



U.S. DEPARTMENT OF
HOUSING AND URBAN DEVELOPMENT
OFFICE OF INSPECTOR GENERAL

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**MEMORANDUM NO:
2013-PH-1804**

Memorandum

TO: Gary O. Passage
Director, Office of Multifamily Housing, Pittsburgh Program Center, 3EHMLAV

Craig T. Clemmensen
Director, Departmental Enforcement Center, CACB

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FROM: John P. Buck
Regional Inspector for Audit, Philadelphia Region, 3AGA

SUBJECT: Review of the Administration of HUD Funds by Brownsville Apartments,
Brownsville, PA

INTRODUCTION

We conducted a review of Brownsville Apartments based on a referral from the U.S. Department of Housing and Urban Development's (HUD) Departmental Enforcement Center and the Pittsburgh Office of Multifamily Housing due to concerns that project funds were used inappropriately for purposes other than the operation of the project. This concern was due largely to the owner's lengthy history of being uncooperative with HUD. Our objective was to determine whether the owner of Brownsville Apartments complied with the project's regulatory agreement.

METHODOLOGY AND SCOPE

To accomplish our objective, we obtained and reviewed

- The project's regulatory agreement, rider to the regulatory agreement, section 236(s) rehabilitation grant agreement, use agreements, restructuring commitment letter, mortgage restructuring mortgage note, mortgage restructuring mortgage, rider to the mortgage restructuring mortgage, housing assistance payments full Mark-to-Market renewal contract, and operations manual;

- A payment register from the project’s operating bank account for the period January 2009 to November 2012 and documentation supporting selected payments;
- Bank statements for the project’s operating account for the period January to April 2009 and June 2009 to December 2012;
- Bank statements for the project’s payroll account for the period January 2009 to November 2012;
- Bank statements for the project’s tenant security deposit account for the period January 2009 to December 2012;
- Payroll summary reports and Internal Revenue Service Forms W-2 for the period January 2009 to December 2012;
- Balance sheet and income statement reports for years ending December 31, 2010, and December 31, 2011; and
- HUD regulations at 24 CFR (Code of Federal Regulations) Part 5, subpart H, and HUD Handbooks 4381.5 and 4370.2, REV-1.

In addition, we interviewed the project’s owner and office manager, the project’s public accountant, and HUD officials.

We performed our review from December 2012 to June 2013 at the management agent’s office located at 406 Fallowfield Avenue, Charleroi, PA, and our office located in Pittsburgh, PA. Our review generally covered transactions and events that occurred during the period January 2009 through November 2012 but was expanded when necessary to include other periods. The scope of our review was limited due to the lack of cooperation from the owner in providing documentation, answering questions, and meeting with us to discuss our results and provide feedback. The owner did not respond to our repeated attempts to schedule an exit conference and provide a written response to the draft audit memorandum. Therefore, the review was not performed in accordance with generally accepted government auditing standards. The limitation did not materially affect the results of the audit.

BACKGROUND

Brownsville Apartments is a 45-unit highrise building located in Brownsville, PA. All units receive project-based Section 8 assistance based on a housing assistance payments contract, which has an expiration date of April 30, 2021. The project’s owner is Sage Partners, LP. The managing general partner of Sage Partners, LP, is Sage Partners, LLC, of which the owners are members. Sage Partners, LLC, manages the project. The project has received the following project-based Section 8 funding over the last 4 years:

Year	Section 8 funds authorized and disbursed
2012	\$191,960
2011	203,562
2010	191,250
2009	169,375
Total	\$756,147

The project's mortgage was initially insured under the Section 236 program.¹ In April 2001, the project went through Mark-to-Market² restructuring through HUD's Office of Affordable Housing Preservation and entered into a regulatory agreement. As a result, the project's first mortgage was paid off and replaced with a nonperforming,³ HUD-held mortgage restructuring mortgage of \$589,156. In addition, before the prepayment of the Section 236 mortgage, the mortgage was decoupled from its interest reduction payments feature, and a grant agreement was executed, whereby interest reduction payments were directed to the owner's reserve for replacement account. Therefore, the owner had no recurring debt service and no recurring reserve for replacement payments.

HUD's Departmental Enforcement Center⁴ received seven financial referrals for the project owner's failure to file annual audited financial statements for the project's fiscal years 2002 through 2008. Before our review, the enforcement center communicated with the owner on many occasions about the financial management of the project, including the apparently unauthorized use of project funds and was not able to obtain the documentary evidence to support the use of these funds.

¹ The Section 236 program, established by the Housing and Urban Development Act of 1968, combined Federal mortgage insurance with interest reduction payments to the lender for the production of low-cost rental housing. Under this program, HUD provided interest subsidies to lower a project's mortgage interest rate to as low as 1 percent. This program no longer provides insurance or subsidies for new mortgage loans, but existing Section 236 properties continue to operate under the program. The interest reduction payment results in lower operating costs and, consequently, a reduced rent structure.

² In 1997, Congress established the Mark-to-Market program to help preserve the availability and affordability of low-income rental housing while reducing the cost to the Federal Government of rental assistance provided to low-income households using project-based Section 8 funds. Under this program, HUD resets the rents to the prevailing market level and restructures the property's mortgage debt, if needed, to permit a positive cash flow.

³ Mortgage payment requirements on a "nonperforming" mortgage are determined at the end of each of the project's fiscal years and are based on the amount of surplus cash realized by the project as reported by the owner in the annual financial statements.

⁴ The Departmental Enforcement Center is part of the HUD Office of General Counsel and works with HUD's program areas, such as multifamily housing, in various capacities. The enforcement center's primary goal is to bring noncompliant owners into full compliance so that there is no compromise in the quality of America's housing. To a large extent, owners have agreed to work with HUD to prevent possible enforcement action. Such a proactive stance on the part of owners is in the best interest of all parties, especially residents. In instances in which owners fail to bring properties up to standard and when physical and financial deficiencies persist, the enforcement center may take appropriate enforcement action, including administrative sanctions, such as civil money penalties, suspension, and debarment, and possible referral to the U.S. Department of Justice for civil action and to HUD's Office of Inspector General when criminal activity is suspected.

In 2008, the enforcement center issued legal notices to the owner citing the owner's failure to file annual audited financial statements and the apparently inappropriate use of project funds. Having received no correction to the enforcement center's declared violations or response from the owner, the enforcement center pursued civil money penalties for the owner's failure to file annual audited financial statements. This effort was intended to induce the owner to file, resulting in HUD's having more current project financial data from which to draw its conclusions relative to the owner's financial compliance.

In June 2009, HUD's motion for default judgment was granted by the administrative law judge in the civil money penalties case, and judgment in HUD's favor was entered for civil money penalties totaling \$125,000. That judgment was forwarded to the financial litigation unit of the U.S. Attorney's Office for the Western District of Pennsylvania. However, because of the legal structure of the owning entity, HUD's civil money penalties judgment does not reach to the individuals responsible for the operation of the project. Therefore, collection of the judgment will likely be limited to a lien against the owner's only asset, the project, against which HUD already holds a mortgage in first lien position. The enforcement center decided not to pursue the civil money penalties because the penalties appeared to be uncollectible.

In November 2012, an article in a local Brownsville newspaper reported that Brownsville officials planned to cite the owner for failing to clean up a bed bug infestation that tenants said the owner ignored despite their repeated complaints. According to the article, the residents told borough authorities that the owner had not responded to their complaints about bed bugs, the leaking roof, and the broken elevator and that the owner prohibited the local code enforcement officer from entering the building to conduct an inspection. The owner did not respond to the newspaper's request for comment. The article also reported that in December 2010, the building's boiler broke, leaving tenants with no heat. The owner distributed space heaters, but repairs to the boiler were not completed until the following March.

On December 20, 2012, the Director of HUD's Philadelphia Office of Multifamily Housing sent a letter to the owner of Brownsville Apartments as formal notice that the project was in violation of its regulatory agreement. HUD listed the following violations and required corrective action within 30 days to prevent default of the regulatory agreement:

- Failure to submit financial statements for the years 2002 through 2012 as required by section 12(e) of the regulatory agreement.
- Failure to provide HUD with specific answers to questions relative to the income, assets, liabilities, contracts, operation, and condition of the project as required by section 12(f) of the regulatory agreement.
- Failure to keep books and accounts of the operations of the mortgaged property in accordance with HUD requirements as required by section 4(e) of the rider to the regulatory agreement.

The owner did not comply with HUD's direction and failed to take the necessary corrective action. HUD planned to declare the owner in default of its regulatory agreement but did not want to impede our audit.

RESULTS OF REVIEW

Based on our limited review, we determined that the owner of Brownsville Apartments did not comply with the project's regulatory agreement. The owner did not maintain sufficient books and records, failed to submit required financial statements, and failed to notify HUD as required before permitting a new management agent to operate the project. The owner also used project funds for ineligible expenses and could not demonstrate that all costs incurred were fair and reasonable expenses related to the project.

The Project Lacked Sufficient Books and Records

The project did not have proper books and records. It did not have a general ledger or a chart of accounts. The books for the project consisted of a listing of checks disbursed from the project's operating fund. Section 4(e) of the rider to the regulatory agreement notes that the books and accounts of the operations of the mortgaged property and the project must be kept in accordance with the requirements of HUD. HUD Handbook 4370.2, REV-1, requires books of original entry to be kept current at all times, and postings must be made at least monthly to ledger accounts. Project owners' not properly maintaining the project's books and accounts results in inaccurate and incomplete reporting and restricts HUD's ability to effectively monitor the financial condition of the project. The project lacked controls to ensure that it maintained proper books and records.

The Project Had Failed To Submit Annual Audited Financial Statements to HUD Since 2002

The owner had not submitted annual audited financial statements to HUD since 2002, the year after the project's mortgage was restructured. Section 12(e) of the project's regulatory agreement requires the project to submit annual audited financial statements. Without the financial statements, HUD cannot determine how Section 8 funds are used, nor can it determine how much money, if any, is owed by the owner against the HUD-held mortgage. HUD had received no mortgage payments from the owner.

In response to our request for the project's most recent 2 years' audited financial statements, the owner provided balance sheet and income statement reports for 2010 and 2011, prepared by a public accounting firm. The public accounting firm's reports on its reviews did not assert that it audited the financial statements. Those reports could not be considered audited financial statements because they were incomplete and did not comply with HUD requirements. The reports did not include a statement of cash flows, a statement of retained earnings, a certification by the borrower, the report on the internal control structure, the report on compliance with applicable laws and regulations, and the supplemental data reports and notes as required by HUD Handbook 4370.2, REV-1. In addition, the balance sheet and income statement reports were on a cash rather than an accrual basis as required by the handbook.

Further, the person who prepared the documents was the same person who performed payroll services for the project and, therefore, was not qualified to do an audit of the project's financial statements. The handbook requires that financial statements be audited by either a certified public accountant or a licensed or registered public accountant having no business relationship with the owner except for the performance of audit, systems work, and tax preparation. The project lacked controls to ensure that it created and submitted annual audited financial statements as required.

The Owner Did Not Comply With the Terms of the Owner-Management Certification

The owner failed to notify HUD that it allowed a new identity-of-interest management agent to operate the project. Section 10 of the project owner's and management agent's certification for multifamily housing projects for identity-of-interest or independent management agents makes the owner responsible for submitting a new management certification to HUD before permitting a new agent to operate the project and collect a fee. The last certification the owner submitted to HUD was dated September 19, 1996, and identified The Information Management Group, Inc., as the management agent for the project for the life of the mortgage. However, the owner's identity-of-interest company, Sage Partners, LLC, had been the management agent since 2001. The project lacked controls to ensure that it submitted a new management certification as required.

The Project Incurred Ineligible Expenses

During the period January 2009 to November 2012, the project made the following ineligible payments from its operating fund account

- \$87,571 to the management agent (Sage Partners, LLC) for management fees. On December 21, 2006, HUD notified the owner that it was no longer permitted to collect management fees for the project due to the owner's failure to address outstanding management issues. On October 19, 2006, HUD directed the owner to hire a professional management company to manage the project, but the owner did not comply with HUD's direction.
- \$23,562 to the owner. Section 8(e) of the regulatory agreement states that owners must not, without the prior written approval of the HUD Secretary, make or receive and retain any distribution of assets or any income of any kind of the project except surplus cash.
- \$520 for a Christmas party. Section 4(c) of the rider to the regulatory agreement limits expenditures to reasonable operating expenses and necessary services and materials for the project.

Additionally, as of December 2012, the project had not returned \$27,209 in reserve for replacement funds that was approved by HUD in 2007 to be used as emergency withdrawals from the project's reserve for replacement account to temporarily cover operating expenses until the project received its July and August 2007 housing assistance payment funds. HUD controls the project's reserve for replacement account and releases funds to the project after reviewing

and approving a request for funds from the project. Reserve for replacement funds are to be used only for capital improvements and emergency purposes. The project lacked controls to ensure that it used project funds only for eligible expenses.

The Project Had Unsupported Expenditures

During the period January 2009 to November 2012, the project made the following unsupported payments from its operating fund account

- \$365,533 for salaries to the owner (\$258,750) and three employees (\$106,783). HUD Handbook 4381.5 requires owners to provide a listing of the staff members whose salaries will be paid from the project's operating account. The list must include job titles, approximate salary, a statement of each position's duties, and whether the position is full time or part time. HUD did not have these supporting documents, and the owner did not provide them to us during our review. Further, according to HUD, the \$68,000 average annual salary drawn by the owner as an employee of the management agent was excessive when compared to salaries paid at similarly sized multifamily projects in western Pennsylvania. Section 4(c) of the rider to the regulatory agreement limits expenditures to reasonable operating expenses.
- \$244,595 to Lando Construction for repairs (roof, boiler, carpentry, drywall, plumbing, etc.). Some invoices contained no information to describe the work performed. The owner could not provide documents, such as contracts, cost estimates, or price quotes, to support the reasonableness of the cost or to document why a contractor other than the low bidder was selected to do the work. According to HUD Handbook 4381.5, HUD expects owners and agents to solicit written cost estimates from at least three contractors or suppliers for any contract, ongoing supply, or service that is expected to exceed \$10,000 per year. For any contract, ongoing supply, or service estimated to cost less than \$5,000 per year, the agent should solicit verbal or written cost estimates. A record of any verbal estimate obtained should be made. Documentation of all bids should be retained as a part of the project records for 3 years following the completion of the work.
- \$31,563 to three individuals. The owner provided no documentation to support the payments to these individuals. Section 4(c) of the rider to the regulatory agreement limits expenditures to reasonable operating expenses and necessary services and materials for the project.
- \$23,810 to the project's maintenance manager. The invoices contained no information to describe the work performed. Contrary to HUD Handbook 4381.5, the owner could not provide documents, such as contracts, cost estimates, or price quotes, to support the reasonableness of the cost. The maintenance manager was paid \$17,800 as an employee during the audit period. In addition, the maintenance manager appeared to have been connected to Lando Construction. The address on the maintenance manager's invoice was the same as the address shown on the invoices for Lando Construction. Also, the invoice format for the maintenance manager and Lando Construction was the same.

- \$18,230 to two banks for credit card charges. These payments were partial payments against the account. The account carried an unpaid balance of \$8,900 as of January 2009. The unpaid balance had increased to \$9,100 as of November 2012. During that period, additional charges were made to the account for goods and services, including \$3,366 for finance charges on the unpaid balance. Although the owner provided the credit card statements and receipts to support most of the current charges on the statements, neither the statements nor the receipts contained information to identify the unit or area of the project for which the goods and services were needed. Further, since the project did not have a work order system for maintenance requests, we could not relate the purchases to a project work order. Section 4(c) of the rider to the regulatory agreement limits expenditures to reasonable operating expenses and necessary services and materials for the project.
- \$14,472 to the tenant security deposit account. Notes in the description field of the payment register indicated that these payments were made to reimburse the tenant security deposit account. Section 8(g) of the regulatory agreement notes that funds collected as security deposits shall be kept separate and apart from all other funds of the project in a trust account, the amount of which shall at all times equal or exceed the aggregate of all outstanding obligations of the account. It appeared that the owner had been using these funds for temporary transfers to its operating account to cover project expenses. For example, as of December 1, 2012, the bank statement for the tenant security deposit account showed that the balance was only \$118.
- \$5,500 on two checks made out to “cash.” The owner provided no documentation to support the payments. Section 4(c) of the rider to the regulatory agreement limits expenditures to reasonable operating expenses and necessary services and materials for the project.
- \$3,000 to an individual. Although the owner provided a copy of a letter allegedly documenting a conversation that occurred in January 2008 between the owner and the individual to whom the payments were made, the circumstances described in the letter were dubious. The letter stated that the individual agreed to provide cleaning services at the project for a period of 12 months at a rate of \$250 per month and that the individual requested that payment be rendered for those services at the end of the year. No documentation was provided to demonstrate that the services were performed. Section 4(c) of the rider to the regulatory agreement limits expenditures to reasonable operating expenses and necessary services and materials for the project.

The project made the following unsupported payment from its reserve for replacement funds:

- \$3,050 drawn down from the project’s reserve for replacement account for an emergency biohazard cleanup of a unit. The owner requested and received \$6,550 from its account for this work; however, the project’s check register and bank statements showed that only \$3,500 was paid to the contractor for this work. Therefore, the \$3,050 drawn down but not paid to the contractor was unsupported.

The project lacked controls to ensure that it complied with HUD requirements to limit expenditures to reasonable operating expenses and necessary repairs to the project that are properly supported.

Summary

The owner of Brownsville Apartments did not comply with the project's regulatory agreement. The owner did not maintain sufficient books and records, failed to submit required financial statements to HUD, and failed to notify HUD as required before permitting a new management agent to operate the project. The owner also used project funds for ineligible expenses and could not demonstrate that all costs incurred were fair and reasonable for expenses related to the project. This condition occurred because the project lacked controls to ensure that it complied with its regulatory agreement and applicable requirements and because of the owner's demonstrated cavalier attitude toward its responsibilities as an owner of a HUD-funded housing project. As a result, the owner materially violated the terms of the project's regulatory agreement, and HUD could not determine whether mortgage payments were owed by the owner against the HUD-held mortgage and, if they were owed, how much was owed. In addition, the project incurred ineligible expenditures totaling \$138,862 and unsupported expenditures totaling \$709,753.

RECOMMENDATIONS

We recommend that the Director of the Pittsburgh Office of Multifamily Housing

- 1A. Require the owner to deposit \$138,862 from non-Federal funds into the project's reserve for replacement account for the ineligible costs identified by the audit.
- 1B. Require the owner to provide documentation to support the \$709,753 in unsupported disbursements identified by the audit or reimburse the project's reserve for replacement account from non-Federal funds for any disbursements that it cannot support.
- 1C. Require the owner to calculate and support the amount of funds required to be on deposit in the tenant security deposit account and deposit funds into the account, if needed, so that the balance in the account is equal to or exceeds the amount of funds required to be in the account.
- 1D. Declare the project in default of its regulatory agreement and apply remedies available under the regulatory agreement up to and including foreclosure.

We also recommend that the Director of HUD's Departmental Enforcement Center

- 1E. Pursue administrative sanctions, as appropriate, against the owner for the regulatory violations cited in this memorandum.

Appendix A

SCHEDULE OF QUESTIONED COSTS

Recommendation number	Ineligible 1/	Unsupported 2/
1A	\$138,862	
1B		\$709,753

- 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/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.