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CHAPTER 4  
PROBLEMS BEFORE FINAL CLOSING

4-1. GENERAL.

- A. Additional Attention must be given to projects that are experiencing difficulties that may lead to default before reaching final closing. Diagnose problems and take immediate measures during critical periods of project construction to avoid foreclosure or assignment, and to avoid serious hardship to mortgagors, contractors and mortgagees.
- B. Prompt Action must be taken to correct problems as they arise. Where requested relief cannot be granted for statutory, regulatory or administrative reasons, however, a prompt and final disapproval must be given.

4-2. PROBLEMS LEADING TO DEFAULT include:

- A. Construction Problems due to:
  - 1. Work stoppage,
  - 2. Contractor abandons job,
  - 3. A change in the contractor, owner or architect during construction,
  - 4. Construction defects untreated for 30 days, and
  - 5. Extended periods of bad weather, strikes, etc.
- B. Financing Problems due to:
  - 1. Contractor's inability to complete because of under financing.
  - 2. Overruns in carrying charges due to circumstances beyond the contractor's and mortgagor's control.
  - 3. Overruns in construction hard costs caused by:
    - a. Mandatory changes,
    - b. Voluntary changes, and
    - c. Price escalation.

(4-2) C. Inadequate Income due to:

1. Underestimated operating expenses,
2. Overestimated rents and long-term occupancy levels,  
and
3. Inadequate or lack of operating deficit.

4-3. WORK STOPPAGES, CONSTRUCTION DEFECTS, ETC. Report to the Office of Insured Multifamily Housing Development, HMI, all projects that experience serious defects or other serious construction related problems that may lead to delayed completion, foreclosure or assignment of the project; a work stoppage extending 20 days; and latent defects that may lead to foreclosure or assignment.

A. Information Sources.

1. The HUD representative must report delays and serious construction problems detected during project monitoring (see paragraph 1-3.B.).
2. The Chief Architect must advise you of any reported: serious construction problems, critical deficiencies in the architect's performance, slow and/or nonpayment of the contractor or by the contractor to subcontractors, suppliers, etc., and other conditions that require your assistance to resolve (see paragraph 1-3.C.3.).
3. The Chief, Mortgage Credit, must advise you where the mortgage is out of balance. See paragraph 1-16.B.2.
4. Written and oral inquiries and/or complaints by the various project participants.

B. Identify All Construction Problems that may delay completion or lead to foreclosure assignment.

C. Provide Full Details of the construction related problem in a referral memorandum including at least:

1. A copy of the HUD Representative's Trip Report, Form HUD-5379, identifying the problem,
  2. The HUD Representative's opinion of the cause and recommendation for correction,
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3. Actions taken by the Chief Architect and other Field Office staff, and
  4. Actions taken by the owner, architect, contractor, mortgagee and bonding company, if any.
- D. Reporting. Follow-up reporting to the Director, Office of Multifamily Housing Development, HMI, is not required after the initial report, unless specifically requested.
- 4-4. DEFAULTS DURING CONSTRUCTION. Consider alternative measures that can be offered to avoid foreclosure and hardship to all concerned parties regardless of the cause.
- A. Request Field Counsel to provide legal guidance and participate in meetings to discuss the consequences of default and possible preventive measures.
  - B. Telephone Mortgagee.
    1. Speak to a responsible official and obtain an opinion on the cause of default, methods of cure and probability of cure.
    2. Advise the mortgagee:
      - a. To preserve its rights against the surety by giving prompt oral and written notification of the contractor's lack of performance or default, and by demanding performance under the contract of surety (see paragraph C. below), and
      - b. To consult with its attorney and to secure HUD approval before entering into any formal or informal agreement with the surety.
  - C. Notification of Surety. Mortgagee must send a notice to the bonding company with a copy to the general contractor for all conditions affecting the bonding company's interests. The notice should be sent to the bonding company's principal office, and its regional or branch office, attention: Claims Department.
    1. Conditions requiring notification, include:
      - a. A sustained work stoppage,
      - b. Nonpayment of subcontractors, suppliers,

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- (4-4)           c. Failure to maintain satisfactory progress.
2. Conditions that require obtaining surety's approval in advance include:
- a. Approving a change order or aggregate of change orders that exceed 10 percent of the contract price, and
- b. Extension of the bond by surety where there is a compelling reason why the contractor cannot remedy a latent defect before the bond's expiration date.
3. The mortgagor is responsible for requesting surety's performance, the mortgagee must act to protect its and HUD's interests, and HUD must take the final action to protect its interests under conditions in paragraph 1. above.
- D. Advise the Mortgagor of the contractor's violation, and/or lack of performance by the architect or mortgagor, and give 30 days for correction.
- E. Assess The Situation by considering:
1. Percentage of construction complete,
2. Occupancy (including current estimates of income, expenses and occupancy projections),
3. Type of assurance of completion (personal guarantees, bonds, cash escrow),
4. Status of escrow deposits,
5. Undrawn amount of letters of credit (including working capital), and
6. Any other pertinent information.
- F. Hold Staff Meeting to assess available options and prepare a position to present to interested parties. The staff meeting should include the Field Office Manager, Field Counsel, DHD, Section Chiefs, and if the project is occupied, the Director of Housing Management.

1. Regional and/or Headquarters staff may also be present as appropriate.

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2. Separate meetings by staff with one or more of the non-HUD parties may be helpful before holding a general meeting with all interested parties.
- G. Convene a General Meeting of all interested parties with either a direct or indirect interest in the project to explain the consequences of default. Hold such a meeting even where there is no possibility of HUD granting a mortgage increase or other form of relief.
1. Emphasize that all non-HUD participants must make a meaningful contribution before HUD will assume any additional risk. Such contributions include:
    - a. Infusion of new capital through adding partners, syndication or other investments, and/or
    - b. Concessions by the mortgagee to avoid a loss (e.g., deferral or forgiveness of interest, taking a partial assignment of the partnership interest, etc.).
  2. State firmly and unequivocally that the non-HUD parties must work out the remedy if the default is to be cured.
  3. Clarify that unless a written firm proposal for a workout is developed, assignment or foreclosure of the mortgage will be the consequence.
  4. Address the remedies covered in paragraph 4-5 below, as appropriate.
- H. Extension of Mortgagee's Election Period should not be granted where a workout proposal is not developed. Thirty days should be the maximum extension in most cases.

4-5. REMEDIES TO AVOID/CURE DEFAULTS.

- A. Call on the Bonding Company to perform, where applicable.

1. Request Field Counsel to communicate with surety where it fails to perform to terms of the bond, and

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- (4-5) 2. Where surety refuses to honor its obligations after communications by Field Counsel, request the Department of Treasury to initiate procedures for removal of the surety from the Treasury Circular 570. List the surety, contractor, and project; describe the particulars, including nature of the problem, length of delays and actions taken by mortgagor, mortgagee and HUD to secure surety's performance; and attach a copy of the bond(s).  
Mail to:  

U.S. Department of Treasury  
Surety Bond Branch  
Financial Management Service  
Washington, D.C. 20227
  3. Distribute copies of the letter to the Washington Docket, Field Office Docket and Director, Office of Insured Multifamily Housing Development, HMI.
- B. Mortgagee or Title Company Control Payments through issuance of two- or three-party checks to assure that disbursed mortgage proceeds are applied for the intended purpose and not diverted to other uses.
1. All money drawn for construction must actually be paid to subcontractors, suppliers, and workers on the job.
  2. Money drawn for specified purposes, e.g., architect's fees, insurance premiums, taxes, etc., must not be diverted to other uses.
- C. Transfer Construction Funds To Soft Cost Expenses, i.e., keep the mortgage in balance (see paragraphs 1-16.B.2. and 1-16.C.). The liquidated damages clause in the construction contract provides a source of funds for overruns in interest, taxes, MIP and insurance (soft costs) that are due to construction delays which are the general contractor's fault.
1. Authorize The Transfer of Funds from the construction contract for payment of soft cost overruns, where it becomes apparent that the scheduled date for completion cannot be met due to

the fault of the contractor. The amount of transferred funds must be reflected on subsequent Forms HUD-92448, as a decrease to item 7, Sum of Cost Breakdown Items Plus Inventories of Materials.

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- a. The transfer of funds will get the attention of the contractor, surety (if any), mortgagor and mortgagee, as well as address any financial necessity.
  - b. Notify the contractor, surety (if any), mortgagor and mortgagee by certified mail of the amount and the reason for the transfer.
  - c. Require written acknowledgement of the notification from the mortgagee and surety, if any.
2. Computation For Funds Transfer from the construction budget. When the amount originally allocated to interest on Form HUD-92451, Financial Record of Mortgage Loan Transaction is exhausted or near exhaustion, request the architect and HUD representative to estimate the earliest date of construction completion. Use this date to:
- a. Set an assumed completion date.
  - b. Compute the minimum liquidated damages for the period between the completion date specified in the construction contract, as adjusted by approved change orders, and the assumed completion date.
  - c. Transfer the computed amount from Column J, Construction, to Column G, Carrying Charges and Financing, on Form HUD-92451.
    - 1) Allocate full amount to interest, initially.
    - 2) Only use funds for MIP, taxes and insurance after funds for these line items, and AMPO or the working capital escrow have been exhausted.
- D. Use of Contractor's Holdback, subject to provisions of paragraph B. above. See paragraph 1-27.D.

- E. Infusion of New Money. See paragraph 4-4.G.1.
- F. Release Assurance of Completion Cash Escrow where used in place of a performance and completion bond for the construction contract.

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- (4-5) 1. The Field Office Manager may authorize such release, where:
    - a. The project is nearly complete,
    - b. Project completion and final closing may not be attainable with the remaining mortgage proceeds alone or in combination with the mortgagor's other available assets, and
    - c. Release of the funds will offer an excellent chance for project completion and final closing with clear title.
  - 2. The entire escrow may be released under such circumstances except for 2-1/2 percent of the contract, which amount is needed to fund the latent defects escrow, subject to:
    - a. The mortgagee must take steps to assure that all required payments by the contractor have been made or will be met to preclude uncovered liens, and
    - b. Disbursement of such funds and mortgagor's additional contributions must be under strict control of the mortgagee or a title company.
  - 3. Distribute the Field Office Manager's written authorization for release of the funds as follows: original to the Washington Docket with copies to the Field Office Docket, Closing Attorney, and Mortgage Credit Control File.
- G. Deferral of Principal Payments where the project is complete and ready for occupancy but cannot go to final closing. See paragraph 1-31.
  - H. Mortgage Increase may be provided as discussed in paragraphs 1-29 and 1-30, where economically feasible. Where the contractor is changed because the original

contractor becomes bankrupt, abandons the job, or the contract is terminated due to inadequate contractor performance, any mortgage increase must also be processed in accordance with the following:

1. Reprocess the Project. See paragraph 1-30.A.3.
  - a. Use rents, expenses, and occupancy ratios current as of the date of reprocessing.

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  - b. Take into account the new builder's cost to complete, amounts expended to date, and any increase in carrying charges, financing, etc., due to increased mortgage amount and/or extra construction time over the original estimate.
2. Mortgage Increase Conditions.
  - a. The mortgagor provides any required front money.
  - b. Any recovery from the original contractor or surety must be applied first to reduction of the mortgage on a mandatory basis,
  - c. The balance of the net recovery after legal expense, if any, may be used to indemnify the mortgagor, mortgagee, and others, and
  - d. A legal document providing for paragraphs b. and c. above must be included as a rider to the Regulatory Agreement and Mortgagee's Certificate at final closing, where such recovery has not been made before and considered in the cost certification.
- I. Immediate Rent Increase where rental assistance funds are available; if the project is occupied; and the market supports higher rents.
- J. Reanalyze the Cost Certification for inclusion of all allowable costs where final closing has not occurred.
- K. Working Capital Deposit Balance in accordance with paragraph 1-25.D.
- L. A Section 223(d) Operating Loss Loan where eligible.

- 4-6. DEFAULT REPORT BEFORE FINAL CLOSING, FORM HUD-58047.  
Report monthly on the default and describe the plan for curing it.
- A. If Default Cannot be Promptly Cured, provide a current estimate of income, expenses and occupancy projections.
1. Director, Office of Insured Multifamily Housing Development, HMI, and Regional Director of Housing within two weeks of default. Regional Office comments are solicited by the Director, Office of

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- (4-6) Insured Multifamily Housing Development, HMI, and will be considered if received within reasonable time.
2. Field Office Housing Management Division Director for use with the Multifamily Default Status Report, Form HUD-92426.
- 4-7. DECISION TO FORECLOSE where the contractor becomes bankrupt, abandons the job, or the contractor is terminated due to inadequate contractor performance. Encourage the mortgagee to consider foreclosure and tender of the unfinished property to HUD, where the Field Office Manager agrees in writing that it would be advantageous to the insurance fund, e.g., instances where interruption of construction occurs at an early stage and market and/or economic conditions have worsened to preclude attaining project viability. Consider surety's position in reaching this determination.
- A. Mortgagee Tenders Unfinished Property. Where the Field Office Manager agrees in writing that accepting conveyance of such unfinished property would be more advantage to the insurance fund than pursuing project completion:
1. Promptly Convey the decision to all interested parties.
2. Request Field Counsel to maintain close communication with the mortgagee's and mortgagor's counsel and seek advice from the Office of General Counsel as necessary.
- B. Estimate Completion Cost for the unfinished project to support a subsequent damages claim against the surety for damages due to contractor's failure to perform.

C. Document Distribution. Original documents, including the Field Office Manager's authorization to accept the unfinished project, in the Washington Docket with one copy to the Field Office Docket, Field Counsel and Mortgage Credit Control File.

4-8. RECOVERY OF MORTGAGE PROCEEDS. In the event of a mortgage insurance claim before final closing instruct the mortgagee to establish communications with the Chief, Multifamily Claims Branch, HFMMC, regarding the surcharge of insurance benefits. All insurance benefits must be surcharged as follows:

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- (4-8) A. Remaining Cash available to the mortgagor,
- B. Balance of Excess Funds designated for escrow requirements, and
- C. Excess Mortgage Proceeds used to fund construction and/or permanent loan discounts not earned before the claim. See Handbook 4430.1 REV-1, paragraph 1-30.D.
- 4-9. TAX-EXEMPT BOND FUNDED PROJECT DEFAULT before final closing. See Handbook 4430.1 REV-1, paragraphs 1-21. and 1-22., for additional information and riders included in the Note and Mortgagee's Certificate in regards to a default.
- A. Prepayment Lock-out and/or Penalty Override. Consider exercising HUD authority to override mortgagee's prepayment lock-out and/or penalty provisions only where:
1. The project mortgagor has defaulted and HUD has received notice of such default, in accordance with 24 CFR Section 207.256,
  2. HUD determines that the project is experiencing a net income deficiency that is attributable to more than management inadequacy or lack of owner interest, and that the deficiency's magnitude leaves the mortgagor unable to make required debt service payments, pay all project operating expenses and fund all required HUD reserves,
  3. HUD finds that there is a reasonable likelihood that the mortgagor can arrange to refinance the

defaulted loan at a lower interest rate or otherwise reduce the debt service payments through partial prepayment, and

4. HUD determines that refinancing the defaulted loan at a lower rate or partial prepayment is necessary to restore the project to a financially viable condition and to avoid an insurance claim.

B. **Deadline Extension For Filing Claim Intentions.** Mortgagee must request a three-month extension of the election notice filing deadline in the event of a default within the term of the prepayment lock-out and/or penalty. See Handbook 4430.1 REV-1, paragraph 1-21.C.2., and the Mortgagee's Certificate.

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1. Analyze the project's financial condition and assess the feasibility of arranging a successful refinancing.
  2. Recommend that the Field Office Manager grant the 3-month extension or a shorter extension of the election notice filing deadline, based upon positive conclusions reached by the analysis in paragraph 1. above.
  3. Do not consider additional extensions of the election notice filing deadline, unless specifically requested by the mortgagee.

4-10. GRANT/LOAN PROJECT WITH A PRO RATA DISBURSEMENT AGREEMENT that defaults before completion of construction (see paragraph 1-26.C.). The governmental entity must disburse the remaining funds where the request for funds remains in the same ratio as previously authorized.