



The City of Santa Ana, CA

Neighborhood Stabilization Program 2



Issue Date: June 17, 2013

Audit Report Number: 2013-LA-1006

TO: William Vasquez, Director, HUD Los Angeles Office of Community Planning and Development, 9DD

///SIGNED///

FROM: Tanya E. Schulze, Regional Inspector General for Audit, Los Angeles Region 9, 9DGA

SUBJECT: The City of Santa Ana, CA, Did Not Administer Neighborhood Stabilization Program 2 Funds in Accordance With HUD Rules and Requirements

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of the City of Santa Ana's Neighborhood Stabilization Program 2.

HUD Handbook 2000.06, REV-4, sets specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the audit.

The Inspector General Act, Title 5 United States Code, section 8L, requires that OIG post its publicly available reports on the OIG Web site. Accordingly, this report will be posted at <http://www.hudoig.gov>.

If you have any questions or comments about this report, please do not hesitate to call me at 213-534-2471.



June 17, 2013

The City of Santa Ana, CA, Did Not Administer Neighborhood Stabilization Program 2 Funds in Accordance With HUD Rules and Requirements

Highlights

Audit Report 2013-LA-1006

What We Audited and Why

We audited the City of Santa Ana's Neighborhood Stabilization Program 2 (NSP2). We initiated the audit as part of the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) fiscal year 2012-2013 annual audit plan. Our objective was to determine whether the City administered its program funds in accordance with applicable HUD rules and requirements. Specifically, our focus was to determine whether the City administered its program to ensure that funds were used for eligible activities.

What We Recommend

We recommend that the Director of HUD's Los Angeles Office of Community Planning and Development require the City to (1) repay \$669,632 in ineligible costs; (2) establish and implement more effective policies, procedures, and controls for its program; and (3) ensure that all City personnel who review and monitor program activities are trained to identify questioned costs.

What We Found

The City did not administer its program funds to meet the objective of ensuring that funds were used for eligible activities and returning single-family homes to productive use as required under HUD rules and requirements. The City incurred more than \$1 million in costs that was either ineligible or could have been better used to maximize its program. Specifically, the City reimbursed its developer more than \$669,000 in NSP2 funds for ineligible costs and at least \$375,000 for unnecessary bank charges.

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BACKGROUND AND OBJECTIVE

On February 17, 2009, Congress enacted Public Law 111-5, known as the American Recovery and Reinvestment Act of 2009. Title XII of Division A of the Recovery Act provided additional emergency assistance for the redevelopment of abandoned and foreclosed-upon homes as initially authorized under Division B, Title III, of the Housing and Economic Recovery Act of 2008. The U.S. Department of Housing and Urban Development (HUD) implemented the Neighborhood Stabilization Program 2 (NSP2) to stabilize neighborhoods, the viability of which had been and continued to be damaged by the economic effects of foreclosed-upon and abandoned properties. NSP2 references the funds authorized under the Recovery Act. HUD competitively awarded \$1.93 billion in NSP2 funds to 56 grantees, which included States, units of general local government, nonprofits, and a consortium of nonprofit entities.

The City of Santa Ana, CA, was awarded \$10 million in NSP2 funds to be used across targeted areas in 18 census tracts with high rates of abandonment and foreclosure that if left unaltered, would have a debilitating impact on real estate values, crime rates, and neighborhood stability. Initially, the City committed to use the funds to provide downpayment assistance to 10 households and acquire and rehabilitate foreclosed-upon properties, including 60 single-family homes and 30 rental housing units, to go to households at or below 120 percent of the median income. HUD required the City to spend all of its allocated NSP2 funds before February 11, 2013. In July 2011, HUD awarded the City more than \$1.4 million in formula-based NSP3 funds. The City used these funds as a continuation of its activities from NSP1 and NSP2.

On March 1, 2010, the City executed an agreement with ANR Santa Ana, NSP, LLC, as the developer responsible for overseeing the acquisition, rehabilitation, and sale of NSP-funded properties. As a developer for NSP2, ANR Santa Ana, NSP, LLC, will also operate under the name ANR Homes, Inc. The developer had entered into multiple construction agreements with its identity-of-interest entity, ANR Industries, Inc., to be the designated contractor responsible for the rehabilitation work at the properties. Both the developer and contractor are located at the same address and have the same principals. In addition, when we requested a list of employees for the developer, the City provided a list of employees for the contractor indicating that these employees performed the developer duties.

The City administered these programs through the use of a developer to acquire and rehabilitate single-family properties under the programs. While HUD allows this practice, developers are distinctly different from subrecipients because they may earn a developer's fee and are also not held to the same level of procurement, record-keeping, or audit requirements as subrecipients. As a result, it is incumbent on the grantees to structure programs to avoid undue enrichment. For instance, grantees were encouraged to structure assistance to developers that undertook acquisition or rehabilitation as loans rather than grants (see appendix C). The City provided NSP2 funds to the developer in the form of loans used specifically for the acquisition of single-family properties that were rehabilitated and sold to qualified home buyers. These NSP2 loans were partially paid back in the form of program income to the City from the proceeds of the sale of the rehabilitated properties at an average rate of 41 percent of the total funds provided, while

the remaining 59 percent was unrecovered funds classified as NSP2 net investment (see appendix E).

The objective of our audit was to determine whether the City administered its NSP2 funds in accordance with applicable HUD rules and requirements. Specifically, our focus was to determine whether the City administered its program to ensure that funds were used for eligible downpayment assistance, acquisition and rehabilitation, and administrative activities.

RESULTS OF AUDIT

Finding 1: The City Reimbursed Its Developer More Than \$669,000 in NSP2 Funds for Ineligible Costs

The City reimbursed its developer more than \$669,000 in NSP2 funds for ineligible costs incurred during the acquisition and rehabilitation of NSP2 single-family properties that should have been covered by the developer's fee. The problem occurred because the City's senior management analyst was not aware of the NSP regulations and policy guidance on developer's fees when the City approved the developer's reimbursements. As a result, the City incurred more than \$669,000 in ineligible costs that should not have been reimbursed to the developer and could have been used to further maximize its program.

The City Reimbursed Its Developer for Ineligible Costs

The City reimbursed its developer more than \$669,000 in NSP2 funds for ineligible costs incurred during the acquisition and rehabilitation of NSP2 single-family properties that should have been covered by the developer's fee. According to Section 601, Developer Fee, of the agreement between the City and the developer, the developer was paid a developer's fee based on 10 percent of the following total costs for each property: acquisition sales price, rehabilitation costs, actual acquisition and sale closing costs, insurance related to acquisition and rehabilitation, property taxes, and maintenance costs (utility and landscaping). The agreement was silent regarding whether the developer could receive developer's fees along with additional project management expenses and overhead and profit.

According to NSP Policy Alert - Guidance on Allocating Real Estate Development Costs in the Neighborhood Stabilization Program - January 13, 2011, "the purpose of allowing the developer's fee to be included in the cost of a project is to compensate the developer for related overhead expenses and to provide a return on the developer's investment (profit)." HUD's NSP Policy Alert also states that "if a developer's budget called for directly paying a project manager and also a developer fee that would be double-dipping and would not be allowed. Direct costs or indirect costs of a developer related to project management should be paid only through the fee" (see appendix C). However, the City's senior management analyst approved and the City reimbursed the developer \$506,013 in overhead and profit and \$163,619 in management charges associated with the acquisition and rehabilitation of 32 properties (see appendix

D). Therefore, we considered the \$669,632 (\$506,013 + \$163,619) to be ineligible NSP2 costs since they should have been covered by the developer's fee.

Responsible City Officials Were Not Aware of the Requirements

The senior management analyst approved these ineligible costs without being aware that HUD requirements prohibit developers from earning overhead and profit and management charges along with a developer's fees. The City's approval allowed it to reimburse the developer more than \$1 million in developer's fees to cover any overhead and profit and management charges incurred under the program and more than \$669,000 in charges that should have been covered in the developer's fees.

According to the agreement between the City and developer, the developer was paid a developer's fee based on 10 percent of the following total costs for each property: acquisition sales price, rehabilitation costs, actual acquisition and sale closing costs, insurance related to acquisition and rehabilitation, property taxes, and maintenance costs (utility and landscaping). This fee was subject to the developer's providing the City proper documentation evidencing such costs incurred for each property. Among the documentation, was an invoice showing the fee earned for services provided on a property. Once approved, the City would pay the developer the fee at the close of escrow to a qualified home buyer. In this case, the developer received more than \$1 million in developer fees related to the work performed on 32 properties reviewed during this audit.

The developer hired an identity-of-interest contractor to perform rehabilitation work on its properties. The contractor charged overhead and profit for rehabilitation work performed on each of the properties. This overhead and profit were based on a percentage of total rehabilitation cost of the property. In this case, it was an overhead and profit margin of 20 percent of the total rehabilitation costs for each property that totaled more than \$506,000. In addition, the contractor charged more than \$163,000 in management fees that was to cover any costs related to personnel managing the rehabilitation work at each property. Both of these amounts should have been covered by the developer's fee.

The developer's total reimbursement of more than \$1.6 million was part of the more than \$4.8 million (see appendix E), or 34 percent, of the funding it received under the City's program between February 11, 2010, and February 11, 2013. See the table below for the total amount reimbursed to the developer.

Description	Amount reimbursed	Percentage of total NSP2 funds provided to the developer
Developer's fee	\$1,023,473	21 percent
Overhead and profit	\$506,013	10 percent
Management charges	\$163,619	3 percent
Total	\$1,693,105	34 percent

The developer submitted documentation to the City, giving the impression that it had performed all of the work, not the contractor. This documentation did not clearly distinguish whether the developer or the contractor performed the work associated with earning the developer's fees in accordance with rules and regulations. HUD regulations at 24 CFR (Code of Federal Regulations) 570.501(b) state that the recipient is responsible for ensuring that funds are used in accordance with all program requirements. The use of entities such as developers and contractors does not relieve the City of this responsibility. As a grantee, the City was responsible for ensuring that the developer and its identity-of-interest contractors complied with applicable rules and regulations. Without this assurance, the developer received more than \$669,000 in ineligible overhead and profits and management fees that should have been covered by the developer's fees.

Because the developer hired an identity-of-interest contractor, the conflict-of-interest provisions in 24 CFR 570.611 and 85.36 would apply. Paragraph (f)(4) of 24 CFR 85.36 states that the cost plus a percentage of cost method of contracting must not be used, and that was the method used by the developer and contractor.

Conclusion

The City reimbursed \$669,632 in ineligible costs that included overhead, profits, and management charges. We attributed this issue to the City's senior management analyst's not being aware of the NSP regulations and policy guidance on developer's fees when the City approved the developer's reimbursements. As a result, rehabilitation costs were inflated by these costs, the developer received undue enrichment, and the City could have used the funds to further maximize its program.

Recommendations

We recommend that the Director of HUD's Los Angeles Office of Community Planning and Development require the City to

- 1A. Repay, using non-Federal funds, \$669,632 in ineligible costs, which included overhead, profit, and management charges, to the U.S. Treasury.
- 1B. Establish and implement more effective policies, procedures, and controls for its programs to ensure that participating developers do not continue to incur ineligible costs such as overhead, profit, and management charges.
- 1C. Ensure that all City personnel who review and monitor NSP expenses are trained to identify ineligible developer expenses such as those identified during our audit.

RESULTS OF AUDIT

Finding 2: The City Reimbursed Its Developer at Least \$375,000 for Unnecessary Bank Charges

The City reimbursed its developer at least \$375,000 in NSP funds for unnecessary bank charges incurred as part of the acquisition of NSP2 properties. This condition occurred because the City's policies and procedures allowed the developer autonomy in obtaining non-NSP2 funds without City analysis to ensure that associated costs were necessary and reasonable. As a result, the developer incurred unnecessary bank charges using NSP2 funds. The City could have used these funds to maximize the acquisition and rehabilitation of additional properties under its program, thus meeting HUD's objective of returning abandoned and foreclosed-upon homes to productive use.

The Developer Incurred Unnecessary Bank Charges Under the Program

Rather than using the City's NSP2 funds, the developer used private bank loans to rehabilitate properties under the program. In most instances, the developer used these bank loans to pay for part of the purchase price and related soft costs of these properties. As a result, it incurred at least \$375,000 in unnecessary bank interest, loan fees, and other bank-related charges that pertained to the NSP2 properties (see appendix D). If the developer had used the City's allocated NSP2 funds directly, it could have avoided these unnecessary bank expenses.

The developer acquired 33 single-family properties under the program. The total acquisition cost for these 33 properties, not including closing costs, was more than \$7 million (see appendix E). Of this amount, more than \$2.3 million was from private bank loans. This amount covered 32 percent¹ of the acquisition costs for which the developer could have used NSP2 funds to acquire the properties. The developer used the NSP2 properties as collateral to obtain additional loans to rehabilitate the acquired properties. The proceeds from these loans could not be described as the developer's own funds.

According to 2 CFR Part 225, appendix A, to be allowable under Federal awards, costs must be necessary and reasonable for proper and efficient performance and administration of Federal awards (see appendix C). The City's policies and procedures for acquiring and reselling single-family properties did not provide

¹ Total acquisition was \$7,167,168 (\$4,855,034 in NSP2 funds and \$2,312,134 from private loans). The private loan funds covered 32 percent (\$2,312,134/\$7,167,168) of the total acquisition cost.

guidance for analysts to review these outside funding sources to ensure that associated costs were necessary and reasonable. Without these policies and procedures in place, the City may have incurred expenses that could be unnecessary in furthering its NSP activities.

Conclusion

The City reimbursed its developer at least \$375,000 for unnecessary bank charges related to the acquisition of NSP2 properties. The City could have implemented policies and procedures that allowed it to conduct a cost analysis of the developer's non-NSP2 funds and the incurred bank fees to determine whether there were potential cost savings to maximize program funds available to meet the program objectives. By doing so, the City could have used at least \$375,000 in program funds to further its NSP activities. The same issue will continue to occur under NSP3 unless the City considers this action.

Recommendations

We recommend that the Director of HUD's Los Angeles Office of Community Planning and Development require the City to

- 2A. Implement better policies and procedures that would allow the City to conduct a cost analysis of its developer's own financing that could potentially minimize instances of unnecessary expenses such as bank interest, loan fees, and other incurred bank-related charges identified during this audit, while ensuring compliance with applicable HUD rules and requirements. By doing so, the City would ensure that at least \$375,742 in NSP2 funds would be put to better use to further the goals of its program.

SCOPE AND METHODOLOGY

We performed our onsite work at the City's Community Development Agency located at 20 Civic Center Plaza, Santa Ana, CA, between August 2012 and March 2013. Our audit covered the period February 1, 2010, to June 30, 2012, and was expanded to other periods as necessary.

To accomplish our audit objective, we

- Reviewed relevant HUD NSP2 regulations;
- Reviewed the City's NSP2 policies and procedures;
- Reviewed executed NSP2 agreements;
- Reviewed pertinent information from the Disaster Recovery Grant Reporting system;
- Reviewed files and expenditures that pertained to the administration, single-family, and downpayment assistance activities of the City's program;
- Reviewed the acquisition file for the NSP2 multifamily rental housing project; and
- Interviewed key personnel from the City and HUD.

Initially, we selected a nonstatistical sample of 10 transactions, based on dollar amount (highest), covering all four activities from the City's program.

1. Acquisition, rehabilitation, and resale of single-family residences;
2. Administration;
3. Acquisition and rehabilitation of rental housing; and
4. Downpayment assistance

Based on results from the initial review, we proceeded with the audit and selected additional samples to review. Our sample included a review of all properties acquired under the acquisition, rehabilitation, and resale of single-family properties activity during the grant period.

Our overall sample covered a total of nearly \$7.9 million, equal to 83 percent of the total amount of more than \$9.5 million spent by the City. We reviewed all three² NSP2 downpayment assistance (this activity was closed on September 14, 2012) participants. We also reviewed the acquisition of the City's NSP2 rental housing property.

² There were three downpayment assistance participants; however, two of them purchased homes under the acquisition, rehabilitation, and resale of single-family properties activity and were included in the activity's total of 33 homes. We reviewed 32 of the 33 homes during the audit.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

INTERNAL CONTROLS

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined that the following internal controls were relevant to our audit objective:

- Effectiveness and efficiency of program operations – Implementation of policies and procedures to ensure that NSP2 funds are used for eligible purposes.
- Reliability of financial information – Implementation of policies and procedures to reasonably ensure that relevant and reliable information is obtained to adequately support program expenditures.
- Compliance with applicable laws and regulations – Implementation of policies and procedures to ensure that NSP2 activities comply with applicable HUD rules and requirements.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Significant Deficiency

Based on our review, we believe that the following item is a significant deficiency:

- The City did not monitor its program to ensure that funds were used in compliance with HUD rules and requirements (findings 1 and 2).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

Recommendation number	Ineligible 1/	Funds to be put to better use 2/
1A	\$669,632	
2A		\$375,742

- 1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local policies or regulations.
- 2/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified. In this instance, the funds to be put to better use totaled \$375,742 in NSP2 funds used for unnecessary bank charges, which could have been better used to further the goal of the program had the City properly monitored its developer. Implementation of better policies and procedures will help minimize instances of unnecessary expenditures.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

May 23, 2013

Tanya E. Schulze
Regional Inspector General for May 23, 2013

Tanya E. Schulze
Regional Inspector General for Audit
US Department of Housing and Urban Development
Office of the Inspector General
611 W. Sixth Street, Suite 1160
Los Angeles, CA 90017

Dear Ms. Schulze:

Our office is in receipt of the recently completed draft audit report from the Office of the Inspector General's (OIG) for the City of Santa Ana's administration of \$10 million in Neighborhood Stabilization Program 2 (NSP2) funding as part of the American Recovery and Reinvestment Act of 2009. We have reviewed the two audit findings and recommendations and wish to provide a written response that disputes these findings and challenges the methods used by the OIG auditors. Of particular concern to Santa Ana, is the OIG auditor's selective reference to NSP policy guidance published by the US Department of Housing and Urban Development's Office of Community Planning and Development. It appears that the OIG auditors cited only a few NSP Policy Alerts and selected excerpts, resulting in conclusions we find unjustified. We strongly believes that the structure of Santa Ana's NSP2 program will be validated once relevant NSP regulations and policy guidance provided by HUD are properly considered.

During the course of our May 22, 2013 exit conference and now through this letter, Santa Ana is formalizing our response to the OIG's audit of our NSP2 program. We dispute the following findings:

Finding 1: The City of Santa Ana Reimbursed Its Developer More than \$669,000 in NSP2 Funds for Ineligible Costs

BACKGROUND

NSP2 and Community Development Block Grant rules, based on OMB Circulars regarding Uniform Administrative Procedures and Cost Principles, allow fees to be paid to both developers and contractors. Federal regulations and HUD best practices specify that Grantees have a responsibility to gauge the reasonableness of these fees by underwriting the project and evaluating costs, estimating income and expenses and weighing risk and rewards to determine the appropriate fees. In Santa Ana, our records demonstrate that these determinations have been made in a manner consistent with:

Comment 1

federal Appendix A to Part 570 "Guidelines and Objectives for Evaluating Project Costs and Financial requirements IV".

Based on comments made at our exit conference with OIG representatives, it appears that OIG is demanding Santa Ana provide a standard of financial oversight of its Developer that is not required by federal regulations. OIG has further insisted that Santa Ana is responsible to perform oversight of the Contractor hired by our Developer. This insistence is contrary to HUD Los Angeles Community Planning and Development staff's understanding and guidance with respect to applicable federal regulations.

Comment 2

This is not to imply that Santa Ana has not in fact closely monitored ongoing development and construction activities associated with our NSP2 program. On the contrary, our monitoring activities have been well documented by the OIG auditors and after their seven month review, the OIG had no findings regarding Santa Ana's development and construction monitoring. In the draft audit report, the OIG auditors, however, had greater difficulty accepting the business practice of "vertical integration" and the establishment of sole purpose limited liability corporations, which are both elements of Santa Ana's NSP2 program. The OIG auditor's contention that the Developer and the Contractor are a single entity and that as a result, costs incurred are ineligible under NSP2 is simply incorrect. In fact, at the May 22 Exit Conference the OIG agreed that vertical integration wherein the Developer and Contractor are affiliated (and the sharing of employees between those two separate legal entities), is acceptable.

Developer and Contractor roles

The City entered into a contract with the Developer to:

1. Select homes that met the NSP eligibility criteria;
2. Identify the necessary rehabilitation scope;
3. Select and contract with a licensed contractor to undertake the rehabilitation;
4. Obtain the funds necessary to acquire, rehabilitate, maintain and market the home;
5. Manage the rehabilitation process;
6. Undertake marketing efforts to identify qualified home buyers;
7. Evaluate the qualifications of potential home buyers that wish to participate in the program; and
8. Administer the process for selling the home to the selected low and moderate income home buyers.

The Developer obtained a loan for part of the acquisition and all rehabilitation expenses. The Developer then contracted with a Construction Contractor to perform the rehabilitation and received a 10% developer fee as compensation for the above-listed

responsibilities, which was paid at the time the renovated home was sold to qualified purchasers, pursuant to our agreement with the Developer.

The Developer and Construction Contractor are separate legal entities that are substantiated by separate:

- State of California corporate documents
- Articles of Incorporation
- Internal Revenue Service Employer Identification Numbers
- Members of the Corporation
- Income tax returns filed

In addition, the corporate structure is different between the Developer and Contractor. The Developer is a Limited Liability Company (LLC) and the Contractor is a Type S Corporation. Further, only the Contractor has a State issued contractor's license.

During the course of the seven month audit, we have provided information on all our NSP 2 transactions including Contract Invoices and Developer Fee Summaries which documents the developer fee paid to the Developer. We have also provided to the OIG auditors the Notice to Proceed, Construction Contract and Job Cost Journal for our NSP2 projects. These documents further demonstrate that the Developer contracted with an entirely separate general contractor and legal entity for the rehabilitation.

Policy Guidance

Comment 3

We feel that the structure of our NSP2 program is proper and validated by the guidance contained in the following three separate policy documents issued by HUD's Office of Community Planning and Development:

Policy Alert 2011-09- Guidance on Allocating Real Estate Development Costs in the Neighborhood Stabilization Program updated September 16, 2011. This significant Policy Alert was also only partially cited by the OIG Auditors in their draft report. The auditors neglected to make any reference to the three page "Allowable Costs" matrix for NSP acquisition and rehabilitation programs broken down into the three phases - Pre- Development, Development and Post Development. This matrix identifies the use of construction contractors and allowable costs and supports Santa Ana's contention that our NSP2 program has been operated in a manner consistent with HUD guidelines.

Additional clarification stated in 2011-09:

- "The purpose of allowing the developer's fee to be included in the cost of a project is to compensate the developer for related overhead expenses..."
- "The overhead expense intended to be defrayed by the developer's fee is very similar to the General Administrative costs in the grantee budget, and may

include such indirect costs as rent, utilities, and other expenses that cannot be linked to a specific project."

Policy Alert 2011-11 -Guidance on Developers, Subrecipients and Contractors- Updated November 16, 2011. This important Policy Alert was only partially cited by the OIG Auditors in their draft report. The auditors neglected to make any reference to the matrix labeled "NSP Program Administration Implications by Entity Type" which provides HUD guidance on the rules that apply to grantees, developers, subrecipients and construction contractors. The material contained in the Policy Alert confirms that HUD anticipated separate and distinct roles to be performed by developers and construction contractors through the NSP Program and serves to validate Santa Ana's implementation of NSP.

Additional clarification stated in 2011-11:

- In the definition of Developer it states that "Developers are program beneficiaries and thus distinct from subrecipients, grantee employees, and contractors."
- To be "treated as a developer, the entity must demonstrate ownership or control of the property to be rehabilitated..."
- Contractor is defined as "an entity that supply goods and services at an agreed-upon rate or price."

Policy Alert 2012-06- Guidance on the Procurement of Developers and Subrecipients- June 1, 2012. This most recent Policy Alert was not cited by the OIG Auditors in their draft audit report but is significant with respect to the Santa Ana NSP program. Previous HUD programmatic audits of our NSP2 program confirmed that both the City of Santa Ana and Developer followed HUD guidelines for Developers selecting third parties (contractor). This included ensuring that the Developer's costs are reasonable and that records to evidence these findings are maintained. As reported to the HUD OIG Auditors, our general procedure in brief, includes the following steps:

1. City staff meets Developer's estimator at the property and they jointly perform an inspection of the property and develop a scope of work and cost estimate. The scope of work is reviewed for eligibility for Program compliance and the cost estimate is reviewed for reasonableness.
2. City staff performs further due diligence review of the final construction budget to further ensure cost reasonableness and that all rehabilitation items are addressed. The Repair Report and construction budget approved by City staff is then incorporated into the construction contract between the Developer and the Contractor.

Comment 4

3. City staff monitors the rehabilitation for compliance with the approved Repair Report and construction budget. At the completion of the rehabilitation, City staff performed a final inspection and (if appropriate) issues a Certificate of Completion.
4. At the completion of every project and upon escrow closing, Developer provides the City with a reconciliation of costs, including the approved Repair Report, construction budget and a journal of the actual costs incurred by Contractor for the renovation of the property. Total compensation paid to Contractor as general contractor was limited to the lower of their construction budget or actual costs plus 20% general contractor profit and overhead.

CONCLUSION

The City contends that it took the steps necessary as required by regulations to operate the NSP 2 program in accordance with HUD regulations. In accordance with NSP Policy Alert 2012-06, the City complied with the requirement that the "grantee should be careful in reviewing the eligibility and reasonableness of costs..." especially in cases of entities who are directly affiliated with a developer. The City did review costs for eligibility and reasonableness.

Given the concerns raised about the connection between the Developer and Contractor, we would like to provide a brief overview of the applicable case law regarding the doctrine of "piercing the corporate veil", which was referenced by OIG in the exit conference and in prior discussions with City staff. Generally, the doctrine of piercing the corporate veil is applied by courts when determining whether shareholders and/or parent corporations should be held liable for the actions of a corporation. California federal courts apply what is known as the Seymour test which considers the degree to which shareholders respect the identity of the corporation, including whether they follow corporate formalities; the degree to which injustice to the litigants would result were the corporate identity recognized; and the fraudulent intent or misuse of the corporate form by the incorporators. See *Seymour v. Hull & Moreland Engineering, Inc.*, 605 F.2d 1105 (9th Cir. 1979).

In this case, it is clear that the Developer and Contractor followed appropriate corporate formalities given that they have separate Articles of Incorporation, tax identification numbers and income tax returns. Moreover, the formation of an LLC is a legitimate act and a common practice in development projects. The Developer LLC is an entity formed solely for the duration of the NSP funding from the City of Santa Ana; therefore, it is not unusual that staff would be shared amongst entities.

During the exit conference, the OIG agreed that the amount of Developer fees received and the profit and overhead received by the Contractor were both reasonable, and, agreed, as stated above, that vertical integration is acceptable. Thus, the amount received by the two entities is not at issue. This is evident by the OIG's confirmation that had the Construction Contract been given to another entity this would not be a finding. The City believes it complied with all regulations, federal objectives were achieved, and requiring the repayment of \$669,632 is not reasonable, nor warranted. Further, Santa Ana maintains that the OIG Auditors are demanding the City provide a standard of financial oversight of our Developer well beyond that required by federal regulations.

Comment 5

Finding 2: The City of Santa Ana Reimbursed Its Developer at Least \$375,000 for Unnecessary Bank Charges

BACKGROUND

Santa Ana maintains that leverage is a requirement of the NSP 2 program. The NSP 2 application provided points if the jurisdiction could provide proof that there would be leveraged funds. In addition, we are required to track in DRGR such leverage. Therefore, it is contradictory that the other funding the Developer obtained to leverage NSP funds would be considered "unnecessary bank charges". The report states that the bank charges were unnecessary, but did not provide any analysis as to what portion, if any, were unnecessary or unreasonable. It is not logical or reasonable to determine that all of the bank charges were unnecessary or unreasonable. Santa Ana's program was designed after careful consideration, to provide flexibility to respond to the dynamics of the foreclosure real estate market in our area. Various scenarios were evaluated including one in which the volume of foreclosures exceeded our cash flow solely from federal NSP funding. For Santa Ana's program, access to construction financing through the private sector provided both leverage under the NSP guidelines as well as an additional margin of liquidity to assure we could respond to market conditions prior to program income being recycled into our accounts.

It is relatively easy to critique our approach after the fact, but Santa Ana genuinely viewed the bank charges as reasonable given its broader objectives which resulted in an additional \$4.8M leveraged into the program. This \$4.8M leveraged \$4.6M in NSP funds. The approach the City selected is very similar to that taken by private developers and lenders as well - seeking to leverage their financial resources rather than commit all their working capital to several projects and not being able to pursue other opportunities until real estate projects in the pipeline were completed.

Comment 6

CONCLUSION

Guidance from HUD's Office of Community Planning and Development supports Santa Ana's approach. We would like to cite for the record, Policy Alert 2011-09 Guidance on Allocating Real Estate Development Costs in the Neighborhood Stabilization Program updated September 16, 2011. This significant Policy Alert was only partially cited by the OIG Auditors in their draft report. The auditors neglected to make any reference to the three page "Allowable Costs" matrix for NSP acquisition and rehabilitation programs including "interest and fees on construction loans" as allowable costs. This matrix supports Santa Ana's contention that our NSP2 program and our approach to secure construction financing is entirely consistent with **HUD** guidelines.

In closing, Santa Ana welcomes the opportunity to further substantiate our position with regard to the OIG audit findings, should it be required. The City maintains that the findings are incorrect and that the structure of our NSP2 program will be validated once all relevant NSP regulations and policy guidance provided by HUD's Office of Community Planning and Development are properly considered. At the Exit Conference the OIG staff indicated that they would let the City know what, if anything, needs to be submitted in terms of further documentation as this process continues.

Thank you for your time and consideration.

Sincerely,

Sandra D. Gottlieb
Acting Executive Director
Community Development Agency
City of Santa Ana

cc: Yolanda Chavez, Deputy Assistant Secretary for Grant Programs
Fredrick Lee, Assistant Regional Inspector General for Audit
William Vasquez, Director, Office of Community Planning and Development
Chin Woo Choi, Program Manager, Office of Community Planning and Development
Elliot Olaniyan, NSP Specialist, Office of Community Planning and Development
Kevin O'Rourke, Interim City Manager

OIG Evaluation of Auditee Comments

Comment 1 We agree that both developers and contractors are allowed eligible fees related to services and work performed under NSP2 in accordance with applicable rules and regulations. However, we disagree with the City's comment that its only responsibility was to determine the reasonableness of incurred expenses under NSP2. We included 24 CFR 570.501(b) within the report to provide regulations regarding the City's responsibility for administration of its program funds.

Comment 2 We agree that a developer may engage in vertical integration, as well as establishing sole purpose limited liability corporations to operate in an efficient and effective practice. We also understand the roles and responsibilities of the developer and contractor in accomplishing the objectives of NSP. However, 24 CFR 570.501(b) states that the grantee is responsible for ensuring that the program funds are administered appropriately and ensuring that the developer and its identity-of-interest contractor comply with applicable rules and regulations. During our review, we did not see that the developer performed the related developer's duties to earn the developer's fees collected; instead, the contractor's employees performed such duties.

Because the developer hired an identity-of-interest contractor, the conflict-of-interest provisions in 24 CFR 570.611 and 85.36 would apply. Paragraph (f)(4) of 24 CFR 85.36 states that the cost plus a percentage of cost method of contracting must not be used, and that was the method used by the developer and contractor.

Comment 3 We agree with the City's assessment of the cited policy guides related to allowable NSP acquisition and rehabilitation costs incurred and earned by the developer and its designated contractor. As previously stated, our issue is that the developer did not perform the related developer's duties to earn the developer's fees collected; instead, the contractor's employees performed such duties.

Since the developer hired an identity-of-interest contractor, profit, overhead, and all indirect costs were shared by the two entities. The City did not provide a list of developer employees to account for overhead expenses. Therefore, as stated in the cited policy alert, the purpose of the developer's fee is to compensate the developer for related overhead expenses. As a result, the developer received more than \$669,000 in ineligible overhead and profits and management fees that should have been covered by the developer's fees.

Comment 4 We understand that there are roles and responsibilities of the developer and its designated contractor. We did not agree that the amount of developer's fees received and the profit and overhead received by the contractor were both reasonable. We have issues with the developer's receiving more than \$1 million in developer's fees without performing the necessary developer duties to earn that fee. We also have issues with the contractor's receiving more \$669,000 in ineligible overhead and profits and management fees that should have been

covered by the developer's fees. However, if the more than \$669,000 in ineligible costs had been paid from the developer's fee as required by the policy alert, we would not take issue with the \$1 million in developer's fees received.

Comment 5 We agree that HUD allows grantees to leverage its funds to maximize their ability to meet objectives and goals of NSP2. We revised the statement to address the issue that the policies and procedures in place were silent in the area of the City's analyzing the developer's own financing for potential cost savings to the program. Our review identified that the City could have conducted an analysis of the bank fees to determine whether there could have been cost savings for both the developer and the City. It should be noted that we are not requesting that this questioned amount of \$375,742 in program funds be returned to HUD. Instead, we believe that if the City had implemented additional policies and procedures that included cost analysis of the developer's own financing, there could have been potential cost savings to its program. As a result, we revised this finding to clarify the issue of the City's not having policies and procedures in place to analyze a developer's own financing for potential cost savings that could maximize program objectives.

Comment 6 The City will have the opportunity to work with HUD to address the finding during the audit resolution process. It can provide additional documentation to support its position at that time.

Appendix C

CRITERIA

Notice of Funding Availability (NOFA) for the NSP2 Under the American Recovery and Reinvestment Act, 2009 - May 4, 2009

The Recovery Act repealed Section 2301(d)(4) of HERA [Housing and Economic Recovery Act of 2008], which set requirements for the disposition of revenues generated by NSP assisted activities. Therefore, regular CDBG [Community Development Block Grant] rules governing program income shall apply. Recipients are strongly encouraged to avoid the undue enrichment of entities that are not subrecipients. For example, recipients are encouraged to structure assistance to developers that undertake acquisition and/or rehabilitation as loans rather than grants.

NSP Policy Alert: Guidance on NSP-Eligible Acquisition and Rehabilitation Activities – December 11, 2009

Private Nonprofit, a For-profit organization, or an Individual as developer (not a subrecipient) - such entities are not subject to recordkeeping or audit requirements that do apply to subrecipients. This flexibility creates a burden on the grantee to underwrite all such transactions to avoid undue enrichment.

NSP Policy Alert: Guidance on Developers, Subrecipients, and Contractors – August 27, 2010

When negotiating a developer fee, it is crucial for grantees to clearly specify what project costs can and cannot be paid with NSP fees. For example, if a developer's budget called for directly paying a project manager and also a developer fee that would be double-dipping and would not be allowed. Direct costs or indirect costs of a developer related to project management should be paid only through the fee. Grantees may also require a developer to pay some of the holding costs and receive reimbursement through the fee. Though not required by NSP, such a provision is used to encourage developers to complete projects in a timely manner. If a developer agreement does not include specific property addresses, then the contract should include a detailed list of criteria describing eligibility for acquisition and include a list of NSP-related obligations that carry forward with the property. It is also advisable for grantees to retain the right to individually sign off on each acquisition by a developer.

NSP Policy Alert: Guidance on Allocating Real Estate Development Costs in the Neighborhood Stabilization Program – January 13, 2011

Developer's Fees

Entities may charge developer's fees only when (i) activities are carried out pursuant to 24 CFR 570.202(b)(1), which allows a grantee to provide CDBG or NSP funds to private individuals and other entities to finance the acquisition and rehabilitation of property for use or resale for residential purposes, or (ii) NSP funds are provided to private individuals and other entities to finance construction of new housing in connection with the redevelopment of demolished or vacant properties.

The purpose of allowing the developer's fee to be included in the cost of a project is to compensate the developer for related overhead expenses and to provide a return on the developer's investment (which return may be referred to as "profit" for simplicity's sake). The overhead expense intended to be defrayed by the developer's fee is very similar to the General Administrative costs in the grantee budget, and may include such indirect costs as rent, utilities, and other expenses that cannot be linked to a specific project.

When negotiating a developer's fee with a third party, it is critical for the grantee/subrecipient to clearly specify what project costs can and cannot be paid with NSP funds. Since a portion of the developer's fee is to defray overhead expenses, the development agreement should not include allowances for both the fee and items of cost that are properly classified as overhead. If the developer's fee includes an allowance for profit, the grantee/subrecipient should ensure that the return on the developer's investment is reasonable (taking into account the riskiness of the project).

NSP2 Grant Agreement Between the U.S. Department of Housing and Urban Development and City of Santa Ana

The Grantee shall have 36 months from the date of HUD's execution of this Grant Agreement to expend the total NSP2 Grant amount pursuant to the requirements of this Agreement, the Recovery Act, HERA and the NOFA, as amended.

The Grantee is reminded that the Revised Budget and Activity List must still comply with the requirements of the NSP2 NOFA. Specifically, the Grantee is required to 1) return a minimum of 100 abandoned or foreclosed homes back to productive use or otherwise eliminate or mitigate the negative effects on the stability of the target geography and 2) ensure that the target geography in which the Grantee intends to carry out NSP2 activities has an average combined needs index score of 18 or greater.

NSP2 Grant Services Agreement Between the City of Santa Ana and ANR Santa Ana NSP, LLC

401. Rehabilitation Costs Paid with NSP Funds. It is the intent of the parties to use NSP funds for acquisition and related soft costs.

600. Developer Fee. The Developer shall be paid 10 percent (10%) of the cost of the acquisition sales price of each property, plus all rehabilitation costs, actual acquisition and sale closing costs, insurance related to acquisition and rehabilitation, property taxes and maintenance costs (utility and landscaping) subject to proper documentation evidencing such costs ("Developer Fee").

707. Conflict of Interest. Developer shall comply with and be bound by the conflict of interest provisions set forth at 24 CFR 570.611, as well as state regulations pertaining to conflict of interest.

2 CFR 225 – Appendix A – General Principles for Determining Allowable Costs

C. Basic Guidelines

1. Factors affecting allowability of costs. To be allowable under Federal awards, costs must meet the following general criteria:
 - a. Be necessary and reasonable for proper and efficient performance and administration of Federal awards.

24 CFR 85.36 Procurement.

(f) Contract cost and price

- (3) Costs or prices based on estimated costs for contracts under grants will be allowable only to the extent that costs incurred or cost estimates included in negotiated prices are consistent with Federal cost principles (see § 85.22). Grantees may reference their own cost principles that comply with the applicable Federal cost principles.
- (4) The cost plus a percentage of cost and percentage of construction cost methods of contracting shall not be used

24 CFR 570.501 Responsibility for grant administration

- (b) The recipient is responsible for ensuring that CDBG funds are used in accordance with all program requirements. The use of designated public agencies, subrecipients, or contractors does not relieve the recipient of this responsibility. The recipient is also responsible for determining the adequacy of performance under subrecipient agreements and procurement contracts, and for taking appropriate action when performance problems arise, such as the actions described in § 570.910.

24 CFR 570.611 Conflict of Interest.

- (a) Applicability. (1) In the procurement of supplies, equipment, construction, and services by recipients and by subrecipients, the conflict of interest provisions in **24 CFR 85.36** and 24 CFR 84.42, respectively shall apply.

Appendix D

SCHEDULE OF INELIGIBLE AND UNNECESSARY COSTS

NSP2 single-family property	Ineligible project overhead and profit (finding 1)	Ineligible project management fees (finding 1)	Unnecessary loan charges (finding 2)
A-1	\$12,285	\$7,782	\$15,475
A-2	\$17,294	\$10,540	\$21,081
S-1	\$19,225	\$2,612	\$10,128
A-3	\$24,865	\$9,759	\$11,876
S-2	\$15,617	\$4,135	\$10,279
S-3	\$12,816	\$6,548	\$6,749
A-4	\$3,509	\$609	\$12,282
A-5	\$15,358	\$6,446	\$13,285
A-6	\$17,838	\$6,449	\$13,242
A-7	\$19,764	\$3,265	\$15,387
A-8	\$13,036	\$5,386	\$14,262
A-9	\$10,316	\$3,178	\$16,887
A-10	\$17,051	\$6,727	\$15,245
A-11	\$18,803	\$9,119	\$12,486
A-12	\$16,924	\$7,105	\$12,716
A-13	\$13,406	\$4,425	\$12,308
A-14	\$15,127	\$3,855	\$12,608
A-15	\$14,507	\$3,067	\$11,476
A-16	\$12,066	\$3,500	\$10,308
A-17	\$3,623	\$1,331	\$13,059
A-18	\$16,293	\$1,277	\$11,677
A-19	\$26,411	\$7,873	\$9,765
A-20	\$16,433	\$3,457	\$8,626
S-4	\$15,221	\$6,653	\$9,311
A-21	\$16,326	\$4,268	\$15,081
A-22	\$14,979	\$4,454	\$9,462
A-23	\$16,514	\$4,337	\$8,093
A-24	\$22,455	\$6,579	\$8,870
A-25	\$17,177	\$6,666	\$8,164
A-26	\$14,391	\$4,760	\$8,720
A-27	\$19,194	\$3,632	\$8,538
A-28	\$17,190	\$3,824	\$8,296
Total	\$506,014	\$163,618	\$375,742
Average	\$15,813	\$5,113	\$11,742

Appendix E

SCHEDULE OF NSP2 DRAWDOWNS AND NET INVESTMENT

Sample #	Acquisition price	NSP2 drawdown	Program income	NSP2 net investment
A-1	\$250,000	\$154,302	\$66,429	\$87,872
A-2	\$262,350	\$179,433	\$73,337	\$106,097
S-1	\$196,000	\$195,596	\$81,261	\$114,335
A-3	\$124,816	\$129,469	\$67,895	\$61,574
S-2	\$227,000	\$231,804	\$108,290	\$123,514
S-3	\$232,650	\$232,181	\$111,637	\$120,544
A-4	\$215,567	\$73,614	\$57,465	\$16,149
A-5	\$203,000	\$112,268	\$455	\$111,813
A-6	\$212,580	\$126,111	\$14,120	\$111,992
A-7	\$182,000	\$173,067	\$80,443	\$92,624
A-8	\$227,700	\$180,822	\$75,281	\$105,541
A-9	\$270,000	\$177,505	\$57,666	\$119,839
A-10	\$209,118	\$162,683	\$70,150	\$92,533
A-11	\$206,308	\$154,589	\$22,300	\$132,289
A-12	\$205,000	\$137,889	\$33,711	\$104,178
A-13	\$223,003	\$143,852	\$58,949	\$84,903
A-14	\$213,067	\$118,644	\$35,557	\$83,087
A-15	\$194,740	\$133,621	\$35,094	\$98,527
A-16	\$255,816	\$155,861	\$52,172	\$103,689
A-17	\$288,000	\$159,589	\$69,078	\$90,511
A-18	\$187,033	\$172,371	\$68,398	\$103,973
A-19	\$170,795	\$175,973	\$28,486	\$147,487
A-20	\$212,815	\$183,943	\$77,714	\$106,229
S-4	\$233,717	\$188,940	\$76,400	\$112,540
A-21	\$226,441	\$163,831	\$66,926	\$96,905
A-22	\$226,740	\$169,612	\$48,339	\$121,274
A-23	\$197,900	\$176,091	\$53,152	\$122,939
A-24	\$198,862	\$170,130	\$158,305	\$11,825
A-25	\$222,750	\$192,777	\$112,747	\$80,030
A-26	\$193,500	\$115,572	\$106,690	\$8,883
A-27	\$232,650	\$10,893	\$206	\$10,687
A-28	\$242,500	\$1,000	\$6,671	(\$5,671)
A-29	\$222,750	\$1,000	N/A	N/A
Total	\$7,167,168	\$4,855,034	\$1,975,325	\$2,878,709
Average	\$217,187	\$147,122	\$61,729	\$89,960
Percentage of total funds			41 percent	59 percent