satisfies:
1. Contract provisions for the start of construction, and
 2. Davis-Bacon wage rate requirements for the start of construction. See Handbook 1344.1 REV-1 for detailed information.
- B. Start of Permanent Construction establishes the date upon which HUD earns its inspection fee. See Handbook 4410.1 REV-2 for detailed information.
- C. Early Start of Construction may be authorized in accordance with provisions in Handbook 4430.1 REV-1, paragraph 1-8. Where it occurs:
1. Require a preconstruction conference before the start of initial construction.
 2. Require monitoring of the work and approval of change orders in accordance with provisions of this chapter.
 3. Do not authorize any insured advances until recording of the endorsed instrument at initial closing.
- D. First Events Of The Construction Stage are typically the preconstruction conference, paragraph 1-2 below, and approval of the first insured advance at initial closing. See paragraphs 1-15 through 1-17 below.
- 1-2. PRECONSTRUCTION CONFERENCE is required for every project and must precede the initial start of construction, including early start of construction projects. Consider holding it concurrently with initial endorsement where feasible, since the major participants are present.
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(1-2) A. Required Attendees:

1. Representative(s) of the mortgagor and mortgagee,
2. Mortgagor's supervisory architect,
3. Contractor,
4. Major subcontractor(s),
5. HUD construction representative (staff, in all cases, plus contract personnel, where applicable),
6. HUD mortgage credit analyst, and
7. HUD labor standards specialist.

NOTE: Maintain the attendance list for the Washington Docket.

B. Supplementary Conditions of the Contract for Construction, Form HUD-2554. Address Davis-Bacon Wage Rates, Federal labor standards and equal employment provisions, including:

1. Contractual obligations of the contractor and subcontractors, including contractor's certification on each request for advances of compliance with Davis-Bacon wage rates. Where there is a second mortgage backing a governmental entity loan, advise that Davis-Bacon wage rates also apply.
2. Statement of sanctions imposed for not complying with the supplemental conditions.
3. Requirement that Form HUD-2554 must be made part of the subcontracts for all tiers.
4. Give extra copies of Form HUD-2554 and applicable Davis-Bacon wage determinations to the contractor for any absent subcontractors.
5. Emphasize the importance of Federal wage payments, prompt payroll submissions and record keeping. Instruct that Form WH-1321, Wage Notice to All Employees, must be conspicuously posted on the job site.
6. Indicate who on the Field Office staff will review

for labor standards compliance.

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- (1-2) 7. Give copies of the Equal Opportunity poster to the contractor and each subcontractor to post conspicuously at the construction site.

C. Contract Administration.

1. Explain general contract administration, including responsibilities of the mortgagee, mortgagor, mortgagor's architect, contractor, HUD representative, and Field Office approvals.
2. Explain the procedures for: change orders and architect's supplemental instructions, handling latent site or rehabilitation building conditions, requesting construction document clarifications and handling job problems, shop drawings and sample approvals, noncompliant work and its correction, requesting periodic payments and release of escrows, substantial completion of the work or portion thereof, permissions to occupy including management plans and rent rolls, job meetings, maintenance of test logs, the architect's log, and the HUD representative's on-site facilities.
3. Stress that HUD considers work changes completed in anticipation of a future change order as noncompliant, and that HUD will deny insured advances for it or other work dependent upon it.
4. Explain the contractor's and mortgagor's required preparation for periodic advances, including the procedure for field approval and submission for Field Office approval. Point out the provisions for submitting surveys, title reports, and other documentation in support of construction advances; and explain the requirements for the contractor's retainage and its release.
5. Explain the procedures attendant to requesting payment for materials stored on-site, and, where applicable, for components stored offsite.
6. Explain the procedures for requesting payment for completed offsite work, the required retainage and its release.
7. Address provisions for terminating the construction

contract and architect's contract, and mortgagee's responsibilities during the construction stage and in the event of default.

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(1-2) D. Cost Certification.

1. Explain cost certification requirements for the mortgagor, general contractor and, if applicable, subcontractors, equipment lessors and suppliers. Where there is a second mortgage backing a governmental loan, advise that cost certification also applies to the second mortgage.
2. Explain the time limits for submitting cost certification and that late submission is the basis for adverse action under 24 CFR Part 200.230.
3. Stress that identities of interest that develop or become known after initial closing must be reported to HUD within 5 working days of having such knowledge. That HUD must give prior approval for all identity of interest subcontractors, the penalties where this is not done, certifiable costs regarding self-owned equipment and the prohibition against paper conduits.
4. Clarify the 50/75 percent rule.

1-3. CONSTRUCTION MONITORING is critical for immediately identifying problems and taking prompt corrective action during the period for which defaults are the highest.

- A. Assignments. Require the Chief Architect to assign a staff or contract HUD representative to each project upon approving an early start, where applicable, or 1 week before initial closing where there is no early start.
1. Use contract personnel where projects are remote or would otherwise unreasonably burden staff resources. Use technical disciplines contracts in accordance with outstanding instructions.
 2. Assure that project assignments by the Chief Architect to individual HUD representatives are across program lines and in geographical groupings or natural travel circuits to maximize on-site time to travel time ratios.

- B. HUD Representative's Duties. Require the assigned HUD representative to visit the site twice a month or more frequently where warranted by problems or impending default. The HUD representative must conduct monitoring in accordance with provisions of Handbook 4460.1 REV-1, and report project findings on the HUD

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- (1-3) Representative's Trip Report, Form HUD-5379, in accordance with Handbook 4480.1. Reporting is required on the following:
1. Contractor's organization, operations and supervision.
 2. Architect's supervision and services.
 3. Special circumstances, occupancy, delays, claims, disputes, etc. The HUD representative must specifically identify when the slow start or progress of offsite work may delay occupancy of completed units.
 4. Noncompliances in the work.
 5. Payments to the contractor, and by the contractor to subcontractors, material suppliers, etc.; and Labor and Equal Employment Opportunity (EEO) provisions, including the number of Davis-Bacon wage interviews conducted and reported on Form HUD-11.
 6. Percentage of project completion and scheduled completion. Percentage of completion for each additive change order and percentage of completion for offsite work.
 7. Start of initial and permanent construction.
 8. Serious construction problems must be specifically reported by the HUD representative. See paragraph C.3. below.
- C. Chief Architect's Duties are detailed in Handbook 4460.1 REV-1, paragraph 3-3, and include: assignment of inspectors, office review inspectors' reports, office review change orders, field supervise inspectors' performance by making at least two field review inspections for each project, and training

inspectors in monthly sessions.

1. Authorize the Chief Architect to deputize a member of the architectural staff to perform certain functions, as warranted. However, hold the Chief Architect responsible for keeping informed on the general progress of all project work, problems, and the general quality of inspections and inspector performance. Where a deputy performs review inspections, the Chief must personally conduct at

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- (1-3) least one review inspection per project. Where inspectors must be sent long distances to project sites, the supervisor may ride with the inspector on the inspection circuit to conserve travel funds, or make a scheduled inspection for the assigned inspector.
2. Establish procedures through which the Chief Architect may secure required engineering assistance for the inspection function, e.g., through use of Field Office engineers not under the Chief Architect's control, Regional engineers, contract engineers, etc.
 3. Require the Chief Architect to report to you:
 - a. Serious construction problems as they occur, prepare a referral memorandum to Headquarters, and provide status reports as appropriate. See paragraph 4-3. for instructions on reporting serious construction problems to the office of Insured Multifamily Housing Development, HMI.
 - b. Critical deficiencies in a supervisory architect's performance, and to provide you with a file supporting the findings. Paragraph 6-2.B. lists critical deficiencies in the supervisory architect's performance.
 - 1) The file should include copies of applicable HUD Representative's Trip Reports, Form HUD-5379, Supervisory Review Reports, Form HUD-5379, correspondence and minutes or summaries of meetings.
 - 2) Where appropriate, require the Chief Architect to prepare a letter to the project owner calling for replacement of

the supervisory architect. See Chapter 6 and Appendix 4, Specimen Letter - Request Termination of The Owner-Architect Agreement, for guidance.

- c. Slow or nonpayment from the mortgagor to the contractor or from the contractor to subcontractors, material suppliers, etc. (see paragraph B.5. above). Take action in accordance with paragraph 1-16.D., where appropriate.

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- d. Any condition reported by the HUD representative or otherwise known, that the Chief Architect cannot reconcile within 30 days, or otherwise requires your assistance to resolve.

D. Oversight Review. Visit each project site once during construction to the extent possible. The visits are to assess the performance of subordinate supervisors and staff, compare project design and construction with conventional projects in the area and to keep current with changes in your jurisdiction. Also visit completed HUD projects enroute to or near the site to review project performance with project management and tenants against design expectations. Require the assigned HUD representative and/or Chief Architect or deputy to accompany you on your project review.

- 1. Require the accompanying A&E staff member to identify:
 - a. The HUD representative's assignment documents, and any updating for approved changes and modifications for the as-built set of drawings.
 - b. Shop drawings, cuts, and samples and the timeliness of the contractor's submissions and supervisory architect's approvals.
 - c. Test logs, including: grading compaction test logs, pile logs, concrete test logs, slab or panel reinforcement post tension logs, etc., as they may apply to the project.
 - d. Supervisory architect's log, including minutes of regularly scheduled project meetings.

2. Compare and, if clarification is required, request correlation by the accompanying A&E staff member between:
 - a. Approved change orders and the Architect's Supplemental Instructions, AIA Doc G 710, and the updated drawings for the as-built set.
 - b. Accepted cuts and samples, and requirements of the drawings and specifications.
 - c. Accepted test results, and requirements of the drawings and specifications.

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 - d. Resolution of issues, problems and noncompliances identified in the architect's log, and/or HUD representative's reports.
 3. Require the accompanying A&E staff member to correlate various elements of the installed work, including materials, components, and equipment with requirements of the contract drawings, specifications and approved change orders.
 4. Require the accompanying A&E staff member to correlate completed work and materials stored on-site with that approved on the last pay draw. Where components are stored offsite, visit the storage facility and compare the inventory against approved documents.
 5. Observe the work, reporting, and resolution of identified issues in general; query the project superintendent and other project representatives on job progress and unresolved problems; and check for proper posting of Davis-Bacon wage rates and Equal Employment Opportunity (EEO) posters.
 6. Compare on-site observations with the last HUD Representative's Trip Report, Form HUD-5379, and complete a supervisory review in accordance with instructions in Handbook 4480.1 for Form HUD-5379. As an alternative, you may have the accompanying Chief Architect (or deputy) complete this report as one of the required supervisory reviews.
 7. Use the Chief Architect's supervisory reviews and

your on-site review reports to assess the Chief Architect's performance and to identify staff training needs.

1-4. LABOR AND FAIR HOUSING AND EQUAL OPPORTUNITY (FHEO) LIAISON.

- A. Davis-Bacon Wage Rates. Forward the original copy of all Davis-Bacon Wage Interviews, Form HUD-11, completed by the HUD representative to the Labor Officer/Wage Compliance Specialist. Require the Architectural Branch to keep a copy of each completed Form HUD-11 in the Construction Record Binder.
- B. Labor Violations. Advise the Labor Officer of continuing minor infractions that cannot be resolved or of any identified or suspected major violations.

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(1-4) C. FHEO Violations. Advise the Director of FHEO of continuing minor violations that cannot be resolved or of any identified or suspected major violations.

1-5. CONTRACTOR'S MONTHLY REQUISITION must be made on Form HUD-92448, completed in accordance with Handbook 4480.1. The Contractor's Prevailing Wage Certificate on the form's reverse side must be signed for all but the first requisition at initial closing, except that it must be signed where the requisition at initial closing includes payment for work completed under an early start.

- A. Eligible Items For Inclusion on Form HUD-92448.
 - 1. Acceptably completed on-site work, i.e., in full compliance with contract documents.
 - 2. Materials acceptably stored on-site itemized by quantity and cost.
 - 3. Components acceptably stored offsite, where provisions are made at initial closing in accordance with Handbook 4430.1 REV-1, paragraph 1-14.I., and the requirements of paragraph 1-6 below are met.
- B. Ineligible Items For Inclusion on Form HUD-92448.
 - 1. Noncompliant work and work supported or dependent upon noncompliant work. Work changes completed in

anticipation of future change order approvals are noncompliant work.

2. Additive change orders. See paragraph 1-8 for the contractor's requisition of payment, and release of funds to the mortgagor for acceptably completed additive change orders.
3. Offsite work. See paragraph 1-7 for the contractor's requisition of payment, and release of funds to the mortgagor for acceptably completed offsite work.

C. Modification of Contractor's Requested Amount.

1. Line item modifications/approval may only be made by the on-site HUD representative in accordance with Handbook 4480.1.

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- a. The HUD representative determines by job site observation that the requisition is reasonable and that sufficient funds remain to pay for incomplete work and any unacceptable work upon its correction.
 - b. Where there is disagreement with the requisition, the HUD representative:
 - 1) Enters trade item modifications in column C, Form HUD-92448, Contractor's Requisition, and
 - 2) Explains the modification in the HUD-Representative's Trip Report, Form HUD-5379.
 2. Modification of the HUD representative's conclusions may only be made by an authorized official who has made an on-site review of the issue(s).
 3. Completion of Form HUD-92448, Items (1) through (13), are made by Mortgage Credit in accordance with Handbook 4480.1.

D. Supporting Documentation.

1. Require receipts, bills of lading for on-site deliveries, billings for on-site work, evidence of

on-site payrolls, etc., to help staff reconcile differences with contractor claims. where necessary, request a quantity survey by the supervisory architect or other independent party.

2. A survey may be required with each contractor's requisition for improvements not previously shown on a survey, as provided by the Construction Contract and the Building Loan Agreement.
 - a. Require a survey where the siting of structures or setting of finished floor elevations in relation to contract document requirements are questioned. Since approximately 50 percent of construction complaints arise from faulty site drainage and damage to foundations, wet basements, etc., because of faulty site drainage; and since site drainage typically cannot be corrected where finished floor elevations for ground floors are set too low, give this concern high priority.

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 - b. Require a survey where there is a question concerning the location of materials stored on-site. The project may have great difficulty establishing and exercising rights to materials that are stored partially or entirely outside project boundaries.
 3. Require a survey for the next to last advance in every instance. See paragraph 1-19.C.

1-6. COMPONENTS STORED OFFSITE.

- A. Eligible Building Components. Only "building components" qualify for insurance of advances when stored offsite.
 1. An eligible "building component" is a manufactured or preassembled building element which, by reason of bulk, size or weight, vulnerability to weather conditions or lack of space at the site, is impractical to store at the site.
 2. Precast concrete floor, wall, and roof panels; assembled bath and/or kitchen core units; and fully fabricated structural steel beams and columns qualify as eligible "building components."

3. Items, e.g., kitchen appliances, carpeting, wood roof trusses, etc., are not eligible "building components."

B. Basic Requirements for insured advances.

1. The mortgagee must have agreed to the necessary provisions at initial closing. See Handbook 4430.1 REV-1, paragraph 1-14.I., for detailed information.
2. The Construction Contract must include the rider "Amendment To The Construction Contract For Payment For Components Stored Offsite." See Handbook 4430.1 REV-1, Appendix 9.
3. Payments are limited to the invoice value of the components listed on the HUD approved appendix to the Contractor's and/or Mortgagor's Cost Breakdown, Form HUD-2328, Appendix A to the Contract.
4. The contractor and its surety bear full responsibility for fraudulent claims for payment and fraudulent disposition of such payments. Safeguards are to protect against premature

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- (1-6) payments, against materials that do not meet contract requirements and against losses not covered by insurance.
5. The construction contract must be secured by a 100 percent performance and payment bond.
 6. Components must be stored at a location approved by the mortgagee and the local HUD office.
 7. Only "building components" qualify for insurance of advances when stored offsite. See paragraph A. above.

C. General Contractors' Responsibilities.

1. All direct and indirect costs associated with the storage and transportation of components stored offsite.
2. Obtaining a risk of loss insurance policy which covers the components. Evidence of this insurance must be submitted to HUD prior to the approval of

any advance for components stored offsite.

3. Assurance that there is a valid security agreement that is a first lien on the components.

D. Mortgagee's Responsibilities.

1. File Uniform Commercial Code (UCC)-1, financing statements with the proper office in the proper jurisdiction.
2. Make whatever additional filings are necessary to maintain a first lien on the components until they are incorporated into the building(s).
3. Release the financing statement filings as appropriate.
4. Unconditionally certify by letter to HUD that the security instrument(s) is (are) a "first lien" on the components covered by the instrument(s). The mortgagee's certification must be supported by an opinion from the mortgagee's counsel.

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- (1-6) 5. In the event of default under the mortgage, either assign its security interest to HUD or acquire title through foreclosure to the components intended for use or incorporation into the building(s) and convey title to HUD.

E. Contractor's Requisition. All requests for payment for components stored offsite must be submitted on Form HUD-92448, Contractor's Requisition, accompanied by the following:

1. A statement from the owner's architect certifying that:
 - a. He/she has visited the storage site and inspected the components for which payment has been requested.
 - b. The components are in good condition and they comply with the contract requirements.
 - c. The components are properly stored and protected.

- d. The components are segregated, in an easily identified manner from other materials stored at the same site and are marked for identification.
2. A bill of sale accompanied by an itemized invoice transferring title of the components to the mortgagor.
3. A copy of the security agreement provided to the mortgagee by the mortgagor.
4. A copy of the financing statement or statements filed by the mortgagee in accordance with the uniform Commercial Code.
5. A warranty from the mortgagee that the security instruments represent a first lien on the building components.
6. An opinion from the mortgagee's attorney that he/she has reviewed the security agreement and associated documents relative to the components for which advances are sought and that the security agreement creates a valid security interest in the collateral and that when the financing statement or

(1-6) statements is (are) duly filed, the secured party will have a first lien.

F. Review of Contractor's Requisition.

1. The HUD representative must request an inventory of the "stored components" and a breakdown of the line item of which the stored components are a part before approving payment for the components stored offsite. The breakdown must state:
 - a. Cost of Components (invoice value).
 - b. Cost of transportation from the offsite storage location to the construction site.
 - c. Cost of Installation.
 - d. Costs of any other items included in the line item.

2. The breakdown is to insure a remaining undisbursed balance sufficient to cover the costs of transportation and installation, and any other items included in the line item.
 3. Do not approve payment for components stored offsite where a contractor's performance is marked by serious deviations from the contract documents, or if payment will cause excessive additional interest costs.
 4. Do not approve any insured advances for components stored offsite where the contractor does not have a 100 percent performance and payment bond.
 5. Do not approve insured advances for components stored offsite in an amount exceeding 50 percent of the contract amount.
 6. The minimum advance is \$10,000.
 7. Limit advances for components stored offsite to the cost of components (invoice value) less the usual 10 percent holdback.
- 1-7. OFFSITE CONSTRUCTION is separate from the project "Contract" work. Where offsite work is completed by the owner, rather than by a municipality or utility company, a separate construction contract is required, even if completed by the project contractor. Offsite work must

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- (1-7) also be funded from sources outside the mortgage, except that an escrow for its completion may be funded from available excess mortgage proceeds.
- A. Completion Monitoring. Require the HUD representative to report on Form HUD-5379 for each contract, where more than one contract is involved:
 1. The percentage of acceptably completed offsite work, whether the work is completed by the controlling municipal authority, public utility, or by the mortgagor, and
 2. Slow start or progress of offsite construction that may delay occupancy of any dwelling units or facilities that may otherwise become available.
 - B. Slow Completion. Where timely completion of offsite

facilities appears to be a problem, require the mortgagor to furnish completion projections for:

1. The initial units or facilities intended for occupancy, and
 2. The offsite facilities upon which their occupancy depends.
- C. Contractor's Requisition is by letter to the owner. Do not use the Contractor's Requisition, Form HUD-92448, to reflect the value of acceptably completed offsite work, even if completed by the project contractor. See paragraph 1-21.A. for the mortgagor's application for escrowed funds, where completion of offsite construction is ensured by use of an escrow.
- D. Construction Changes for offsite work must be requested by letter using Form HUD-92437, Request For Construction Changes, as a guide, however, do not use Form HUD-92437 for offsite change orders.
- 1-8. CONSTRUCTION CONTRACT CHANGES (change orders) to the scope of contract work, contract price or contract time must be requested by the mortgagor through the mortgagee on Form HUD-92437, Request For Construction Changes. Form HUD-92437 must be completed and supported in accordance with instructions on the form and reviewed by staff in accordance with Handbook 4480.1. Each discipline must also adhere to specific change order instructions in their respective technical handbooks.

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- (1-8) A. Approve Change Orders only when they are necessary, are a betterment, or an equivalent.
1. Require the Architectural Branch to:
 - a. Review all requested changes for technical acceptability.
 - b. Enter the plus or minus contract price change, as applicable.
 - c. Identify on the face change orders that qualify for payment from the contingency reserve, where applicable, e.g. substantial rehabilitation projects.

- d. Identify on the face change orders that arise because of error, omission or negligence on the part of the architect, contractor or owner.
 - e. Refer to the Valuation Branch any changes that may effect marketability, value, income, or maintenance or operating cost.
- 2. Require the Valuation Branch to review all requested changes that may effect marketability, value, income, or maintenance or operating cost; and to identify and explain any estimated increase or decrease in net project income on the reverse of Form HUD-92437. See paragraphs F., G. and H. below restricting mortgage increases and requiring mortgage decreases.
 - 3. Require the Mortgage Credit Branch to complete all requested changes according to Handbooks 4480.1, and 4470.1 REV-2.
 - 4. Do not approve any change orders submitted after the Final HUD Representative's Trip Report, except where:
 - a. The change order pertains to "Items of Delayed Completion," or
 - b. Written approval is given by the Office of Insured Multifamily Housing Development, HMI.

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(1-8) B. Necessary Changes are those that arise from:

- 1. Latent conditions (unseen site conditions for new construction and unseen building conditions for substantial rehabilitation projects) that differ from that defined by the construction contract documents.
- 2. Changes in the applicable codes, ordinances or other workings of the law after initial closing (for insured advances projects) or firm commitment (for insurance upon completion projects).
- 3. The architect's errors or omissions, including:
 - a. Failure to comply with applicable codes and ordinances, and

- b. Failure to provide for conditions that may adversely affect occupant life safety or health, the project's physical integrity, or pose potential project liability.
- 4. Damage to completed construction:
 - a. Caused by a natural disaster declared by Federal or State government, to the extent such damage was not covered by casualty insurance, and
 - b. Under the owner's responsibility, i.e., contractor already paid for having acceptably completed that portion of the work, regardless of the cause of damage.
- C. Betterment Changes are those that are economically justified. They must either increase net income, reduce long-term project maintenance and/or operating expenses, or otherwise enhance the mortgage security.
- D. Equivalent Changes are those proposed because:
 - 1. The specified item is not readily available and the substitution provides equivalent or better utility and performance for every significant consideration, including marketability, durability, and maintenance and operating costs, or

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 - 2. The proposed substitution reduces the contract price, therefore the mortgage, but provides equivalent or better utility and performance for every significant consideration, including marketability, durability, and maintenance and operating costs.
 - E. Surety Approval must be secured in writing before approving any change or aggregate of changes that increase the construction contract price 10 percent or more. There is no consent requirement where the project's assurance of completion is by a cash escrow or letter of credit.
 - F. Additive Change Orders. Do not give any explicit or implied assurance that an increase in the insured mortgage amount will be granted when approving

construction changes. An increase in the mortgage, including that for additive change orders, may only be granted as provided in paragraphs 1-29 and 1-30.

1. Require the mortgagor, except for "necessary" change orders on substantial rehabilitation projects, to escrow funding with the mortgagee 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.
 - 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 cost, may not be disbursed until final closing.
 - b. Permit mortgagee to accept a third party letter of credit instead of a cash deposit, subject to the mortgagee agreeing to provide the cash equivalent, where the letter of credit is not immediately met.
 - c. Recognize the cost of third party paid change orders at cost certification, where there are available mortgage savings.

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2. Approve payment from the established contingency reserve in an amount not to exceed the HUD cost estimate for "necessary" additive change orders on substantial rehabilitation projects. "Betterment" change orders are not eligible for payment from the contingency reserve.
 - a. Require an escrow for any amount that the contractor's cost estimate exceeds the HUD estimate.
 - b. Authorize use of excess mortgage proceeds, if available, to satisfy the escrow requirement, subject to the disbursement limitations in paragraph 1.a. above.
 3. Require the following procedures for mortgagor's

application of funds for completed additive change orders:

- a. Form HUD-92464, Request for Approval of Advance of Escrow Funds, where an escrow is used. See paragraph 1-21.
 - b. Form HUD-92403, Application for Insurance of Advance of Mortgage Proceeds where a rehabilitation project's contingency funds or excess mortgage proceeds are used. See paragraph 1-22.B. for additional requirements where excess mortgage proceeds are disbursed.
- G. Deductive Change Orders. Where the HUD estimated decrease in Contract price for any aggregation of change orders:
1. Remains less than 2-1/2 percent of the Contract price, reduce the Contractor's "Final" Requisition, Form HUD-92448, by the appropriate amount.
 2. Equals or exceeds 2-1/2 percent of the Contract price and for all subsequent deductive change orders regardless of the amount:
 - a. Reflect the decrease in the Contractor's Requisition, Form HUD-92448, Item (7).
 - b. Reduce the original mortgage amount at cost certification, where required. See Handbook 4470.1 REV-2, paragraph 11-12.A. for instructions on mortgage reduction.

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- (1-8) H. Changes That Adversely Affect Income are a basis for change order rejection, except where it is a necessary change order. Where the situation is unavoidable:
1. Meet with the Chiefs of Valuation and Architecture and if needed with the mortgagor, supervisory architect and contractor to devise a mutually acceptable remedy that minimizes any adverse project impact.
 2. Require the Chief of Valuation to forward a Trial Form HUD-92264 and Trial Form HUD-92264A reflecting the new data for Mortgage Credit redetermination of the maximum insurable mortgage.

3. Require Mortgage Credit to check Item 3.b. on the face of Form HUD-92437, as a condition of change order approval.
 - a. Item 3.b. states, "That in order to reflect the net decrease in cost or reduction in mortgage based on net income or number of family units, resulting from acceptable present and previous construction changes, the amount of \$ _____ shall be deducted from the amount entered on the line entitled 'Sum of Cost Breakdown Items Plus Inventories of Materials,' Form HUD-92448. This amount may be modified by later changes."
 - b. The amount of reduction entered must be the greater of:
 - 1) The difference between the preceding maximum mortgage and the maximum mortgage redetermined as consequence of the change order.
 - 2) The net decrease in costs resulting from acceptable construction changes.

I. Extension of Contract Time.

1. Approve an extension only where:
 - a. The delay was beyond the contractor's control (e.g., weather, strikes, differing site conditions, etc.) and is documented, or associated with an approved change order,

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- b. The extension request was submitted within the 20-day limit provided by the Contract, Article 2, 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 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. Require funding for the increased cost for

overhead, interest, taxes, insurance, MIP, and contractor's general requirements by use of a cash escrow, or excess mortgage proceeds, or from the contingency reserve (on a substantial rehabilitation project).

- a. Require use of Form HUD-92403 for the release of excess mortgage proceeds or contingency reserve funds set aside to fund contract time extensions.
 - b. See Handbook 4470.1 REV-2 (4450.1 REV-1 for the contractor's general requirements) for detailed information on computing the increased cost.
 - c. See paragraphs 1-8.F.3.b., 1-21., 1-22, and 1-23. concerning limitations on the use of excess mortgage proceeds, mortgagee's use of a promissory note or letter of credit instead of a cash escrow, and certification of third party paid change orders.
3. Enforce liquidated damages in accordance with the Contract, Article 3, where the delay is within the contractor's control or the request for extension has not been filed within the prescribed period. See paragraphs 1-16.C. and 4-5.C., on keeping the mortgage in balance and Handbook 4470.1 REV-2, paragraph 8-10, for computing the additional soft costs resulting from the contractor's delay.

J. Distribution.

1. Require the Mortgage Credit Branch to:
 - a. Maintain a Change Order Summary Sheet for all change orders approved for distribution. See Handbook 4470.1 REV-2 for detailed information.

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- (1-8) b. Type or rubber stamp on the back of the first six copies of the multicopy change order form, "When the HUD estimated cost of all accepted changes results in a decrease in the total construction cost, the insurable mortgage will be similarly decreased; but if the net effect is an increase, the additional costs will be defrayed by the mortgagor. The acceptance of any change or changes involving a net increase does not increase the mortgage amount." The

statement is printed on the last copy only, but must appear on all copies.

c. Type the conditions of acceptance or reasons for nonacceptance listed on the approved processing copy of the change order on the back of all other copies.

d. Forward all copies for your signature.

2. After signature, require the Program Branch to forward:

a. The original and three copies to the mortgagee,

b. The processing copy to Mortgage Credit, and

c. Two copies to the Architectural Branch, one for inclusion with the Master Set of drawings and specifications and one copy for the HUD representative.

3. The mortgagee forwards one copy each to the mortgagor, contractor and supervisory architect, and retains the original for its files.

1-9. ARCHITECT'S SUPPLEMENTAL INSTRUCTION, AIA Document G710.

A. Uses of AIA Document G710:

1. Issue directives to the contractor to bring construction into compliance with the contract documents.

2. Interpret or clarify the contract drawings and specifications.

3. Order minor changes in the work, not involving cost or time e.g., relocating a door or window opening, etc.

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(1-9) 4. Accept specified equivalents, e.g., add makes/models to the list of specified equipment.

B. Monitor Usage closely, for compliance with paragraph A. above, and require replacement of the supervisory architect where the Architect's Supplemental Instructions are chronically or egregiously misused.

See chapter 6 for details on replacement of the supervisory architect.

- C. Distribution. Require that for each AIA Doc G710 issued to the contractor that the architect include one copy in the architect's job log, and forward one copy each to the mortgagor and mortgagee, and two copies to the HUD Chief Architect. Require the Chief Architect to retain one copy with the Master Set of Drawings and Specifications, and forward one copy to the HUD representative.
- 1-10. CHANGES TO OFFSITE CONSTRUCTION must be requested by letter or other acceptable format. Do not use Form HUD-92437 for offsite work. Process using procedures for Form HUD-92437 as a general guide for technical review, approval and distribution.
- 1-11. PERMISSION TO OCCUPY, Form FHA-2485, must be executed by HUD before the mortgagor permits occupancy of any dwelling unit, care facility unit, or other project service facility. The physical completion and required documentation are outlined on the form and in paragraphs A. and B. below.
- A. Physical Completion. The Work or portion thereof for which a Permission To Occupy is approved must be sufficiently completed in accordance with the Contract Documents so the mortgagor can occupy or utilize the identified portion of Work for its intended use.
 - 1. Support facilities must be in place. Examples include:
 - a. Utilities must be connected, and service facilities, including trash storage and disposal, must be available,
 - b. Pedestrian access and required handicapped accessibility from public streets and parking areas, through outside routes and any building lobbies and common areas, and to listed units and facilities must be safe, usable and convenient,

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- (1-11)
 - c. Vehicular ingress and egress routes and parking areas must be safe, usable, and convenient,
 - d. Nurses stations, congregate kitchen and dining,

therapy, common use areas and similar services must be available for accepted care units,

- e. All fire life-safety equipment, facilities, and protected means of egress must be in place, and
 - f. Areas made accessible, as a result of using the units and facilities accepted for occupancy, must not pose a hazard to occupants or the public.
2. Acceptability of each unit and facility for which a permission to occupy is requested must be established by review of the property and signature of the respective certifications on Form FHA-2485 by the contractor, supervisory architect, and HUD representative.
- a. Minor items that do not preclude occupancy are permitted, but must be listed as an attachment to Form FHA-2485. This serves both as a notice of outstanding work requiring prompt completion, and helps resolve future debate regarding incomplete or improperly performed contract work versus occupant damage for which the contractor is not responsible.
 - b. Hold the contractor fully responsible for any incomplete or improperly performed contract work whether or not listed.
- B. Submission Documents. The mortgagee must sign Form FHA-2485 agreeing with the request and stating that insurance risks have been covered for the project. The mortgagor must include the following documents with the completed Form FHA-2485:
- 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 permits or authorizations required by law.
 - 2. Rent Schedule and Information on Rental Project, Form HUD-92458,

4. Certificate of Management Agent, Form HUD-9839, and
5. Management Agent Profile, Form HUD-9832, or certification that one is already on file with the particular Field Office.

Note: Items 2. through 5. above must only be submitted with the first submission of a Permission To Occupy.

C. Partial Occupancy Approval.

1. Favorably consider partial occupancy of units as they become available, where:
 - a. Vandalism of and theft from completed units and the property in general would be minimized, or
 - b. Needed project income is provided, or
 - c. An earlier rent-up date could be achieved than would be attained if permissions to occupy were deferred until completion of all units, or
 - d. The mortgage security would otherwise be enhanced, and
 - e. Utility and heating/cooling costs for the occupied units can be metered separately from the contractor's usage during continuation of construction, or an acceptable predetermined arrangement for occupied unit utility and heating/cooling costs is established.
2. Approve a series of Permissions To Occupy as units or facilities become available, where practical, e.g., for individual buildings on multi-building projects, or individual floors or wings on larger buildings. Approve a single permission to occupy for all units and/or facilities, where dictated by management considerations, e.g., very small projects.

1-12. RENT SCHEDULE. Instructions prohibiting additional tenant charges and for reviewing Form HUD-92458 for subsidized projects are in Handbook 4350.1, Chapter 7. Coordinate reviews with the Director, Housing Management Division. HUD no longer restricts rents for unsubsidized projects.

1-13. COMPLETION OF CONTRACT WORK.

A. Construction Contract Provisions.

1. Article 2.A. identifies the date for completion of the contract work, and procedures for extension of the time.
2. Article 2.C. provides for imposition of liquidated damages in the event the contract work is not completed within the specified time or as extended.
3. Article 2.D. makes the date the HUD representative signs the final HUD Representative's Trip Report, provided that the trip report is subsequently endorsed by the Chief Architect, the date for determining whether the contractor has met provisions of Article 2.A.
4. The final HUD Representative's Trip Report may not be signed until all work required by the construction contract is fully completed, except for items of delayed completion. See paragraph C. below for items of delayed completion.
5. Require the HUD representative to stress the Contract provisions at the preconstruction conference and at job meetings after 80 percent completion.
6. Article 1. of the Contract gives it precedence over all inconsistencies between the Contract and the General Conditions.

B. Final HUD Representative's Trip Report. Require accomplishment of the following:

1. Contractor's preparation and submission to the architect and HUD representative of a comprehensive list (punch list) of work to be completed or corrected before project review for issuance of the "final trip report." Require the list 30 days before the anticipated construction completion date.
2. Architect's review of the contractor's punch list against observed job conditions, appropriate modification and distribution of the modified list to the contractor and HUD representative.

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- (1-13)
3. Contractor's completion of the itemized work, and any other required work whether or not listed, before the scheduled site visit for issuance of the "final trip report."
 4. HUD representative's review of the completed project, preferably accompanied by the contractor, supervisory architect, and mortgagor. Require an additional site visit where the work is not acceptably complete.
 5. HUD representative's preparation of the "final trip report" on Form HUD-5379, HUD Representative's Trip Report, where the work is found acceptable.
 - a. The report must be completed and dated on the site visit date to avoid unfairly penalizing the contractor by imposing extra days of liquidated damages or denying incentive pay as may be applicable.
 - b. The report must include the following statements:
 - 1) "Construction acceptably completed," or "Construction acceptably completed subject to withholding disbursement or escrowing funds for completion of the listed items of delayed completion."
 - 2) "Utility services: (list services including electricity, gas, water, sanitary sewer, storm sewer, telephone, and cable TV as applicable), are complete, connected, and operable." Where connection is precluded by incomplete offsite work add to the statement, "Connection for (list) is awaiting installation of offsite lines."
 - c. The report must list any items of delayed completion, the estimated cost for completing the work, and a recommended completion date(s) for the listed work.
- C. Items of Delayed Completion.
1. Are work items beyond the contractor's control to complete, e.g.:
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- (1-13)
- a. Inability to install landscaping during freezing conditions.
 - b. Unavailability of items due to strike or other temporary outage.
2. May not preclude the mortgagor from occupying or utilizing the project and its facilities for the intended use.
 3. May not exceed two percent of the Contract amount.
 4. Retain 150 percent of the amount estimated by the HUD representative for completion of items of delayed completion as undisbursed funds, or if undone at final closing, as an escrow for completion of the work.
 5. Must be completed within 12 months of the date of the final HUD Representative's Trip Report.
- 1-14. GUARANTEE PERIOD. Require that a HUD representative make a 9- and 12-month inspection in accordance with Handbook 4460.1 to identify and report on latent defects, failures, items of delayed completion and any casualty damage.
- A. Inform the Mortgagee, mortgagor and contractor in writing of identified deficiencies before the contractor's 1 year warranty expires.
 1. Require correction from the contractor for construction deficiencies, including remedy through equipment and materials warranties, and
 2. Notification of the insurance underwriter for extended hazard or casualty damage as appropriate.
 - B. Seek Remedy through surety or use of retainage, escrow or letter of credit where available, if the contractor does not correct construction deficiencies in a timely fashion.
 - C. Invite the Director of Housing Management (DHM) to participate at all levels of guarantee period activities, and forward a copy of all HUD representative reports, and correspondence to the DHM, mortgagee, mortgagor, contractor and surety relating to guarantee period construction deficiencies.
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1-15. FUNDS AVAILABLE FOR APPLICATIONS FOR INSURED ADVANCES are reflected in the Financial Requirements for Closing, Form FHA-2283; Building Loan Agreement, Form HUD-92441; Mortgagee's Certificate, Form HUD-2434 (FHA-3320 for cooperatives); and consist of:

A. Mortgage Proceeds, except that use of any excess mortgage proceeds is limited. See paragraph 1-23 for additional information on excess mortgage proceeds.

*

B. Mortgagor's front money cash escrow, where required to make up the balance between the available mortgage proceeds and the total required for construction, fees, carrying charges, and financing.

*

C. Grant/Loan Proceeds from either governmental sources and/or nongovernmental sources. See paragraph 1-27 for additional information on grant/loan proceeds.

1-16. FUNDS DISBURSEMENT PRIORITY FOR INSURED ADVANCES.

*

A. First, disburse all funds from the cash escrow established by the mortgagor for on-site construction, fees, carrying charges and financing front money escrow), unless a pro-rata disbursement arrangement (for tax credit projects only) has been previously approved by the Hub Director.

*

B. Second, disburse grant/loan proceeds, except where the initial closing provides for a prorata disbursement arrangement (governmental sources only). Release of grant/loan proceeds may not be targeted to the completion of specific on-site improvements. See paragraph 1-27 for additional instructions.

C. Third, mortgage proceeds. Do not disburse any mortgage proceeds until all escrow, and grant/loan proceeds, not subject to a pro-rata disbursement arrangement, have been paid out. Where the Field Office has approved going to initial closing before a governmental source grant/loan is in place, do not disburse any mortgage proceeds until such grant/loan is in place. At that time proceed in accordance with the provisions of paragraph 1-15.

*1-16.1 PRO-RATA DISBURSEMENT OF FRONT MONEY AND MORTGAGE PROCEEDS ON TAX CREDIT PROJECTS

The mortgagor's front money cash escrow in cases involving low-income housing tax credits (LIHTC) or historic tax credits need not be fully disbursed before the disbursement of the mortgage proceeds.

A. The mortgagor's front money cash escrow is deposited with the mortgagee in an amount sufficient to meet requirements at initial endorsement under outstanding instructions and so reflected on the Mortgagee's Certificate.

B. The mortgagee and the HUD field office set up a disbursement schedule based on the ratio of mortgagor's cash escrow and mortgage proceeds to be disbursed. The cash escrow and mortgage proceeds are disbursed concomitantly (on a pro-rata basis).

C. The pro-rata disbursement must be reflected on the Mortgagee's Certificate and the Building Loan Agreement. Form HUD-92403, Application for Insured Advances of Mortgage Proceeds, is processed in accordance with outstanding instructions, except that it must show the approved funding from both the mortgage proceeds and the mortgagor's cash escrow in proportion to the terms of the pro-rata agreement.

D. Release of the front money cash escrow may not be targeted to the completion of specific on-site improvements. *

1-17. MORTGAGOR'S APPLICATION FOR INSURED ADVANCES for on-site improvements must be made on Form HUD-92403, Application for Insurance of Advances of Mortgage Proceeds.

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(1-17)A. General Criteria.

1. Initiated by the mortgagor through the mortgagee, reviewed and recommended by Mortgage Credit and approved by the DHD.
2. Submitted monthly, unless required more frequently to avoid a default.
3. Must be supported by the Contractor's Requisition, Form HUD-92448, for any payments due under the Construction Contract, and by proper bills and/or receipts for other mortgageable items. See paragraph 1-5 for details on Form HUD-92448.
4. Mortgagee must secure a current extension of the title policy evidencing clear title before

disbursing the funds.

- B. Mortgage Credit Review. Require Mortgage Credit to review and process Form HUD-92403 in accordance with Handbooks 4480.1 and 4470.1 REV-2, Chapter 8. Major mortgage credit responsibilities include:
1. Reconcile any discrepancies between the mortgagee's cumulative total for all advances, including the advance under consideration and conclusions reached in the processing before recommending the advance for approval.
 - a. Enter any required adjustments in Column B and note, "No Adjustment Necessary, Except As Indicated," or "No HUD Adjustment Necessary," as appropriate.
 - b. Enter the approved amount in the "Certificate of Mortgage Insurance" on the face of the form, and where the mortgagee's request is reduced explain the disallowance on the form's reverse side.
 2. Determine monthly that advances are proportionate to construction progress.
 - a. Require the Chief of Mortgage Credit to advise you where advances for "soft costs," i.e., financing and carrying charges, are in excess of work progress as shown by the most current Progress Schedule accepted by the Chief Architect and the percentage of project completion reflected on Form HUD-92448.

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- (1-17) b. Take action according to paragraph C. below where the mortgage is not in balance due to the fault of the contractor.
3. Secure approval from the Labor Relations Officer/Wage and Hour Compliance Specialist for any advance requesting release of any portion of the contractor's 10 percent holdback.
 4. List the escrow(s) and amount(s) required at final closing for items of delayed completion, mechanic's or other liens, and/or other purposes in the "Explanation of Disallowed Amounts" space on the "Final" advance.

- a. Show the total required escrow amount in the space provided in the "Certificate of Mortgage Insurance."
 - b. Withhold the required escrow amount from the amount approved for mortgage insurance in the "Certificate of Mortgage Insurance."
- C. Keep The Mortgage in Balance. Require the Chief of Mortgage Credit to prepare (with Field Counsel's assistance) a letter from you to the mortgagee with copies to the mortgagor, contractor, surety, supervisory architect, and legal counsels for the mortgagee, mortgagor and surety, where the mortgage gets out of balance (see paragraph B.2. above). The letter must:
1. Advise of the apparent lack of construction progress and impending shortage of mortgage proceeds,
 2. Request that the parties meet with you to identify the cause(s) of the slow construction progress and devise mutually acceptable remedies, and
 3. Identify that you will implement the transfer of funds from the construction budget for the purpose of defraying "soft costs" in the event acceptable progress is not achieved within a prescribed period. See paragraph 4-5.C.
 4. Proceed with the instructions in paragraph 4-5-C., where satisfactory construction progress has not been made within the prescribed period.

(1-17)D. Slow or Nonpayment of Obligations to/by Contractor.

1. Require the Chief of Mortgage Credit/Chief Architect to prepare (with Field Counsel's assistance) a letter from you to the mortgagee with copies to the mortgagor, contractor, surety, supervisory architect, and legal counsels for the mortgagee, mortgagor and surety, where:
 - a. There are nonpayment disputes between the mortgagor and the contractor or between the contractor and subcontractors, material

suppliers, etc., or where such payments are not being made in a timely fashion, and

b. The slow or nonpayment conditions are deemed to jeopardize mortgage security.

2. The letter must:

a. Advise of the apparent deficient payment record,

b. Request that the parties meet with you to identify the cause(s) of the payment problem and devise mutually acceptable remedies, and

c. Identify that you will pursue control of payments by the mortgagee or title company through use of two- or three-party checks in the event the problem is not resolved within a prescribed period. See paragraph 4-5.B.

3. Take action in accordance with paragraph 4-5.B., where satisfactory resolution of the problem is not achieved within the prescribed period.

E. Records Maintenance and Distribution.

1. Require Mortgage Credit to maintain a record of approved disbursements on Form HUD-92451, Financial Record of Mortgage Loan Transaction in accordance with Handbooks 4480.1 and 4470.1 REV-2.

2. Distribute the executed Form HUD-92403 as follows: Distribute executed applications, except for the final advance, as follows: original to the mortgagee with copies to the Washington Docket, Field Office Docket, and Mortgage Control File.

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(1-17) F. General Categories of Insured Advances are: initial advance, intermediate advances, next to last advance and the final advance.

1-18. INITIAL ADVANCE is usually made at initial closing, but may be made later.

A. Eligible Disbursements are limited to the mortgagor's early expenditures that have been paid or are due and payable, e.g.:

1. Financing fees.
2. Mortgagee's fees for:
 - a. Initial service charge (origination) not to exceed two percent of the Mortgage.
 - b. Permanent lender commitment fees not to exceed the lesser of:
 - 1) The amount paid, or
 - 2) One and one half (1-1/2) percent of the Mortgage.
3. HUD fees for: examination and inspection, and the first year's mortgage insurance premium (MIP).
4. Architect, engineer, surveyor or testing fees paid directly by the mortgagor for project design. Require Form HUD-92403-1, Mortgagor's and Architect's Certificate, for all advances for a prime architect's design services, whether requested at the initial or an interim advance. See Handbook 4430.1 REV-1, paragraph 1-11.B., for detailed information on prime architects.
5. Organizational expenses to initiate a project and to organize its planning, financing, hazard and liability insurance, and construction.
6. Consultant's fees, where used by a nonprofit mortgagor, for services leading to the initial closing, consistent with Handbook 4500.1 REV-2, Allowance for Making Nonprofit Projects Operational (AMPO) and Use of Housing Consultants. Do not approve more than 60 percent of the allocated fee for disbursement at initial closing.

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- (1-18) 7. Legal expenses to create the mortgagor entity and review documents related to the initial closing; but not to create tax shelters, trusts, etc., nor for expenses related to land acquisition, zoning, title and recording charges. Retain enough of the total approved on Form FHA-2283 to have at least 25 percent available to cover legal services for final closing.

8. Title and recording relating to initial closing, including: recording fees, mortgage and stamp taxes, survey recording fees, title insurance and title work required for initial closing. Retain enough of the total approved on Form FHA-2283 to cover final closing title and recording fees.
9. Sums allocated to acquisition cost of land (new construction) or acquisition cost of existing property (substantial rehabilitation), not to exceed the HUD estimate of "as-is" value of the unimproved site or "as-is" value of the property before rehabilitation.
10. Insurance premiums for extended hazard, liability, and other common risk insurance. All such insurance and workman's compensation for which the contractor is made responsible under terms of the Construction Contract, including the General Conditions and General Requirements of the Specifications, must be requested on the Contractor's Requisition, and
 - a. Must be shown on Form HUD-92403 under Construction cost per Form HUD-92448, but
 - b. May not be additionally shown as mortgagor's "other fees."
11. Contractor requisition for:
 - a. Bond premiums, insurance premiums, building permit, water tap and sewer connection fees and similar fees paid before initial closing.
 - b. Construction trade items only where:
 - 1) There's an approved early start, or
 - 2) Components stored offsite are approved and the requirements for payment are met. See paragraph 1-6 for detailed information.

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- (1-18) 12. Other front-end expenditures.
- B. Advances at Initial Closing. Require submission of the mortgagor's application for the initial advance 10 working days before initial closing, where it is to be

disbursed at the initial closing. Reconcile any differences, explain disallowances and give the mortgagor time for alternative actions required to facilitate a smooth closing.

- 1-19. INTERIM ADVANCES occur between the initial advance and the next to last advance. Eligible disbursements include mortgagor's expenditures that have been paid or are due and payable, but for which funds have not been disbursed under a previous advance, e.g.:
- A. Acceptably Completed Contract Work and material acceptably stored on-site, where supported by a completed Contractor's Requisition, Form HUD-92448.
 - B. Interest Earned for the requested periods.
 - 1. Mortgagee's refunding of any interest to the mortgagor is a kickback and prohibited.
 - 2. Treat any such refund as a direct mortgage reduction.
 - C. Supervisory Architect's Fee based on the monthly work progress, not to exceed a rate equal to the percentage of project completion.
 - D. Other Items listed in paragraph 1-18.A. above, whether incurred before or after initial closing; and as additionally incurred during the course of construction, e.g.:
 - 1. Taxes accrued after initial closing.
 - 2. Legal fees for interim activities in creating a project. Retain at least 25 percent of the total approved amount until the final draw.
 - 3. Organizational fees limited to documented costs to control and manage construction, e.g.: accounting and controlling disbursement of mortgage proceeds and working capital; coordinating permissions to occupy; and liaison with HUD, the mortgagee, contractor and architect during construction.

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- (1-19) 4. Consultant's fee, where applicable, consistent with Handbook 4500.1 REV-2, Allowance for Making Nonprofit Projects Operational (AMPO) and Use of

Housing Consultants.

- E. Cost of Equipping and Renting the Project. These expenditures may only be requisitioned on Form HUD-92403 where there is a nonprofit sponsor.
1. The allowance for making a project operational (AMPO) is funded from mortgage proceeds for the cost of equipping and renting the project for nonprofit projects only. See paragraph 1-24.D.
 2. The working capital deposit is required instead of AMPO for the cost of equipping and renting the project for profit motivated mortgagors, however, it is not advanced through use of Form HUD-92403. The working capital deposit is escrowed with and controlled by the mortgagee. See paragraph 1-25.
- 1-20. NEXT TO FINAL ADVANCE is where construction is complete, except for any approved items of delayed completion. Eligible disbursements include:
- A. Mortgagor's Continuing Expenditures for items listed for initial and interim advances and as may otherwise be eligible, that have been paid or are due and payable, but for which funds have not been disbursed under a previous advance.
 - B. Contractor's 10 Percent Holdback for nonidentity of interest contractors, subject to the provisions of paragraph 1-27C.
- 1-21. FINAL ADVANCE occurs at final closing and must take into account the funds required to set up escrows for "items of delayed completion," "to be paid in cash items," and any other required escrows. See paragraph 1-27 for release of holdback.
- A. Eligible Distributions include:
1. Audit fees pertaining to mortgagor's cost certification.
 2. Legal fees associated with counsel's review of final closing documents.
 3. Organizational costs involving final closing.

- (1-21)
4. Title and recording fees associated with final closing.
 5. Any remaining balance for items listed for the initial, interim and next to final advances.
- B. Insurance Upon Completion Projects only have one advance, the final advance at final closing.
- C. Conditions for the Final Advance. Require Mortgage Credit to review the following documents in accordance with Handbook 4470.1 REV-2 before the final advance:
1. Mortgagor's cost certification and complete Form FHA-2580, Maximum Insurable Mortgage, for a redetermination of the mortgage.
 2. Escrow Deposit Agreement, Form FHA-2546, for any items of delayed completion.
 3. Escrow Agreement for Unpaid Construction Costs, Form HUD-92476-1, for any unpaid construction costs.
 4. Request for Final Closing of Credit Instrument, Form HUD-92023, for insured advance projects and Form 2455 for Insurance Upon Completion projects.
 5. Submission of the Contractor's Requisition, Form HUD-92448, including endorsement of the Contractor's Prevailing Wage Certificate, for any Contract sum including any holdback.
 6. Require a 10-working day early submission of the mortgagor's application for final advance, to explain required escrows to the mortgagor before the closing date and to facilitate a smooth closing.

1-22. MORTGAGOR'S APPLICATION FOR ESCROWED FUNDS.

- A. Form HUD-92464, Request for Approval of Advance of Escrow Funds, must be used where the escrow is to ensure completion of offsite improvements, additive change orders, or mortgagor's unpaid construction items.
1. The mortgagor initiates and forwards Form HUD-92464 through the mortgagee. Require its review by Mortgage Credit.

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- (1-22)
2. Require the HUD representative to reflect the percentage of acceptably completed escrow work on the HUD Representative's Trip Report, Form HUD-5379, and the Chief Architect to forward a copy after review to the Chief Mortgage Credit for use in reviewing Form HUD-92464.
 3. Do not authorize advances in excess of the documented percentage completed, less previous payments and a 10 percent retainage.
 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, follow the procedures in paragraph 1-22.B. below.
- B. Distribution. Return the original copy of Form HUD-92464 to the depositor, and retain one copy each for the Washington Docket, Field Office Docket, and Mortgage Credit Control File, after its approval, approval as modified or disapproval with explanation.

1-23. Distributions From Excess Mortgage Proceeds.

- A. Eligible Distributions. Cash Available to the mortgagor listed on line 42 of Form FHA-2283, Financial Requirements for Closing may be allocated to the following items:
1. The lesser of HUD's estimate of the "as-is" value of land or the actual latest arm's length purchase price for new construction projects.
 2. The lesser of HUD's estimate of the "as-is" value of property before rehabilitation or the mortgagor's acquisition cost/existing indebtedness for substantial rehabilitation projects.
 3. The cost of any demolition reflected in the Fair Market Value of Land with payment approved as demolition progresses.
 4. Cash escrow to cover offsite construction cost. Where excess mortgage proceeds are used for this purpose:
 - a. Specify the amount for offsite work in one of the unused columns of Form HUD-92451, Financial Record of Mortgage Loan Transaction.

- (1-23)
- b. Requests for release of funds must be made on Form HUD-92403, Application for Insurance of Advance of Mortgage Proceeds.
 - 1) Certifications by the mortgagor, architect and HUD representative plus the criminal certification contained on the Form HUD-92464 must be included with the request.
 - 2) Disbursements must be in proportion to the percentage of offsite work completed, less a 10 percent holdback.
 - 5. Cash escrow to cover non-realty items, i.e., major movable equipment, (applicable only to Sections 232, 221(d) SRO and 242.
 - 6. Construction and/or permanent loan discounts required to be paid at initial closing.
 - 7. Cash escrow for the:
 - a. Working capital deposit,
 - b. Initial operating deposit,
 - c. Interest shortfall,
 - d. Loan discounts not paid at initial closing.
 - 8. Approved change orders, if any remaining balance.
 - 9. When an escrow item is to be funded from excess mortgage proceeds:
 - a. Mortgagor must identify in writing the escrow(s) to be established with these funds.
 - b. Funds for any discounts not required to be paid at initial closing, must be held until final closing.
 - c. Paragraphs 18(b), (c), (d) and (f) of Form HUD-2434, Mortgagee's Certificate, must be checked and amended to reflect the amount of any loan discount in escrow.
 - d. Segregate funds in an unused column on Form HUD-92451, Financial Record of Mortgage Loan Transaction, to avoid the unnecessary accumulation of interest.

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(1-23) B. Requests For Release of Funds must be made on Form HUD-92403, Application for Insurance of Advance of Mortgage Proceeds, and are subject to the disbursement procedures applicable to the escrow item(s) being requested.

1. Where excess mortgage proceeds are used to fund the escrow for completion of offsite improvements, additive change orders, or mortgagor's unpaid construction items:
 - a. Certifications by the mortgagor, architect and HUD representative plus the criminal certification contained on the Form HUD-92464 must be included with the request.
 - b. Disbursements must be in proportion to the percentage of work completed, less a 10 percent holdback.
2. Do not allow mortgagor to draw down excess mortgage proceeds to fund a cash escrow, and later substitute a letter of credit to satisfy the escrow requirement as a means of drawing cash out the project.

C. Restricted Excess Mortgage Proceeds. The difference by which the HUD estimate exceeds the construction contract amount are proceeds not to be available to the mortgagor during construction.

1. These funds may not be used to satisfy any escrow requirements and must be held until final closing.
2. Identify these funds in an unused column of Form HUD-92451 as restricted funds.

1-24. RELEASE OF LETTERS OF CREDIT. See Handbook 4430.1 REV-1 regarding mortgagee's options for use of a letter of credit. In the event of a claim:

- A. Assignment. Do not accept an assignment of the letter of credit to HUD from the mortgagee.
- B. Undrawn Balance. Treat any undrawn balance from a letter of credit or escrow agreement as cash held by the mortgagee.

- C. Cash Equivalent. Require the mortgagee to provide cash equal to the undrawn balance, if demand on a letter of credit is not met.

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- 1-25. ADVANCES FOR CARRYING CHARGES, FINANCING EXPENSES, ETC., are provided by The Building Loan Agreement, Form HUD-92441, paragraph (5).
- A. Line Item Amounts on Form HUD-92451, Financial Record of Mortgage Loan Transaction, should equal the amount for the corresponding line item on the Project Income Analysis and Appraisal, Form HUD-92264, or applicable underwriting form for the Section of Act.
- B. Prohibited Advances. Do not release funds in excess of itemized allocations, except to prevent a default, where:
1. HUD agrees to a reallocation; and
 2. There is a corresponding reduction in another line item.
- C. Advance Amounts to the extent the charges have accrued or been earned, or that the Borrower is otherwise entitled to payment.
- D. Allowance to Make the Project Operational (AMPO) is used for nonprofit sponsors as approved by the DHD. See Handbook 4470.1 REV-2, Chapter 8, and Handbook 4500.1 REV-2 for detailed instructions on eligible expenditures and restrictions.
1. General categories of eligible expenditures include:
 - a. Additional soft costs, ground rents and special assessments resulting from construction delay,
 - b. Necessary change orders resulting from latent site conditions and/or construction requirements imposed by the local authority after start of construction,
 - c. Mortgage insurance premium for the second year, and property insurance policies and real estate taxes for the first year after project completion, and

- d. Costs incidental to project operation, e.g., advertisement, furnishing model rental units, and furnishing/equipping lobbies, management office and community spaces.

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- (1-25) 2. General categories of ineligible expenditures include:
 - a. Additional fees/profits for attorneys, architects and other development team members,
 - b. Purchase/lease/operating expense for motor vehicles, and
 - c. Acquisition of equipment not essential to project operation.
 - 3. Allocation of AMPO balance at final closing:
 - a. Allocate any balance to the reserve for replacements.
 - b. AMPO is for the benefit of the purchasing nonprofit mortgagor where a builder-seller is involved (Section 221(d)).
 - 1) The builder-seller may only receive AMPO funds for approved eligible expenditures, after the nonprofit entity receives title to the completed project.
 - 2) Apply the full AMPO fund to the reserve for replacements, where a sale to a nonprofit entity is not completed.
 - E. Consultant's Fee, For Nonprofit Sponsors. Advance fees in accordance with the terms of the executed contract. Follow guidelines in Handbook 4500.1 REV-2, Allowance for Making Nonprofit Projects operational (AMPO) and Use of Housing Consultants.
- 1-26. WORKING CAPITAL DEPOSIT is established with the mortgagee at initial closing for all but nonprofit mortgagors. See Handbook 4430.1 REV-1, paragraph 1-26, for details. It may be funded by cash, letter of credit or excess mortgage proceeds, if any.
- A. Purpose. The deposit is used to:

1. Defray cost of initial marketing and rent-up. This includes: sales and advertising, model furnishing, and equipment and supplies essential to initial rent-up, etc.

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- (1-26)
2. Set up accruals for items due during the first operating year that project income is not expected to cover, including real estate taxes, permanent property insurance premiums, mortgage insurance premium, ground rents and assessments.
 3. 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.
 4. May be allocated to the reserves for replacement for a project with low income housing tax credits, where acceptable to the mortgagor and HUD.
- B. Control And Release Of Escrow. The mortgagee controls disbursements from the escrow, except where the mortgagor certifies at firm commitment that any balance of the escrow will be applied to the reserve for replacements on a Low Income Housing Tax Credit (LIHTC) project. In reviewing a mortgagor's request for release of part of the escrow, consider the following:
1. Mortgagor's request for the release of such escrow funds must be by letter through the mortgagee, rather than on Form HUD-92403.
 2. 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).
 3. Avoid premature disbursements and unnecessary expenditures.
 4. See Handbook 4470.1 REV-2, paragraph 18-4.F. for detailed instructions for HUD control and release of the escrow where the mortgagor certifies at firm

commitment on an LIHTC project to apply any balance to the reserve for replacements.

5. As portions of a project are ready for occupancy, a partial disbursement may be permitted for reasonable opening expenses: however, it must be determined that the escrow is not exhausted before the entire project is complete.

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- (1-26) 6. An unsolicited recommendation may be offered by the Field Office that the deposit be used to cover any shortfall in interest, taxes, property insurance, mortgage insurance premiums, ground rent and assessments.

7. Fully document all expenditures from the escrow.

- C. Cost Certification Of The Working Capital Deposit. The mortgagor's cost certification may include monies spent from the working capital escrow.

1. The expended portion must be supported by a schedule setting forth the vendor's name, a description of items purchased, total invoice price and the amount paid to date.

2. These expenditures will not be a basis for, or included in, processing a mortgage increase.

- D. Final Release Of Escrow.

1. Release any balance of the working capital escrow to the mortgagor one year after substantial completion where the project is not in default.

2. Hold this escrow until any financial problems are resolved (e.g., has not reached sustaining occupancy, has poor liquidity or high payables, is operating at a deficit or is near default).

3. Authorize the mortgagee to use any balance of the working capital escrow to cure a default, where a default occurs before its release. See paragraph 4-K.

1-27. DISBURSEMENT OF GRANT/LOAN PROCEEDS. Grant/loan proceeds may come either from a governmental source, i.e., Federal, State, or local government agency or instrumentality, or a

nongovernmental source, e.g., a foundation.

- A. General For Governmental/Nongovernmental Source Funds. The proceeds are used to fund a front money cash escrow (Part A of the "Total Requirements for Settlement," Form HUD-92264-A) at initial closing, whether the funding source is a governmental or nongovernmental entity. See paragraph B. below for additional options to a cash escrow available to governmental source entities only.

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- (1-27) 1. Disbursement priority of grant/loan proceeds in relation to mortgage proceeds and other escrows is discussed in paragraph 1-15.
2. Disbursement procedures from the cash escrow is discussed in paragraph 1-21.
3. Release of grant/loan proceeds may not be targeted to the completion of specific on-site improvements.

- B. Additional Options For Governmental Source Funds. Where the grant/loan proceeds come from a governmental source, the mortgagor may use instead of a cash escrow:

1. An unconditional irrevocable letter of credit issued by a banking institution (see paragraph 1-23 for release of letters of credit), or
2. An agreement entered into by HUD, the mortgagee, the mortgagor and the governmental entity for a prorata disbursement of the loan/grant proceeds.

Note: Paragraph A.3. above also applies where a letter of credit or a prorata disbursement agreement are used.

- C. Prorata Agreement For Governmental Source Funds. The mortgagor may elect prior to initial closing to use a pro rata disbursement agreement instead of a cash escrow, where it is accepted by HUD, the mortgagee, the governmental entity, and mortgagor, and subject to the following:

1. The mortgagor must post either a cash escrow or an unconditional letter of credit equal to or greater than 10 percent of the grant/loan proceeds. This is to be used for the governmental entity's pro

rata contribution toward the mortgagor's monthly advance request, where the governmental entity does not advance the funds to the mortgagee in a timely fashion.

- a. HUD must retain control of the escrow in a separate agreement,
- b. The mortgagor must reinstate any portion of the escrow drawn before final closing within 10 days of the draw down, and
- c. The escrow may be released at final closing.

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- (1-27)
2. HUD has the sole authority to resolve differences in the inspection process and disbursement of grant/loan proceeds.
 3. HUD has the right to approve construction advances after considering any reported noncompliance in the work by the governmental entity, where the project is proceeding in compliance with approved plans and specifications.
 4. The mortgagee must concurrently furnish HUD and the governmental entity with copies of Form HUD-92448, Contractor's Requisition, and Form HUD-92403, Application for Insurance of Advances of Mortgage Proceeds.
 5. The governmental entity must process the advance request and make its pro rata contribution to the mortgagee promptly and without adjustment.
 - a. Where the governmental entity finds the need for an adjustment, it must furnish the information to HUD to be reflected in the next month's advance requisition.
 - b. The governmental entity must assume the risk for any grant/loan proceeds disbursed in excess of the amount approved by HUD and must replenish the excess funds within 10 working days of notification by HUD.
 - c. Where the governmental entity fails to advance grant/loan proceeds to the mortgagee in a timely fashion, the mortgagee must draw down

on the escrow/letter of credit identified in paragraph 1. above.

6. Form HUD-92403, Application for Insurance of Advances of Mortgage Proceeds, is processed in accordance with outstanding instructions, except that it must show the approved funding from both the mortgage proceeds and the grant/loan proceeds in proportion to the terms of the pro rata agreement.
7. A copy of the HUD approved request for advances must be sent to the governmental entity. The governmental entity must use the information to:
 - a. Comply with paragraph 5.b. above, and

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- (1-27)
 - b. To make any required reductions to the subsequent request for advances, where its approval of advances exceed the HUD approved amount(s).
- 1-28. RELEASE OF CONTRACTOR'S 10 PERCENT HOLDBACK. The holdback provides an incentive for the general contractor and mortgagor to: promptly complete the project, submit cost certification and reach final closing.
- A. Amount Of Holdback. The Building Loan Agreement requires the mortgagee to retain at least 10 percent of the construction proceeds from each advance. The construction contract also provides for 10 percent holdback from the contractor's monthly payments for acceptably completed work, acceptably stored materials, and where applicable, components acceptably stored offsite.
 - B. Identity of Interest Contractor. Except as provided in paragraphs D. and E. below, do not release any part of the holdback until final closing for a contractor with an identity of interest.
 - C. Nonidentity of Interest Contractor. Release the contractor's holdback or remaining balance at the next to last advance (see paragraph 1-19), where requisitioned on Form HUD 92403, Application for Insurance of Advance of Mortgage Proceeds, and subject to compliance with the following:

1. Contractor's cost certification, where required by paragraph 5-1.B., has been reviewed and necessary adjustments made to Form HUD-92451, Financial Record and Mortgage Loan Transaction,
2. Contractor has disclosed its final obligations on Form HUD-92023, Request for Final Endorsement of the Credit Instrument,
3. All work under the construction contract has been inspected and approved by the controlling jurisdictions and/or authorities,
4. 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 certificates of occupancy.

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5. Permission To Occupy, Form FHA-2485 has been issued by HUD for all units,
 6. All Davis-Bacon payroll requirements have been satisfied,
 7. Surveyor's Certificate, Form HUD-92457, and survey showing the location of all improvements, utility easements and site utility distribution lines have been submitted to HUD, and
 8. Retain, where applicable, an adequate amount for the following:
 - a. Items of delayed completion in an amount equal to 150 percent of the HUD representative's cost estimate for completion,
 - b. Any owed or contested amounts indicated by mechanics, subcontractor, supplier, or equipment lessor liens, etc.,
 - c. Lesser of the liquidated damages or actual damages computed at cost certification, and
 - d. Net effect of negative change orders.

D. Early Partial Release of Holdback.

1. After 90 percent contract completion, the Field Office Manager may release part of the contractor's holdback and suspend further withholding of holdback from payments due, where:
 - a. The contractor has no identity of interest or the contractor's only identity of interest is a project ownership of less than 5 percent,
 - b. The contractor, mortgagor and mortgagee request the early release of the holdback in accordance with Appendix 5 and attach the request to Form HUD 92403, Application for Insurance of Advance of Mortgage Proceeds, and
 - c. Prior written consent from surety, if any, for the early release of holdback is provided with the request, and
2. The Field Office Manager determines that:

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- a. The contractor's general performance warrants partial release of the holdback without conditions, or
 - b. Partial release of the holdback with conditions, e.g., measures to assure immediate distributions to subcontractors or others, would be in the mutual interest of all participants, and
3. The undisbursed holdback must equal or exceed 5 percent of the contract amount.
- E. Projects In Difficulty. Release of part of the contractor's holdback before 90 percent 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. See paragraph 4-5.D.
1. Consider the contractor's performance including:
 - a. The completed work must be satisfactory,
 - b. The percentage of completed contract work must be sufficient to ensure project completion

within the specified contract time, and

- c. Do not release any holdback if there are serious, 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.
- 2. Require a written consent for the early release of holdback from the surety, if any, the mortgagor and mortgagee.

1-29. ASSURANCE OF FUNDS TO MEET OPERATING DEFICITS. At initial closing, the mortgagee may have accepted an Agreement to Furnish Additional Funds, Form FHA-2476, instead of a funded operating deficit escrow (see Handbook 4430.1 REV-1, paragraph 1-28). Remind the sponsor at 80 percent completion of the obligation to fund the escrow on or before the estimated construction completion date.

1-30. PRELIMINARY ASSESSMENT FOR INSURED MORTGAGE INCREASE.

- A. Timing. Do not consider a request for mortgage increase until the project is complete, cost certification is complete, and final closing will likely be achieved immediately following processing of the mortgage increase, except:
 - 1. A mortgage increase may be granted at the time a change order is approved provided:
 - a. It qualifies under paragraph B.3. or B.5. below,
 - b. Other funds are not available to cover the cost involved; and
 - c. It will avoid default prior to final closing.
 - 2. The Field Office Manager determines that a mortgage increase is necessary to avoid default before final closing.

B. Basis For Considering A Mortgage Increase. To cover:

1. Necessary change orders, i.e., latent project conditions, changes in applicable code, architect's error and declared natural disaster damage not covered by casualty insurance, (see paragraphs 1-8.B.1. through 1-8.B.4.a.). Following are limiting factors for approving a mortgage increase based on necessary change orders:
 - a. The cost of necessary changes to a substantial rehabilitation project must exceed the project contingency,
 - b. Require compliance with subitems 1) and 2) below as conditions for a mortgage increase, where there is a determination of architect's/engineer's errors or omissions. A finding of Architect's/engineer's errors or omissions should be made where: there is a failure to request and/or perform necessary subsurface investigations (new construction), or assess existing conditions (substantial rehabilitation project) consistent with sound professional practices); failure to comply with applicable codes and ordinances in existence at initial closing; and failure to provide for conditions that may adversely affect occupant

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- (1-30) life safety or health, the project's physical integrity, or pose potential project liability. The mortgagor must:
- 1) Pursue a claim to judgement against the architect, where: the requirements were overlooked at project planning and design, and the cost of remedy exceeds the estimated cost to the mortgagor, had the property been properly designed initially, and
 - 2) Apply any recovery (less legal and other recovery costs) up to the mortgage increase amount to mandatory prepayment of the mortgage.
- c. Mortgage increases for change orders required due to declared natural disasters are limited only to construction hard costs to the extent

not covered by insurance.

2. Betterment changes. See paragraph 1-8.C.
3. Additional costs caused by extensions in contract time meeting all of the following:
 - a. Approved by HUD,
 - b. Justifiable under AIA General Conditions, and
 - c. Caused by problems beyond the contractor's and mortgagor's control.
4. Additional cost for replacing the original contractor when the original contractor becomes bankrupt, abandons the job or the contract is terminated for cause and the surety has failed to perform. Report any nonperformance by a surety to the U.S. Treasury with a copy of the letter to the Director, Office of Insured Multifamily Housing Development, HMI. See paragraph 4-5.A.2.
5. A substantial error in HUD cost processing which would otherwise result in serious inequities. The error must be a deviation from outstanding technical instructions. Professional differences in opinion and judgement exercised by a technician do not constitute an error in HUD processing.

(1-30)C. Mortgage Increase Restrictions. To be approved:

1. A mortgage increase may not be granted for cost overruns associated with: completion of the work in accordance with the original contract documents by the original contractor, changes made primarily for the convenience of the mortgagor or contractor, nor for the aggrandizement of the mortgagor or contractor.
2. Cost overruns are not a basis for granting a mortgagor's request for mortgage increase nor are changes made primarily for the convenience or aggrandizement of the mortgagor or contractor.
3. A mortgage increase must be greater than: \$50,000 or 2-1/2 percent of the original mortgage where such amount exceeds \$50,000, and

4. It must be supported by debt service, i.e., Form HUD-92264-A, Criterion 5.
 5. A mortgage increase may not be granted for replacing a contractor where the mortgagor sets up a "straw contractor" for purposes of BSPRA.
- D. Preliminary Review of Request For Mortgage Increase. Analyze the request before referring it for technical processing to:
1. Ensure that all requested increases are fully justified and eligible under the criteria in paragraph B. above,
 2. Evaluate the project's potential for reaching final closing in the event the mortgage increase is granted,
 3. Consider other possible solutions, e.g., infusion of new capital through new partners, syndication proceeds, etc., and
 4. Prepare a memorandum for the file outlining pertinent facts and citing the applicable paragraph B. category upon which the technical processing of the request for mortgage increase is to be based.

1-31. PROCESSING A MORTGAGE INCREASE. Forward acceptable requests for mortgage increase to the Technical Branches for processing. Technical processing consists of Step 1 through Step Four below:

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- (1-31)A. Step One. Use the alternative applicable to the condition being considered.
1. Alternative One. Applicable to necessary and betterment change order cost increases (see paragraphs 1-29.B1. and B.2.).
 - a. Architecture and Valuation review the change orders to determine eligibility for processing a mortgage increase and architecture further reviews for the added cost.
 - b. Mortgage Credit computes the allowable costs on Form FHA-2331A, Cost Certification Review Worksheet - Mortgage Credit Staff, Line 1.d.

- c. The adjusted hard cost forms the basis of the mortgage increase computation.
- 2. Alternative Two. Applicable contract time extension increases to soft costs (see paragraph 1-29.B.3.).
 - a. Mortgage Credit computes the allowable costs on Form FHA-2331A, Cost Certification Review Worksheet - Mortgage Credit Staff, Lines 3 through 6.
 - b. The adjusted soft cost forms the basis of the mortgage increase computation.
- 3. Alternative Three. Applicable to construction contract cost increases due to a change in the contractor (see paragraph 1-29.B.4.).
 - a. Architecture computes a new Form HUD-2328, and Form HUD-92264, Section G through Line 50.
 - b. Mortgage Credit computes the allowable costs on Form FHA-2331A, Cost Certification Review Worksheet - Mortgage Credit Staff, Line 1.c. for hard cost increases between the original contractor and the contractor completing the work, and Lines 3 through 6 for soft cost increases associated with the change in contractor.
 - c. The adjusted hard and soft costs form the basis of the mortgage increase computation.

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- (1-31) 4. Alternative Four. Applicable to a substantial error in HUD cost processing (see paragraph 1-29.B.5.).
 - a. Architecture computes a new Form HUD-2328, and Form HUD-92264, Section G through Line 50.
 - b. Mortgage Credit computes the allowable costs on Form FHA-2331A, Cost Certification Review Worksheet - Mortgage Credit Staff, Line 1.c., using the criteria in paragraph c. below.
 - c. The allowable construction costs for processing

the increase will be based upon the lesser of:

- 1) The amount of the construction cost certified by the mortgagor, or
- 2) The upset price of the construction contract as adjusted by approved change orders eligible for a mortgage increase, plus the increases resulting from correction or errors in the original processing.

d. The adjusted hard cost forms the basis of the mortgage increase computation.

Note: The mortgage credit examiner must not use the adjusted upset price of the construction contract as a limiting criterion at cost certification where there is a substantial error in HUD cost processing.

B. Step Two. Mortgage Credit must compute (for use by Valuation in completing Step Three) the eligible costs and fees for the following: architect's fees, bond premium if paid by the mortgagor, other fees not included in the construction contract and paid by the mortgagor, interest, taxes, insurance, AMPO (if applicable), legal, organizational and audit fees, consultant's fees (if applicable), supplemental management fund (if applicable), marketing (if applicable), offsite costs, "as-is" land value and "as-is" value of property (if applicable). Mortgage Credit must comply with the following in computing the costs and fees.

1. Do not increase BSPRA or restore Contingency Reserve or AMPO,

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- (1-31) 2. Do not include non-mortgageable items (construction or permanent loan extension fees; discounts; rate maintenance fees, etc.),
 3. Offset non-mortgageable items by net income (net non-proprietary income if applicable) earned during the construction period,
 4. Apply any remaining net income (net non-proprietary income if applicable) to offset amount of mortgage

increase, and

5. For increases caused by natural disaster:
 - a. Consider in the revised cost any increases from any interim closing for: carrying charges, financing fees, and legal fees. Do not include any cost due to construction delays before the disaster,
 - b. Cut the new estimated replacement cost by the amount of any actual recovery through insurance proceeds, and
 - c. Require prepayments to be made for any late recovery of insurance proceeds.

C. Step Three. Valuation must use the costs and fees developed by Mortgage Credit in Step Two in revising Form HUD-92264. Valuation must consider each of the following:

1. Examination fee, initial service fee, GNMA/FNMA fee, MIP and title and recording based on the approvable increased mortgage amount.
2. Net income derived from market rent, expense and occupancy estimates current as of the date of mortgage increase processing.
3. In Section 8 projects, where Fair Market Rents control rental rates, use the lesser of the following:
 - a. Rents by market comparison as of date of processing, or
 - b. The existing Fair Market Rents adjusted for PBE.

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- (1-31) 4. In the Section 8 Project Based Certificate Program, use contract rents approved under the HAP Agreement.
 5. Where the portion of the mortgage attributable to the increase has an interest rate differing from the original rate, determine maximum mortgage supportable by debt service in the following

manner:

- a. Apply applicable net income ratio to net income.
 - b. Determine the amount of net income necessary to support the original loan using the original debt service rate.
 - c. Deduct the amount in paragraph b. above from the amount in paragraph a. above. The residual may be debt serviced out at the new interest rate to show amount of additional mortgage that may be supported by debt service. If amortization of the original mortgage has commenced, the new debt service rate must reflect the term between anticipated start of amortization of the new mortgage and the ending date of the original loan. If there is no residual, a mortgage increase may not be granted.
 - d. The total of the original mortgage amount plus the amount of mortgage supported in paragraph c. above represents the maximum mortgage supported by debt service.
 - e. Prepare a separate calculation using Appendix 3 to accompany the Trial HUD-92264A to Mortgage Credit showing a composite (blended) interest rate applicable to the new approvable mortgage amount.
6. The rents (rates) obtainable must support the higher mortgage.
- D. Step Four. Mortgage Credit must prepare a revised Form HUD-92264A, using the revised Form HUD-92264 and Trial Form HUD-92264A prepared by Valuation in Step Three.

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- (1-31)
1. Use the rates arrived at in paragraph C.5.e. above to complete a supplemental criterion 5 of Form HUD-92264A when there is a difference in the interest rate applicable to the portion of increased mortgage.
 2. The mortgage attributable to the increase may bear a construction and permanent interest rate

differing from that of the original mortgage. See paragraph C.5.e. above.

- E. Authorization To Reopen Mortgage Transaction. Advise the mortgagee of HUD's approval or denial of the request for a mortgage increase upon completion of technical processing. Use Appendix 1, Specimen Letter - Agreement Authorizing Reopening Of Mortgage Transaction, to notify the mortgagee, where a determination is made to increase the mortgage.
1. Approval of a mortgage increase is subject to the payment of the following fees based on the amount of the increase.
 - a. Examination fee of \$3.00 per thousand.
 - b. Inspection fee of \$5.00 per thousand, applicable only where the increase involves construction (hard) costs.
 2. A mortgage increase does not change the maturity date of the mortgage.
 3. The mortgagee must endorse the letter of agreement as evidence of acceptance.
 4. Distribute copies of the endorsed letter as follows: Washington Docket, Field Office Docket, Field Counsel, Mortgage Credit Control File, and mail a copy to:

U.S. Dept of HUD
Multifamily Insurance Operations Branch
P.O. Box 44124
Washington, D.C. 20026-4124

1-32. DEFERMENT OF PRINCIPAL PAYMENTS. The request for deferment must be supported by the mortgagee.

A. Requests for Deferment will be considered if:

1. There has been a delay in construction; or
2. The project requires additional time to reach sustaining occupancy.

B. Approve The Request when:

1. There are sufficient funds outside mortgage proceeds for payment of interest overrun either by:
 - a. Written assurance from the sponsor, or
 - b. Exercise of action against the contractor.
 2. The mortgagor shows reasonable effort to complete construction and attain a sustaining occupancy.
- C. The Period of Deferment will be the additional time necessary for the mortgagor to stabilize its operation.
- D. Deferment Letter. Use Appendix 2, Specimen Letter - Agreement Authorizing Deferment of Principal Payments For Level Annuity Monthly Payment, and distribute copies as follows:
1. Mortgagee (original and one copy), with one copy each to
 2. Washington Docket,
 3. Field Office Docket,
 4. Mortgage Credit Control File, and
 5. Mail to:

U.S. Dept of HUD
Multifamily Insurance Operations Branch
P.O. Box 44124
Washington, D.C. 20026-4124
- E. Deferment Instruments. The Manager is authorized to approve modifications of the mortgage instruments as may be necessary to effect the deferment of principal payments, provided the instruments have been cleared by the closing attorney.

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1-33. TRANSFERS OF INSURED MORTGAGES are acceptable for the assignment of title, pledge of title and/or partial (beneficial) interest, and the transfer of partial (beneficial) interest through a participation agreement or other arrangement, subject to the following:

A. Assignment or Pledge of Title Before Full Disbursement.

The Director of Housing Development (DHD) must give written approval before a mortgagee may assign or pledge title to an insured mortgage, if the mortgage loan has not been fully disbursed.

1. Assignment of Title: The circumstances must warrant the assignment and:
 - a. The assignee must be an approved mortgagee,
 - b. The mortgage must be assigned and the Note endorsed to the assignee,
 - c. The Building Loan Agreement, with mortgagor's written consent, must be assigned,
 - d. The assurance of completion (with the written consent of the mortgagor, contractor and indemnitor or surety) must be assigned,
 - e. The assurance of installation of offsite facilities, including deposits, must be assigned,
 - f. The working capital deposit, funds required for completion of the project, and all other escrow funds deposited with the project, if any, must be transferred for deposit with the assignee or under its control,
 - g. There must be a written assumption by the assignee of all obligations under the contract of mortgage insurance and of all documents, funds and escrow deposits in connection therewith together with the written opinion of the assignee's attorney as to the validity of the entire transaction and of all documents in connection therewith,
 - h. There must be an Executed Mortgage Record Change, Form HUD-92080,

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- (1-33)
 - i. There must be a written consent by the title insurer of the transfer in regard to the title evidence accepted at initial closing, and
 - j. Field Counsel must render an opinion on the documents listed in paragraph 1.a. through 1.i. above, and on any additional documents that

should be considered due to working of applicable law, to clear the mortgage assignment before the DH/CU notifies any interested parties of assignment approval.

2. Pledge of Title. HUD approval is subject to:
 - a. The mortgagee's written pledge to remove the loan from the warehousing bank within 30 days after final endorsement of the mortgage note,
 - b. Determination by the DHD/CU that the arrangement is practicable, and
 - c. Any approval letter must draw mortgagee's attention to provisions for assignment of the mortgage title, 24 CFR Part 207.261, in the event the pledgee exercises its rights under the pledge.
 - 1) Paragraph A.1. above lists the requirements for assignment of the mortgage title before disbursement of the mortgage, and
 - 2) Paragraph B. below lists requirements for assignment of the mortgage title after disbursement of the mortgage.
3. Distribute Documents for paragraph A. as follows:
 - a. Washington Docket and Field Office Docket: The approval/disapproval letter. Additionally for:
 - 1) Assignments - Copies of all documents in paragraphs 1.a. through 1.j. above.
 - 2) Pledges - Documents in paragraph 2.a. above,
 - b. Office of Multifamily Housing Management, HMH, and Field Office Loan Management Branch: forward the approval/disapproval letter only, and

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- (1-33) c. Mail a copy of Form HUD-92080, Mortgage Record Change, (assignments only) to:

U.S. Department of HUD

Multifamily Insurance Operations Branch
P.O. Box 44124
Washington, D.C. 20026-4124

B. Assignment or Pledge of Title After Full Disbursement may be made by the mortgagee without prior HUD approval, where:

1. The transfer (assignment) or pledge is made to a HUD approved mortgagee,
2. The assignment is reported to HUD in accordance with Handbook 4350.4, paragraph 2-27.

C. Transfer or Pledge of Partial (Beneficial) Interest.

1. Transfer. A mortgagee may transfer a 100 percent (or less) beneficial interest in an insured mortgage or pool of insured mortgages under a participation agreement or arrangement, such as a declaration of trust or the issuance of pass-through certificates, without obtaining HUD approval, subject to the following:
 - a. Legal title to the insured mortgage(s) must remain with an approved mortgagee (principal mortgagee). The mortgagee of record at the time beneficial interests are transferred must remain the principal mortgagee, if it retains title to the mortgage. Title to the mortgage may also be assigned to another approved mortgagee concurrently with or subsequent to the transfer of beneficial interests in accordance with paragraph 1-33. A. or B. above, as applicable. In such case the assignee (mortgagee of record) must be the principal mortgagee.
 - b. The participation agreement, declaration of trust or other instrument under which the partial interest is transferred must provide that:
 - 1) The principal mortgagee must remain mortgagee of record under the contract of mortgage insurance,

mortgagee regarding the rights, benefits, and obligations of the mortgagee, and

- 3) The mortgagor has no obligation to recognize or do business with anyone other than the principal mortgagee or its servicing agent with respect to rights, benefits, and obligations of the mortgagor or mortgagee.
2. Pledge. Prior HUD approval is not required of a pledge of only the beneficial interests under a participation agreement or arrangement. Pledge documents must reflect requirements applicable to a transfer, 24CFR Part 207.261(e), in the event that the transfer provisions are exercised. *

D. GNMA Backed Securities.

1. No partial interest may exist in mortgages backing Government National Mortgage Association (GNMA) Construction Loan Certificates or GNMA Project Loan Certificates.
2. The GNMA must approve the assignment of any insured mortgage used to back securities guaranteed by GNMA.
3. The mortgagee-issuer and the holder of a partial interest under a participation agreement must certify that the interest will terminate upon release (delivery) of the Project Loan Certificates, where an insured mortgage is to be in a GNMA mortgage pool backing one or more GNMA Project Loan Certificates.

- * E. Unauthorized Transfers. The Commissioner may terminate the contract of insurance in the event of an assignment of title, pledge of title and/or partial (beneficial) interest, or transfer of a partial or participating interest, where the applicable conditions of paragraphs A. through D. above are not met. *

- F. Bonds or other obligations issued in connection with an insured mortgage executed in the form of an indenture of trust may be transferred as provided in the indenture. Prior HUD approval is not required, nor does paragraph E. above apply.