
CHAPTER 1. GENERAL CHARACTERISTICS

- 1-1. PROGRAMS. Projects which are intended to be purchased by a management type cooperative can be constructed by an Investor mortgagor entity under both Section 213 and Section 221(d)(3) Market Interest Rate. The mortgagor entity can be a partnership, a corporation or it could be an individual.
- 1-2. INCORPORATED BY REFERENCE. References (1) and (2) of the Foreword are incorporated by reference with respect to the organization of the purchasing cooperative.
- 1-3. PROGRAM DIFFERENCES BETWEEN SECTION 213 AND SECTION 221(d)(3) MARKET INTEREST RATE. The principal difference in the programs is in the maximum insurable loan of the purchasing cooperative * (which is 100% of replacement cost in Section 221 and 98% in * Section 213) and in the "per unit" limits. See Reference (1) of the Foreword.
- 1-4. PROCEDURAL DIFFERENCES BETWEEN SECTION 213 AND SECTION 221(d)(3) MARKET INTEREST RATE. Except for the following, the two programs are procedurally the same:
- a. In Section 221(d)(3) Market Interest Rate cases initiated on an Investor-Sponsor basis:
- (1) The Investor-Sponsor entity is organized with requirements similar to a limited distribution mortgagor insofar as any project operational income is concerned;
 - (2) An escrow, equal to the difference between the maximum mortgage amount available to the cooperative and the lesser amount of mortgage funds available to the investor-sponsor, will be held by the mortgagee and will not be paid to the investor-sponsor unless the project is converted to a cooperative form of operation within two years from the date of completion (if the conversion does not materialize the escrow will be applied against the mortgage or in such other manner as the Assistant Secretary-Commissioner may direct). The amount of mortgage funds available to the investor-sponsor will be the lesser of:
 - (a) 90% of the estimated replacement cost of the project as a cooperative (separate replacement cost as a rental project will not be made), and

- (b) An amount which can be supported by 90% of the net income as a rental project (from separate Form 2264).
 - (3) The consideration for the transfer to a cooperative mortgagor shall not exceed the Investor's cost (including fee) as approved by the Assistant Secretary-Commissioner.
 - b. In order that the project may be successfully operated on a rental basis to serve the intended income groups should the sale to a cooperative fail to materialize, the amount of the escrow described in the preceding paragraph will be increased, if necessary, to equal the amount by which the mortgage would have been reduced by the debt service criterion applicable to a limited dividend mortgagor under Section 221(d)(3). In each such transactions there are two mortgagor entities involved, the selling investor-sponsor entity and the purchasing management type cooperative corporation, each of which is subject to different requirements.
- 1-5. EXPLANATION OF THE INVESTOR-SPONSOR PROGRAM UNDER SECTION 213
- a. This program is authorized under Section 213 of the National Housing Act as amended. It contemplates an investor-sponsor willing to take the initiative in assembling land, developing plans and providing risk capital. Upon completion of HUD-FHA processing, construction is permitted to proceed before the start of the sales program.
 - b. The investor-sponsor must certify an intention to sell to a management-type cooperative corporation within a period of two years after completion. If the sale is successfully completed, the project becomes an FHA-insured, management-type cooperative operated under Section 213, and the investor-sponsor receives the full amount of the sales price equal to the HUD-FHA Estimated Replacement Cost but not in excess of certified cost. If the project is built but is not successfully sold to a cooperative group, the investor-sponsor continues to own it subject to regulations similar to those for a rental project under Section 207, provided reasonable efforts have been made to sell the project to a cooperative group.

(1-5) c. Basic Financial Arrangements - Investor Mortgagor

- (1) A HUD-FHA commitment provides the investor-sponsor with mortgage insurance on a mortgage equal to 90% of project costs.
- (2) During construction, this commitment may be used to secure temporary construction financing subject to approval of the work by HUD-FHA and the mortgagee. HUD-FHA will insure monthly advances on the mortgage in accordance with an approved trade-payment breakdown and the provisions of the building loan agreement.
- (3) The construction financing will be covered by a HUD-insured mortgage loan equal to 90% of the project cost. HUD-FHA endorses the mortgage as being insured by it prior to the commencement of construction. The monthly advances made during construction are insured by HUD-FHA. (There are assurances of completion because the contractor furnishes a corporate surety bond which guarantees performance of the contract and completion of the job; there is a 10% holdback on advances until completion.)
- (4) Upon completion of the physical improvements and prior to final endorsement, the investor-sponsor mortgagor must certify actual cost. This actual cost is then added to the Secretary's estimate of the fair market value of the land included in the mortgage security. If the permanent mortgage available to the investor-sponsor exceeds 90% of this total cost amount, the mortgage will be reduced to equal 90% of certified cost as approved by HUD-FHA. HUD-FHA will then endorse for insurance the permanent mortgage on the completed project.
- (5) The mortgage insurance by HUD-FHA and the permanent financing commitment on the investor-sponsor mortgage provide full support and security for the construction financing. Even if the cooperative does not complete its purchase under its contract, the mortgage of the investor-sponsor will be finally endorsed by HUD-FHA and operated as a rental, so that funds are assured to retire the construction loan.

(1-5) d. Basic Financial Arrangements - Cooperative Mortgagor

- * (1) A HUD-FHA commitment provides the cooperative corporation with mortgage insurance on a mortgage equal to 98% of the project cost. *
- * (2) When the cooperative corporation buys the project, it is provided with a 40-year mortgage equal to 98% of the HUD-FHA estimated replacement cost, or actual cost as certified, if less. The insured permanent mortgage commitment for permanent financing of the cooperative, together with the 2% of purchase price made up from down payments of cooperative members, makes it possible to acquire the project from the Investor-Sponsor. *
- (3) The next steps are to complete all the legal and organizational arrangements for the project. These include: the organization of the investor-sponsor "207 type" corporation by counsel for the investor; the organization of the cooperative "213 type" corporation by counsel for the consumer corporation interested in purchasing the project when completed; an Agreement of Sale between the two corporations; and a Service Contract between the cooperative and a service agency which will take necessary action in organizing the cooperative membership.
- (4) Upon assembly and approval of all required exhibits, including the evidence of permanent financing and the completed plans and specifications, an Initial Closing is then held on the HUD-FHA insured mortgage of the investor-sponsor. At that time, an initial advance is made to reimburse expenditures approved.
- (5) Immediately thereafter, the builder may start construction.
- (6) The solicitation of memberships in the cooperative is started at an appropriate time after construction is under way. The objective is to assemble the membership and required down payments by the time the project is completed.

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- (1-5) (7) The final closing on the mortgage of the investor-sponsor

occurs when construction of the project is completed and approved by HUD-FHA. The investor-sponsor must make a cost certification prior to such closing.

- (8) The investor-sponsor will convey the project to the cooperative corporation when at least 90% of the units have been sold and the cooperative has sufficient funds to complete its down payment. At that time, HUD-FHA endorses the permanent mortgage of the cooperative and the mortgage funds are advanced to provide money to complete the purchase.
- (9) At the initial closing, the investor-sponsor must have a minimum "investment" (as explained below) of:
 - (a) The difference between his mortgage and the total cost of the project; plus
 - (b) A cash working capital deposit equal to 2% of the investor-sponsor mortgage, which is put in an escrow with the mortgagee and is held until the project is completed, subject to certain allocations by the mortgagee.
- (10) Assuming the sponsor already owns the land, and the land is included in the mortgage security, the fair market value for the land, plus the allowance for the builder's profit, should equal the minimum 10% equity required plus any mortgage financing or placement costs over and above the 1-1/2% allowed by HUD-FHA. In such cases, the only new cash required at the initial closing would be the 2% working capital escrow.
- (11) The investor-sponsor mortgagor may issue its deferred, non-negotiable notes in return for cash invested in the corporation or for the land conveyed to it, just as permitted under Section 207.

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- (1-5) (12) During construction the builder receives monthly progress payments under the construction loan based on approved requisitions covering work completed and materials delivered to the site. However, there is a 10% holdback from every payment. This holdback is released upon completion and after cost certification has demonstrated that it is properly due and payable.

In addition, all carrying charges during construction are reimbursable in full provided that the total of such charges do not exceed the amounts estimated by HUD-FHA in the Project Analysis.

- (13) The legal and organizational expenses incurred in the sales and organization program of the cooperative are met by disbursements from the funds deposited in escrow with the mortgagee at the initial closing upon requisitions of the cooperative, or its service agency, in amounts approved by HUD-FHA.
- (14) At the final closing of the mortgage of the investor-sponsor, the HUD-FHA regulations require that the investor-sponsor have a cash investment in the project of at least 2% of cost, as certified by the mortgagor and approved by HUD-FHA. Thus, if the certified cost of the project is sufficiently below the HUD-FHA estimated replacement cost so that no cash investment would otherwise be required above the mortgage, HUD-FHA nevertheless requires that there be a minimum cash investment in the project of 2% of the certified cost. This 2% would include the required amount of working capital which has previously been deposited in escrow to the extent that such working capital is then available and has not previously been spent.

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e. Extent of the Required Cost Certification.

- (1) The primary purpose of cost certification is to see that the mortgage is kept within the statutory percentage allowances permitted by the law. If the total certified cost of the job exceeds the HUD-FHA estimated replacement cost, the mortgage will be insured in the full amount provided by the HUD-FHA insurance commitment. If the certified cost is less than the HUD-FHA estimated replacement cost, the insurable mortgage will be reduced

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- * (1-5) to 90% or 98%, as the case may be, of the certified cost. In addition, the Agreement of Sale must provide that certified cost, as approved by HUD-FHA, is the maximum price at which the project may be sold to a cooperative. *
 - (2) Cost certification by the builder is required whenever there is an identity of interest between the corporation

and its sponsors, on the one hand, and the actual builder on the other. If it can be shown that there is a bona-fide arm's length contractual relationship between the investor-sponsor and the builder of the project, and that the two parties are completely independent of each other, then a lump-sum contract may be negotiated and the builder may not be required to certify his costs. However, the investor-sponsor mortgagor is always required to certify project costs, but to the extent that work is properly covered by lump-sum contracts the certification may include such lump-sum payments.

- (3) Other allowable costs include job overhead expenses and general overhead expenses as defined by HUD-FHA. All reasonable expenses directly related to the job may be included in job overhead, except executive salaries paid to the investor or builder, legal expenses and the like.
- (4) General overhead expenses which are related to the job, but are often impossible to separate from other activities of the builder, may also be included in cost certification, provided that they do not exceed reasonable allowances as determined by HUD-FHA.
- (5) Cost certification may include all of the actual costs incurred for the items listed in the HUD-FHA Project Analysis.
- (6) As to land, the amount listed in the cost certification is not the cost of the land, but HUD-FHA's appraisal of the land as it appears in the project analysis. Likewise, the builder's fee appears in cost certification as a fixed item in the amount set forth in the project analysis. The amount allowed by HUD-FHA for general overhead may also be included as a fixed item.

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- (1-5) (7) As to other project costs, the amounts eligible for cost certification are the actual costs which HUD-FHA determines were reasonably incurred (even though they exceed the amounts set forth in the HUD-FHA Project Analysis) for the following: construction; mortgage placement and financing; legal and organization; and carrying charges. Thus, additional cost of financing, in excess of the 1-1/2% allowed in the HUD-FHA

Estimated Replacement Cost, may be offset and paid with savings in construction or other costs.

- (8) Where the cost of the job exceeds the HUD-FHA estimated replacement cost, the certification of cost will prove to be simple. But the Agreement of Sale must provide that certified cost, as approved by HUD-FHA, is the maximum price at which the project may be sold to a cooperative.

f. Safeguards that the Cooperative Will Actually be Able to Buy.

- (1) Funds to pay the estimated costs of the sales program are included as part of the mortgage of the investor-sponsor and disbursed to the service agency responsible for organizing the cooperative corporation. The Service Contract provides for monthly payments to cover sales costs as the work progresses, with part of the fees to the service agency withheld until successful completion of the sales program. There are also termination provisions and other safeguards in the agreement with the service agency to assure proper performance in building the membership of the cooperative.
- (2) The investor-sponsor also has a stake in the success of the sales program. For, in addition to having his investment continued in the project if the sales program does not succeed, he will be precluded from undertaking another investor-sponsor project if any one in which he participates is not sold to a cooperative during a period of two years following the completion of the project. For this reason, there are provisions in the Agreement of Sale whereby the builder may advance additional funds to help the sales program if needed. Such funds, if advanced and approved by HUD-FHA, will be

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- (1-5) included in the cost certification on the project. As in the case of additional costs of financing, these additional costs of sales may be offset and paid with savings in construction or other costs.

g. Marketability-Investor-Sponsor Type: Congress in enacting the Investor-Sponsor program recognized that the presale of units sometimes presents disadvantages to both the sponsorship and the subscribing public. In Management Type cases,

the contractor must withhold the construction program until the sales have been obtained, and as the sales program continues, early subscribers may drop out. Thus, it may be necessary to sell some of the units more than once. The subscriber may have difficulty visualizing the project from an examination of the plans and specifications. Also in the Management Type he does not know precisely when construction of the project will be commenced.

- (1) While the investor-sponsor type overcomes some of the above objections, it is important to note that, unlike the management type, it does not eliminate the risk of marketability.
- (2) Since investor sponsored projects under Section 213 present the possibility of being dependent on their competitive position in the rental investment market for the two-year marketing period, and perhaps for an indefinite period into the future, investor-sponsor proposals will be considered from two different approaches:
 - (a) As a Rental Project. Processing as a rental project will be based on data from similar rental projects. It will develop rents obtainable, occupancy, expenses and net income to be expected as a rental project. Under Criterion 5 of Form 2264-A, the mortgage amount which can be supported by 90% of the net income with a combination declining annuity mortgage plan, becomes a limitation upon the amount of mortgage available to the investor-sponsor mortgagor.
 - (b) As a Cooperative. Processing as a cooperative is the same as for management type projects.

1-6. GENERAL REQUIREMENTS.

- a. Cooperative Upon Purchase from Investor-Sponsor or Nonprofit Mortgagor. It is required that cooperative subscribers for at least 98% of the units must be obtained and approved by HUD-FHA prior to endorsement of the refinancing mortgage. *
- b. Employment of Independent Attorney; Independent Architect; and Management Agent. As a safeguard to the subscribers, the acquiring cooperative mortgagor corporation is required,

prior to initial endorsement in cases of insurance of advances, and prior to beginning of construction in any case, to obtain the services of:

- (1) An attorney, independent of the builder, who will represent the mortgagor corporation from its inception through final endorsement.
- (2) A licensed architect or engineer acting under a contract with the mortgagor corporation to provide supervisory service during the construction period.
- (3) A management agent, satisfactory to HUD-FHA, who will manage the property for the cooperative corporation.

NOTE: For further information see Sponsorship Section in Reference (1) of the Foreword.

- c. Permanent Financing. No investor-sponsor credit instrument should be endorsed until the Director has received written assurance of permanent financing of the mortgage to be later executed by the purchasing cooperative.
- d. Mortgage Amortization Requirements. This type of project contemplates the existence of two mortgages--the investor-sponsor mortgage to remain in effect so long as the investor-sponsor has title to the project, and a subsequent refinancing mortgage to be executed by the cooperative purchaser. It is equally acceptable for the purchasing cooperative to execute a supplemental mortgage in an amount representing the difference between the total mortgage amount for which it is eligible and the balance due on the investor-sponsor mortgage and then consolidating the investor-sponsor mortgage and the supplemental mortgage under an arrangement that will incorporate into one instrument the mortgage indebtedness of the purchasing cooperative.

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- (1-6) e. Effect of Failure to Sell the Cooperative. The investor-sponsor is required to use his best efforts to sell the project to a cooperative. If his efforts are unsuccessful, the project will be operated on a rental basis under limitations similar to those applicable to Section 207 projects.
 - f. Cooperative Agency Agreements. In cases where the cooperative corporation is represented by a cooperative sponsoring organization, an agency agreement is used to spell out the relationship between the cooperative and such organization.

No model form has been issued on this subject due to the variations in services, charges, and methods of payments involved. The form used is subject to clearance by the Field Office Director and no Washington submission is required in this connection, except that in cases where the HUD-FHA is being requested to certify the cooperative to GNMA as a "consumer cooperative" the proposed agreement must be submitted to the Office of Underwriting Standards for approval. (See References (1) and (2) of the Foreword.)

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- g. If the Investor-Sponsor is Involved in the Selling Effort, neither he nor any entity with which he is connected should be permitted a fee for such services, but he may properly be reimbursed for out-of-pocket expenses.
- h. The Parties should be Specifically Advised that regardless of the type of sales agent, both the agent and employees thereof who are responsible for handling down payment monies should be covered by an adequate fidelity bond, satisfactory to the cooperative's attorney, protecting the subscriber's deposits.
- i. It is the Responsibility of the Field Office to determine the acceptability of the sales agent in each case at the time the acceptability of the sponsorship is being determined.