

CHAPTER 10. CONSTRUCTION INSPECTIONS, PROGRESS PAYMENTS  
AND OTHER ISSUES ARISING DURING CONSTRUCTION

- 10-1. INTRODUCTION. This Chapter details issues that arise during the actual construction phase, including the commencement of work, maintaining project files, inspections and progress payments, final payment, warranties, disputes, and completion where funds are insufficient.
- 10-2. COMMENCEMENT OF WORK
- a. Notice from LPA. The Rehabilitation Construction Contract or the Self-Help Agreement, as applicable, must be so drafted that no contractor is authorized to begin work, and materials may not be delivered to the property, until the steps described in Paragraph 10-2-b below have been completed. Therefore, this Contract or Agreement must provide that work is not permitted to begin, or materials to be delivered, until the LPA notifies the borrower and any contractor to begin. The LPA may provide this notice in any one of the following ways, as required by the Contract or Agreement:
- (1) the LPA may transmit a copy of the executed Rehabilitation Construction Contract or Self-Help Agreement to the contractor and borrower, which Contract or Agreement provides that it is effective, and work shall begin, upon such delivery (after the completion of activities set forth in Paragraph 10-2-b);
  - (2) the LPA may issue a letter to proceed to the contractor, and borrower after the completion of post settlement activities (see Paragraph 10-2-b); or
  - (3) the LPA may utilize any other method which provides written notice to the borrower and contractor to begin after the completion of post settlement activities (see Paragraph 10-2-b) which is approved by LPA Counsel, and which is effective.
- b. Steps Which Must Occur Prior to LPA Notice. Prior to the LPA notice described in Paragraph 10-2-a, the following steps must occur:
- (1) The loan documents (Note, Mortgage, Rehabilitation Loan Agreement, and Rent Regulatory Agreement, if applicable) must be executed by the applicable parties. (See Paragraph 9-3 of this Handbook for additional information.)
  - (2) Loan settlement must be completed. (See Chapter 9 for additional information.)

- (3) The cancellation period required under the Truth-in-Lending Act for owner-occupants of single-family properties, if applicable, must have elapsed. (See Paragraph 9-2-d of this Handbook for additional information.)
  - c. Starting Work. The borrower should cause work to begin within thirty days after the LPA gives the borrower notice to begin work under Paragraph 10-2-a. When the work does begin, the borrower should notify the LPA for its records. If the LPA has received no notification by 30 days, it must follow up with the borrower to determine the status of the work.
  - d. Required Action if Work Fails to Commence Within Sixty (60) Days or if the Contractor Ceases Work for More than 30 Days. Work must begin within sixty (60) days after the LPA gives the borrower and any contractor notice under Paragraph 10-2-a, unless the following exception is granted: the Director of Community Planning and Development in the HUD Field Office may grant an extension for up to sixty (60) additional days for circumstances beyond the control of the borrower. If work has not begun by sixty (60) days after the notice from the LPA to the borrower and any contractor under Paragraph 10-2-a, or within the time limits detailed in an extension approved in accordance with the requirements in the previous sentence, the LPA must take immediate steps to terminate the loan in accordance with the Rehabilitation Loan Agreement between HUD and the borrower. In addition, if the contractor ceases work for more than 30 days, unless extended by the HUD Field Office Director of Community Planning and Development, the LPA must take immediate steps to terminate the loan in accordance with the Rehabilitation Loan Agreement between HUD and the borrower.
- 10-3. REQUIRED DOCUMENTATION ON WORK PROGRESS. The LPA must maintain a case history in each loan file. The LPA must record each inspection, each significant personal or telephone contact with the borrower and contractor, and each significant action by the LPA with regard to the case. Copies of all correspondence, documents and memoranda relative to the case must also be attached in the loan folder as part of the permanent case history.
- 10-4. INSPECTIONS REQUIRED PRIOR TO PAYMENT. The LPA is responsible for obtaining required and other necessary inspections on all properties.
- a. General. Inspections must thoroughly and accurately take note of the amount, value and quality of work completed, and verify that completed work adheres to the write-up and LPA standards as established in its Specification Book or Performance Manual. These inspections are for the benefit of HUD as lender, and for the

locality for the purpose of assuring that Local Rehabilitation Standards are met. The borrower is responsible for inspecting the property for his or her own protection. No payments may be made to a contractor unless the borrower agrees that the payment is warranted and signs the Disbursement Voucher (see Paragraph 10-6 for additional information on progress payments), except as required in Paragraph 10-11-c.

- b. Section 312 Loans of \$200,000 or Less: LPA Inspection Responsibility. Inspections must be made by qualified LPA or codes personnel, or by an independent third party meeting the requirements of Paragraph 10-4-d to assure that the construction work is being completed in accordance with the contract and the requirements of the Local Rehabilitation Standards.
- c. Section 312 Loans Exceeding \$200,000: HUD-Approved Inspector. Where the Section 312 loan exceeds \$200,000, the LPA must select a qualified, independent, third party inspector meeting the requirements of Paragraph 10-4-d, who must not be an employee of the LPA or HUD. The LPA's selection must be submitted to the Rehabilitation Management Specialist in the HUD Field Office for approval. Fees for inspections by a third party are an eligible loan cost. The LPA must inspect the work jointly with the HUD-approved inspector. If the HUD-approved inspector and the LPA both determine that the work warrants a payment, the LPA must authorize payment and approve the Disbursement Voucher in accordance with Paragraph 10-6. If they determine that the work does not warrant payment, they must jointly determine what corrective action is required, and the LPA must inform the borrower of the findings. In case of disagreement, the determination of the HUD-approved inspector must prevail, and the LPA must authorize payment or withhold payment until corrective actions are taken, as determined by the HUD-approved inspector. (Of course, the borrower must also authorize payment before payment can be made, except as otherwise required in paragraph 10-11-c.)
- d. Minimum Qualifications for HUD-Approved Inspector. HUD-approved inspectors must have at least three years of experience as a professional construction inspector or as a professional in a related field, such as architecture, engineering, construction supervision, building or housing code inspecting, or other similar field. This experience must have included doing one or more of the following types of work: preparing or interpreting working drawings and specifications, letting contracts, calculating the extent of necessary repairs, estimating their costs, reviewing others' cost estimates, or inspecting properties to identify code violations or to evaluate construction work that has taken place. The HUD-approved inspector must also have experience with properties being rehabilitated that are comparable to the subject property, if such experience is available in the jurisdiction. (For instance, an

inspector for a multifamily residential property should also have experience with the rehabilitation of other multifamily residential properties.)

- e. Compliance with Davis-Bacon. For Section 312 projects that contain twelve or more residential units, Federal Labor Standards must be complied with during the construction phase. HUD Handbook 1344.1, "Federal Labor Standards Compliance in Housing and Community Development Programs," a copy of which may be obtained at your HUD Field Office, provides detailed guidance on requirements for inspections, which should include on-site employee interviews of workers, posting of Davis-Bacon wage determination, and receiving weekly payrolls. As outlined in the Handbook, progress payments may be withheld from contractors for violation of labor standards requirements. See Paragraph 12-3 of this Handbook for additional requirements concerning federal labor standards.
  - f. Timing of Inspections. The LPA must ensure that such inspections are made in a timely manner so as not to hold up payments to the contractor which are merited. Work must be inspected, at a minimum, at the junctures listed below.
    - (1) Prior to the issuance of all payments to the contractor.
    - (2) When the borrower asks the LPA to inspect the work because he or she is dissatisfied with the quality or progress of the contractor's work; questions whether the contractor's performance is adequate; or when the contractor requests an inspection because he or she believes that the borrower is being unreasonable in his or her demands.
    - (3) Prior to the contractor closing-in work, such as the point at which electrical rough-in work is complete and the contractor is ready to install sheetrock wall panels.
- 10-5. PROGRESS PAYMENT HOLDBACK. A holdback of ten percent (10%) of the value of the work completed for each progress payment to the general contractor, the borrower, and subcontractors under self-help loans, is required during construction.
- 10-6. PROGRESS PAYMENTS TO CONSTRUCTION CONTRACTORS. Upon request for a progress payment by a construction contractor, the LPA and the borrower (or his/her representative) must inspect the work and make a determination if it is acceptable and in compliance with the Rehabilitation Contract. Progress payments to the contractor may be made only after this inspection and approval take place. Such authorization must be evidenced by a Disbursement Voucher. (See Exhibit 10-1.)

a. Inspection Procedure. A suggested procedure is as follows:

- (1) The contractor submits a partial payment request (i.e., the contractor's invoice) to the borrower when work is completed in sufficient quantity and quality, in accordance with the Rehabilitation Contract, to receive a progress payment.
- (2) The contractor must list on the partial payment request the work items for which payment is requested. The LPA may request, as necessary, a listing of the specific work items and the contractor's requested payment amount for each. It is recommended that the LPA prohibit payment for partially completed items except in cases where "rough-in" and completion are clear and distinct phases, such as in electrical and plumbing work.
- (3) The LPA (with the HUD-approved inspector where required) must inspect the work to determine whether it is sufficient in quantity and quality under the terms of the Rehabilitation contract to meet the conditions for a draw.
- (4) A Disbursement Voucher (see sample in Exhibit 10-1) must be prepared, and when the borrower is satisfied that a draw is merited under the contract, he or she must sign the Disbursement Voucher.
- (5) If the LPA, and the HUD-approved inspector where required, also determine that a draw payment is warranted, the Disbursement Voucher must be signed by the LPA.
- (6) The LPA (and HUD-approved inspector, where required) may find that the work warranting a draw differs from the amounts claimed by the contractor. In such cases, provided that the difference is not significant, the LPA may authorize payment for the lesser amount than the contractor's invoice, less the required holdback, based on actual performance in relation to the contract. For example, if the contractor requests a payment for work valued at \$6,000 and the LPA determines that the value of the work satisfactorily completed is \$5,500, the LPA may authorize payment for \$5,500, less the required holdback, rather than withhold payment until the exact amount of work specified in the draw schedule is completed. In no event may an LPA authorize payment for work not meeting the quantity or quality requirements of the specifications in the rehabilitation contract, in the judgment of the LPA or HUD-approved inspector and the borrower (except as required by Paragraph 10-11-c).

b. Alternate Procedures. The LPA may prefer for the contractor to

contact the LPA for a joint inspection with the borrower, or the LPA may choose to make inspections more frequently than originally stipulated. Other procedures are acceptable, provided all parties authorize payment for work on the voucher.

- c. Lien Releases or Title Updates. In order to help protect HUD's security interest in the property, the LPA must develop and implement a procedure to protect against losing the Section 312 Loan lien priority to mechanics', materialmen's or other intervening liens, to the extent such protection is reasonably possible in the jurisdiction. Such a procedure may require obtaining releases of liens from the general contractor, or from subcontractors and materialmen as well as the general contractor, or, in the alternative, obtaining updated title evidence, prior to each disbursement. However, in some jurisdictions, no special draw procedures are necessary if HUD's lien is filed before work begins and/or HUD's security instrument meets the requirements for construction loans.

The LPA Counsel must consult with the HUD Field Office Counsel to obtain information on the procedures required in the jurisdiction, and the procedures developed by the LPA must be approved by the HUD Field Office Counsel.

The LPA must implement any such procedures prior to requesting each drawdown of Section 312 funds, and should retain in its files the required documentation, such as the release(s) of liens or the updated title evidence.

- d. NO PAYMENT MAY BE MADE FOR WORK WHICH DOES NOT MEET THE STANDARDS OF THIS PARAGRAPH 10-6, NOR MAY DISBURSEMENT VOUCHERS BE AUTHORIZED IN ANTICIPATION OF SATISFACTORY COMPLETION OF WORK COVERED BY THE VOUCHER.
  - e. Frequency of Progress Payments. The LPA must establish a progress payment policy which permits payment schedules to include sufficient draws so that small contractors with limited capital can participate in the Section 312 Program, but precludes overly frequent processing of Disbursement Vouchers.
- 10-7. CHANGES IN THE SCOPE OF WORK. No changes may be made in the work write-up, as incorporated in the Rehabilitation Contract, without an authorized Change Order signed by the borrower and the contractor and authorized in writing by the LPA. Exhibit 10-2 is a guideform LPA's may use for Change Orders. Work to be covered by the Change Order must not begin until the Change Order has been signed by both parties and by the LPA to signify approval. Authorization from the Rehabilitation Management Specialist in the HUD Field Office is also required on loans

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exceeding \$200,000. A charge order must not delay the start of construction beyond the requirements detailed in paragraph 10-2-c.

In addition, if the change order would extend construction beyond the AED, the requirements for extending the AED described in paragraph 9-2-a-(2) must be followed. The cost impact on the contract must be considered and must also be dealt with.

- a. Definition of Change Order. A Change Order must describe precisely any modifications to the scope of work and any changes in the contract price. A modification might be relatively minor, such as installing a drop ceiling instead of a sheetrock ceiling at the same cost, or the change may be major, for example, rebuilding a masonry wall that was originally intended to be "pointed up". The scope of work of the Change Order must be prepared according to the standards of an acceptable work write-up (see Chapter 6). It must include the contractor's cost for the new work, and for the deleted work, if any. These cost changes must be verified as reasonable by the LPA.
- b. Covering Additional Cost for Charges, if Any. The cost of changes in the scope of work can be covered by deleting work that is not required (e.g., general property improvements (GPI's) or work to correct incipient violations), by using the contingency reserve, by having the borrower provide additional funds, or by having the contractor absorb the costs. These options are described below.
  - (1) Deletions of Work Included in Original Write-Up. GPI's and corrections of incipient violations included in the original work write-up may be deleted to offset the cost of unanticipated, but essential new work. If this method is selected, the Change Order must indicate the value of the work deleted in comparison to the value of the work added. The value of work deleted must equal or exceed the value of work added, or other funds must be available to make up the difference in accordance with Paragraphs 10-7-b-(2) to 10-7-b-(4). Work to correct deficiencies to local rehabilitation standards or to comply with other Federal requirements may not be deleted to offset the cost of the new work. However, such work may be modified, if a less costly but acceptable method of completing it is available, to free funds to pay for new work.
  - (2) Use of Contingency Reserve. The contingency reserve, if any, may be used to pay for additional work included in a Change Order.
  - (3) Borrower Provides Additional Funds. If the borrower must provide or secure additional funds to cover the work included in the Change Order, such work must not begin until the funds have been deposited in a separate escrow account with the

rehabilitation under a legally binding commitment from a financial institution or the LPA. These funds must be used in accordance with the requirements governing supplemental financing in Paragraphs 7-5-d-(3) and 9-3-i of this Handbook.

- (4) Contractor Absorbs Additional Cost. Rehabilitation construction work has many unknowns, and contractors build into their price a reserve to cover minor unforeseen work items. In such cases the contractor might be expected to absorb the extra cost. This option should be employed with discretion, to cover minor changes only, where the contractor may reasonably be expected to absorb the cost. The LPA should discourage the borrower from pushing the contractor to absorb an unreasonable amount of unanticipated or extra items, since this could give the contractor grounds to abandon the job, and could lead to the need for an extension of the AED, or even a default on the loan.

- c. See Paragraph 11-9 for requirements concerning cost overruns where additional funds cannot be obtained by one of the methods described in Paragraph 10-7-b above.

10-8. FINAL PAYMENT. The final payment, including the holdback amount, may be made to the contractor after all of the following have occurred:

- a. The LPA and the contractor have signed a Certification of Final Inspection and Request for Final Payment (see Exhibit 10-3 for a Guideform) indicating that the construction work has been satisfactorily completed in accordance with the construction contract;
- b. The contractor has given the LPA all the original warranties and guarantees.

The Certification of Final Inspection and Request for Final Payment (see Exhibit 10-3 for a Guideform) must be submitted to the Master Servicer, and the final Disbursement Voucher (see Exhibit 10-1) must be submitted to the Cash Management Contractor like all other disbursement requests. The final release of liens, or other evidence necessary to protect the property from mechanics' or materialmen's liens in the jurisdiction (see Paragraph 10-6-c), must be presented to the LPA before the final payment, including the holdback amount, is made to the contractor.

10-9. REQUIRED ACTION IF WORK IS INCOMPLETE OR UNSATISFACTORY FOR ANY REASON

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The LPA should promptly notify the borrower if the LPA determines,

such as by an inspection of the property, that work is incomplete or unsatisfactory or otherwise not in accordance with the contract. At that time, the borrower should be advised to have the contractor initiate corrective action. PAYMENT MUST NOT BE AUTHORIZED FOR UNSATISFACTORY ITEMS UNTIL THE CONTRACTOR HAS SATISFACTORILY COMPLETED THE NECESSARY CORRECTIVE ACTION. FURTHERMORE, THE BORROWER MUST NOT BE COERCED IN ANY WAY TO APPROVE WORK WHICH IS NOT IN ACCORDANCE WITH THE TERMS OF THE CONTRACT.

10-10. WARRANTIES AND GUARANTEES. The contractor must guarantee all work, materials and workmanship for a minimum of one year from the date of final inspection and approval. Where the contract specifies a warranty period for a particular item of more than one year, the general contractor must warrant the item for the period specified, regardless of whether the work was performed by the general contractor or by a subcontractor. The general contractor must take responsibility for ensuring that the warranty is honored. All requests for warranty repairs should be made in writing by the borrower to the contractor.

10-11. COMPLAINTS AND DISPUTES.

- a. General. The borrower is responsible for resolving any construction and post-construction complaints with the contractor. But rehabilitation construction is a difficult process and minor disagreements are likely to arise. The LPA should assist in getting the borrower and contractor to work together to resolve any differences that arise.
- b. Informal Mediation. When the borrower and contractor have made good faith efforts to resolve their differences without success, the LPA may be called upon to mediate informally. In such cases, the LPA must not assume, as a policy, that either borrowers or contractors are generally "right," but must review all of the facts of each case carefully. The LPA must also establish a formal mechanism for resolving contractor/borrower disputes, as described in Paragraph 10-11-c of this Handbook, where it is unable to assist in the resolution of problems.
- c. Formal Dispute Resolution. If feasible in the jurisdiction, the LPA must establish a legally enforceable method, short of litigation, for resolving disputes that cannot be resolved informally. The dispute resolution mechanism must provide for prompt resolution of problems in order to avoid costly litigation and unnecessary delays in completing construction. The rehabilitation contract should provide for such mechanism (see Paragraph 6-6 for additional information on the rehabilitation contract). Binding arbitration, such as that available through the

as an arbitrator in such matters. The LPA must abide by the findings of the dispute resolution mechanism. The LPA must withhold the balance of the loan in accordance with the Rehabilitation Loan Agreement and refer the case to the Master Servicer for possible foreclosure when, in the case of an unresolved dispute between the contractor and owner,

- (1) the borrower will not submit the dispute to the formal resolution mechanism, or the borrower will not submit the dispute to litigation, and
- (2) the LPA inspection indicates that the work in dispute was done in accordance with the Rehabilitation Contract.

If a finding of a formal dispute resolution mechanism finds that the contractor must be paid, and if the borrower refuses to give his or her approval, the LPA must authorize the disbursement and process for payment without the borrower's signature, noting the reasons for doing so on the Disbursement Voucher and in the LPA's files.

10-12. PROCEDURES IF THE OWNER DECLARES THE CONTRACTOR IN DEFAULT. In cases of contractor default, when the LPA is reasonably certain that the borrower has properly exercised his or her legal rights and responsibilities under the terms of the Rehabilitation Contract, the borrower, with assistance of the LPA if requested, must secure the services of a new contractor to complete the work, pursuant to the requirements of Chapter 6. A new Rehabilitation Contract must be prepared and executed. All actions by the LPA in this regard must be taken in conjunction with LPA counsel, and in accordance with local law. The new contract, and all disbursements thereunder, must meet all requirements of this Handbook.

10-13. COMPLETION OF JOBS WHERE FUNDS ARE INSUFFICIENT BECAUSE OF CONTRACTOR DEFAULT, FAILURE OF THE CONTRACTOR TO HONOR THE WARRANTY, AND THE LIKE.

In some cases where the contractor defaults or refuses to honor the warranty, funds remaining in the rehabilitation escrow account may be insufficient to complete work.

- a. Borrower and LPA Responsibilities. In each case of contractor default, the LPA must carefully assess the particular situation. If efforts to resolve the matter through the contractual dispute resolution mechanism fail, the borrower is responsible to provide the funds needed for corrective action and to take legal action against the contractor to recover the costs and/or to compel the

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contractor to complete the work. The LPA is not obligated to take action against the contractor on the borrower's behalf but it may choose to do so. Additional rehabilitation funds may be

secured from other public or private loan or grant funds, if eligible, or in accordance with the procedures detailed in Paragraph 11-9 of this Handbook, but the LPA is not legally obligated to provide such funds, except in the rare case where a court has ordered it to do so.

- b. Rehabilitation Reserve Fund. LPA's may establish a rehabilitation reserve fund with local funds to deal with such problems on a last resort basis. If such a fund is established, it is suggested that contractors whose work is completed or corrected with funds from the rehabilitation reserve should be prohibited from further work in the program until reinstatement is justified. The LPA might choose to take legal action against contractors to recover these funds and/or to recommend to HUD that the contractor be included on the HUD debarred list. In the meantime, however, the work would be completed and/or corrected, the borrower would be made whole, and construction-related problems of delinquency and/or default would be avoided. The overall cost of a rehabilitation reserve fund to the LPA on an annual basis would probably be small, provided the program is well-administered.
  
- c. Changing the Amortization Effective Date. The AED may be extended, but only if the requirements of Paragraph 9-2-a-(2)-(b) are met. However, in these cases of contractor default, HUD will consider reasonable extensions of the AED beyond the time limits in such paragraph if:
  - (1) truly beyond the control of the borrower,
  - (2) fully justified by the facts, and
  - (3) it appears likely that the borrower will be able to secure a new contractor and have sufficient funds to complete the project.

10-14. REFERRAL TO HUD DEBARRED LIST. As noted in Chapter 6, HUD maintains a list of contractors who are debarred, suspended, temporarily denied participation and who are voluntarily excluded. The LPA must submit the names of contractors who have performed unsatisfactorily to the HUD Area Rehabilitation Management Specialist for possible inclusion on the list.