Issue Date
September 18, 2008
Audit Report Number
2008-AT-1013

TO: James D. Branson, Director, Jacksonville Multifamily Housing Hub, 4HHMLAS

Henry S. Czauski, Acting Director, Departmental Enforcement Center, CV

Donnie R. Murray, Regional Counsel, 4AC

James D. McKay

FROM: James D. McKay, Regional Inspector General for Audit, 4AGA

SUBJECT: Bethany Housing, Inc., South Pasadena, Florida, Did Not Conduct Proper Oversight of Project Operations Resulting in Financial Harm to the Project

HIGHLIGHTS

What We Audited and Why

We audited Bethany Towers Apartments as part of our annual goal for auditing multifamily projects and in response to an audit request from the U.S. Department of Housing and Urban Development's (HUD) Tampa, Florida, Multifamily Division that reports to your office. We focused the audit on the nonprofit owner's and management agents' compliance with the project's regulatory agreement, applicable laws, and other HUD requirements pertaining to the sale and transfer of ownership interest in the project, use of project assets, identity-of-interest relationships, necessity and reasonableness of project costs, and record keeping.

What We Found

The owner and its undisclosed identity-of-interest (IOI) management agent did not provide proper oversight and management of the project's financial affairs. The owner, (a) executed an unauthorized agreement to sell the project, (b) diverted $90,000 in funds paid towards the purchase to its church sponsor, (c) selected an undisclosed IOI management agent, (d) allowed financial harm to the project from IOI dealings, (e) incurred more than $16,000 in ineligible/improperly supported costs, and (f) maintained inadequate books and records. To illustrate, the owner exposed the project to financial harm by allowing the purchaser to interfere with its ability to raise cash for the project. This condition contributed to the project's mortgage default in February 2008 and the project's inability to pay recurring project costs and accounts payable that totaled more than $239,000.

What We Recommend

We recommend that the Director of HUD's Jacksonville Multifamily Housing Hub (a) determine whether to declare the project in technical default of its regulatory agreement and initiate foreclosure proceedings, (b) require the owner to repay or support more than $106,000 in questioned costs, which include the diverted funds discussed above, and (c) require the owner to establish and implement policies and procedures to ensure compliance with HUD requirements. We recommend that the Acting Director of the Departmental Enforcement Center take appropriate administrative action against the owner and its IOI agent for the most significant reported violations. We also recommend that HUD's Regional Counsel, in coordination with HUD's Director, Jacksonville Multifamily Housing Hub, and HUD's Office of Inspector General, seek double damages against the owner for diverting $90,000 received for the sale of the project.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided the owner our discussion draft audit report on August 11, 2008 and held the exit conference on August 21, 2008. The owner provided written comments on August 21, 2008. The owner generally disagreed with the finding.

The text of the owner's written response along with our evaluation of that response can be found in appendix B of this report. We did not include the owner's attachments because they included discussion of tentative conclusions which we did not include in the draft provided for the exit conference.

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BACKGROUND AND OBJECTIVES

Bethany Housing, Inc. (owner), owner of Bethany Towers Apartments, was established on October 17, 1968, as a 501(c)(3) nonprofit charitable organization formed by New Hope Church, formerly known as Bethany Reformed Church. The organization was formed to provide rental housing for lower income elderly or handicapped families. On June 26, 1970, the owner entered into a regulatory agreement with the U.S. Department of Housing and Urban Development (HUD) and acquired Bethany Towers Apartments, a 210-unit elderly high rise located in South Pasadena, Florida. HUD insured the mortgage under the Section 236(j)(1)/202 Supportive Housing for the Elderly program.

The project was owner managed when on July 1, 2005, the owner contracted with an identity-of-interest (IOI) management firm to manage the project. In February 2007, HUD conducted an on-site review of the project. Based in part on the seriousness of deficiencies identified in the review, HUD required the owner to terminate the services of the IOI agent, although at the time, HUD was not aware that the agent was an identity of interest. The firm resigned on March 4, 2007, and the owner selected an independent firm, which assumed management of the project in April 2007.

HUD requested that we audit the project due in part to findings and concerns noted by its February 2007 review. The objectives of our audit were to determine whether the owner and the management agents operated the project in accordance with HUD's regulatory agreement, applicable laws, and other requirements related to (a) the sale and transfer of ownership interest in the project, (b) use of project assets, (c) identity-of-interest relationships, (d) necessity and reasonableness of project costs, and (e) record keeping.

RESULTS OF AUDIT

Finding 1: The Project Was Financially Harmed by the Owner's and an IOI Agent's Mismanagement and Violation of Requirements

The owner and its IOI agent did not provide proper oversight and management of the project's financial affairs. Specifically, the owner,

- Allowed the execution of an unauthorized agreement to sell the project,
- Diverted or allowed the diversion of $90,000 in project funds,
- Allowed the purchaser to select an IOI agent to manage the project,
- Allowed financial harm to the project due to IOI dealings,
- Incurred more than $16,000 in ineligible/inadequately supported costs, and
- Did not maintain adequate books and records

The owner had not established or did not provide and follow policies and procedures to control compliance with HUD requirements. The violations occurred because the owner and its IOI agent did not enforce and comply with program requirements. The violations resulted in financial harm to the project that has jeopardized its ability to continue providing affordable elderly housing.

The Owner Executed an Unauthorized Agreement to Sell the Project

The owner executed an agreement to sell the project without notifying HUD and obtaining HUD approval for the transaction. Section 7(a) of the regulatory agreement provides that project owners shall not, without the prior written approval of HUD, convey, transfer, or encumber any part of the mortgaged property or permit the conveyance, encumbrance, or transfer of any such property. The owner did not disclose the unauthorized sales agreement to HUD. HUD learned of the agreement in November 2007, through an attorney for the parent organization of the now-defunct church that sponsored the project's ownership entity, almost three years after the December 2004 sales agreement. In addition to lacking HUD's approval, the sales agreement was inappropriate, because

- The agreement constituted an unauthorized sale of the project. The agreement required the execution of a warranty deed that was to be held in escrow. It also required payments totaling $60,000 per year (payable $15,000 per quarter) starting 90 days from the effective date of the agreement (December 14, 2004). The final payment was due within 45

days of the seller's final payment on the HUD-insured loan, due in 2012.

However, as detailed in appendix C, the owner executed a ministry agreement that arranged to pay all proceeds from the sale to the project's church sponsor and not to the project. Section 10(g) of the project's regulatory agreement provides that all rents and other receipts of the project shall be deposited in the name of the project in a bank account, the deposits of which are insured. As discussed below, through this arrangement, the owner diverted $90,000 of the sales proceeds for nonproject use.

During the audit, we discussed the above conditions with HUD officials as we assessed and learned more about the undisclosed sale. On March 26, 2008, HUD wrote to the owner, requiring that it either cancel the agreement or HUD would declare a technical default, request the lender to accelerate the mortgage, and begin foreclosure action. The owner and purchaser later provided representation letters to us, stating that the sale agreement was no longer in effect.

The Owner Diverted or Allowed the Diversion of $90,000

The owner and a principal in the IOI agent diverted or were responsible for allowing the diversion of $90,000 in proceeds the purchaser paid to acquire the project. The diversions occurred between February 2005 and December 2006 when the project was not in a surplus-cash position. Section 10(g) of the regulatory agreement provides that all rents and other receipts of the project shall be deposited in the name of the project and used in accordance with the provisions of this agreement for expenses of the project and remittances to the commissioner. Title 12 U.S.C. (*United States Code*) § 1715z-4a(c) provides for double damages for unauthorized use of multifamily assets and income. Title 12 U.S.C. § 1715z-19 provides for sanctions for misuse of project assets and income when the project is in default or in a non-surplus-cash position. The $90,000 diversion, detailed in appendix C, consisted of

- $90,000 paid toward the purchase of the project that the owner and a principal in its IOI agent allowed to be diverted. The owner did not deposit the funds to the project's operating account, and a principal in the IOI agent, who was aware of the payments, did not account for the funds and their use in the project's general ledger. As previously discussed, the owner sold the project without HUD's approval, and HUD required the owner to cancel the agreement. However, during the audit, we determined that before HUD required the owner to cancel the agreement, the purchaser defaulted on the purchase agreement and forfeited the $90,000 to the project. Section 10 of the purchase agreement provided that in the event of default by the purchaser, the seller could retain all deposits paid

or agreed to be paid by the purchaser as liquidated damages. As discussed in appendix C, the $90,000 was diverted to the project's now defunct church sponsor.

The Owner Allowed an Undisclosed Purchaser to Select an Affiliate as the Project's Management Agent

The owner and the unauthorized purchaser caused HUD to approve an undisclosed IOI agent to manage the project. Section 10 of the regulatory agreement stipulates that the owner shall provide for the management of the project. Contrary to this requirement, section 8 of the addendum to the December 2004 sales contract provided that the owner would engage the services of a qualified managing agent to be selected by the buyer. The owner provided the names of two different management agent firms to HUD for approval to manage the project. Both firms included a principal of the firm that had the December 2004 agreement with the owner to purchase the property. The owner and the IOI agent's principal concealed the purchase agreement from HUD and the identity of interest that existed between them and the two proposed management firms. Specifically

- On May 19, 2005, HUD approved the Project Owner's/Management Agent's Certification, form HUD-9839-B for the first proposed agent. In section 12 of the certification, the owner and agent checked the box stating that no identity of interest existed among the owner, the agent, and any individual or companies that regularly did business with the project. The owner and agent knew that the statement was not true.

- On October 13, 2005, HUD approved the Project Owner's/Management Agent's Certification, form HUD-9839-B, for the second proposed agent. In section 12 of the certification, the owner and agent checked the box stating that no identity of interest existed among the owner, the agent, and any individual or companies that regularly did business with the project. The owner and agent knew that the statement was not true.

The records showed that only the second firm executed a management agreement and assumed management of the project. We observed that the owner and agent executed the management agreement on July 1, 2005, which was before HUD approved the Owner/Management Agent Certification. Approximately 21 months after execution of the management agreement, HUD required the owner to replace the agent because of its poor performance. The IOI agent relinquished management to a new, independent management agent, effective April 4, 2007. HUD then requested that we audit the project due to concerns it had about the owner and the released IOI agent's performance. These events occurred without

HUD's knowledge of the identity-of-interest that existed between a principal in the IOI agent, the purchaser, and the owner. HUD officials stated that they would not have approved the IOI agent if they had known about the identity of interest.

The Project Was Financially Harmed by Actions of the Undisclosed Purchaser

A principal in the purchasing entity prevented the owner from seeking HUD program funding available through a local government entity's HUD funded Community Development programs. The regulatory agreement, section 7(c), provides that the owner shall not, without the prior approval of the commissioner, convey, assign, or transfer any right to manage the mortgaged property. HUD's staff had worked to assist the owner in obtaining funding assistance through the government entity. In addition, HUD's staff stated that the potential funding amounted to approximately $1 million in forgivable loans and that the funding was virtually assured if the owner had applied for the assistance. The project provided the local government entity with a repair estimate of more than $2.2 million. The local government entity's representative acknowledged that it was considering the project for multiple-year funding, but it would not confirm the amount or the final funding prospect.

A member of the project's board provided an e-mail, dated August 25, 2007, that showed that the purchaser would not allow the owner to pursue the funding, because it would have obligated the project beyond the 2012 acquisition date stated in the previously discussed unauthorized sales agreement. The owner and purchaser concealed the agreement from HUD. The owner's failure to pursue the assistance deprived the project of possible funding it could have used to pay for improvements and to prepare vacant units for rent. The funding would have released the project's limited operating revenues to pay debt service and routine expenses. The following chart shows the vacancies, estimated lost revenue, monthly income or loss, and repair expenditures for the last nine months in 2007.

Month	Total Units	Vacant units	Vacancy Rate	Estimated lost revenue*	Monthly revenue less operating expense and debt service (deficit)	Expenditure for repair
April 2007	210	22	10.48	$ 5,220	$ 12,736	370
May 2007	210	19	9.05	3,915	(3,508)	7,076
June 2007	210	24	11.43	6,090	(6,415)	4,941
July 2007	210	25	11.90	6,525	4,176	2,934
August 2007	210	28	13.33	7,830	(31,660)	28,842**
September 2007	210	25	11.90	6,525	11,589	2,072
October 2007	210	32	15.24	9,570	(3,044)	1,026
November 2007	210	34	16.19	10,440	(2,330)	936
December 2007	210	36	17.14	11,310	6,700	3,426
Repair Expense						$51,623
Average						$5,736

*Based on a sustaining 95 percent occupancy rate.

**Includes an extraordinary $25,000 air conditioning repair charged to accounts payable.

With $2.2 million in estimated repairs and only $5,736 in monthly average repair expense the project did not have the cash needed to repair the increasing number of vacant units and to make them available for rent. The increasing vacancies and the declining revenues eventually led to a mortgage default in February 2008. These conditions are consistent with comments cited in the project's annual audits for fiscal years ending August 31, 2007, 2006, and 2005. For each of these years, the certified public accountants included similar notes to the financial statements that questioned the project's ability to continue as a going concern unless it reversed the trend of increased vacancies (all three reports) and repair and rehabilitation expenses (the two latest reports). The 2007 report stated that these conditions over the past several years made it difficult for the project to meet current obligations. The 2007 audit showed that on August 31, 2007, the project had more than $239,000 in current operating accounts payable, excluding the current mortgage payable and outstanding repairs.

Questioned Costs

The owner and former agent incurred more than $16,000 for questioned costs detailed in appendix D. The amount consisted of $3,692 for ineligible costs and $12,994 for costs that were not properly supported. Section 7(b) of the regulatory agreement provides that the owner shall not without the prior approval of the Commissioner pay out any funds except for reasonable operating expenses and necessary repairs. Section 10(c) of the regulatory agreement provided that the books, contracts, records, documents and other papers related thereto shall at all times be maintained in reasonable condition for proper audit. The owner and the IOI agent both executed management certifications, whereby they agreed to ensure that all expenses would be reasonable and necessary. The amounts included

- $3,692 for ineligible costs that consisted of $2,854 for holiday meals and $838 for legal fees. The holiday meals for tenants were not necessary

project costs. The invoice for the legal services was billed to an IOI affiliate of a principal in the firm that had an undisclosed and unauthorized agreement to acquire the project.

- $12,994 for costs not properly supported that consisted of $12,505 for legal expenses and $489 for office and travel expenses. The legal expenses included a $10,191 charge that was not supported by an invoice and $2,314 in charges supported by invoices that did not sufficiently describe the services rendered. The owner could not provide adequate documentation to show the purpose of the expenses and to support that they were reasonable project costs. The file showed that the office and travel expenses were to reimburse a former project manager for expenses paid from her personal account. The amount was not supported by proper documentation and evidence that she paid the expenses.

Inadequate Books and Records

The owner and its IOI agent did not maintain the project books and records in reasonable condition for proper audit, nor did they make all records available for examination as required by sections 10(c) and (d) of the regulatory agreement. This condition hampered our ability to assess the project's financial condition and to identify the audit universe from which to select audit samples. We made repeated requests for all project records for the period covered by the review. Specifically, the owner and its prior IOI agent did not

- Record in the project's general ledger the receipt and disbursement of the previously discussed $90,000 that an unauthorized purchaser paid toward the acquisition of the project.

- Maintain cancelled checks for 62 disbursements included in our sample. We did not question the payment amounts because they were for routine type costs and in most instances we could match the check numbers and amounts to corresponding entries on project bank statements.

- Maintain daily collection reports for rental receipts for September 2006 through March 2007.

- Deposit all rental collections directly to the project's operating account. The IOI agent deposited rent collections to the project's operating and payroll accounts. All project collections should have been made to the project's operating account. HUD questioned this condition based on its February 2007 monitoring of the project.

Conclusion

The owner and its prior IOI agent did not provide proper oversight and management of the project's financial affairs. The owner had not established or did not provide and follow policies and procedures to control compliance with HUD requirements. Our review identified an unauthorized sale of the project, more than $106,000 in diverted funds and questioned costs, IOI dealings that financially harmed the project and contributed to a default on the project's mortgage, and inadequate books and records. The violations occurred because the owner and its IOI agent did not comply with and enforce program requirements. The IOI dealings resulted in financial harm to the project that has jeopardized its ability to continue providing affordable elderly housing.

Recommendations

We recommend that the Director of the Jacksonville Multifamily Housing Hub

1A. Determine if the cited violations warrant providing the owner a notice of HUD's intent to declare a technical default and if the violations are not resolved within the allowed time declare the project in technical default of its regulatory agreement and initiate foreclosure proceedings.

1B. Require the owner to pay the project $90,000 for forfeited acquisition proceeds not deposited to the project account and used for project purposes if the Regional Counsel determines that the sales agreement was an enforceable contract.

1C. Require the owner to reimburse the project account $3,692 spent for ineligible party and legal expenses.

1D. Require the owner to properly support or reimburse the project account for $2,803 paid for inadequately supported legal, office, and travel expenses and require the owner to properly support or write off the $10,191 legal expense shown as an accounts payable.

1E. Require the owner to establish and implement policies and procedures to ensure compliance with HUD requirements.

We recommend that the Acting Director of the Departmental Enforcement Center

1F. Take appropriate administrative action against the owner for the unauthorized sale of the project, providing false certifications to HUD, allowing the purchaser to interfere with the management and financial affairs of the project, and for not maintaining proper books and records.

1G. Take appropriate administrative action against the IOI agent for providing false certifications to HUD, and for not maintaining proper books and records, which includes its knowledge and failure to properly account for $90,000 in purchase proceeds paid by its affiliate.

1H. Take appropriate administrative action against a proposed IOI agent for providing a false certification to HUD.

We also recommend that HUD's Regional Counsel, in coordination with HUD's Director, Jacksonville Multifamily Housing Hub, and HUD's Office of Inspector General

1I. Seek double damages against the owner for diverting $90,000 received for the sale of the project if the Regional Counsel determines that the sales agreement was an enforceable contract.

SCOPE AND METHODOLOGY

We performed the audit from January to July 2008 at locations in South Pasadena, Tampa, and Orlando, Florida, including the HUD multifamily field offices, and at the project. We did not review and assess general and application controls over computer-processed data for the project's general ledger. Instead, we conducted other tests and procedures to assure the integrity of the computer-processed data that were relevant to our audit objectives. The tests included but were not limited to a comparison of the computer-processed data to supporting contracts, bids, invoices, monthly accounting reports, reserve for replacement funds requests, and other supporting documentation such as bank statements and third-party verifications. The tests revealed that the general ledger maintained by the owner and its IOI agent did not record all project transactions and that the ledger was not reliable. We observed no data integrity concerns with the ledger maintained by the owner's most recent management agent. The supplemental procedures applied during the audit were sufficient to accomplish the objectives of the audit.

The audit generally covered the period September 1, 2004, through December 31, 2007. We adjusted the period when deemed necessary. To accomplish our objectives, we

- Reviewed HUD's monitoring reports and files for the project, including monthly accounting reports submitted by the former and current management agents;

- Researched applicable statutes, HUD handbooks, the *Code of Federal Regulations*, the project's regulatory agreement, contracts (e.g., management agreements, and owner/management certifications), and other applicable program requirements;

- Reviewed and obtained an understanding of the owner's and agent's procedures and internal control environment;

- Interviewed HUD officials in Tampa, Orlando and Jacksonville; the project owner; and the former and current agents;

- Reviewed the project's audited financial statements for fiscal years ending 2004, 2005, 2006, and 2007;

- Toured the project to obtain a general idea of its type, size, and condition;

- Reviewed the project's financial records such as general ledgers, bank statements, check vouchers, cancelled checks, invoices, contracts, bid documents, and other supporting documentation for $727,536 of the $4,423,652 disbursed for capital and routine expenditures during the audit period. We selected transactions based on concerns raised by HUD, vendor characteristics, significant dollar amounts, and other factors considered relevant to the selection of the audit sample. The results of the review apply only to the items selected and cannot be projected to the universe

We conducted the audit in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

Internal control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

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

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

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

- Policies and procedures that the owner and management agent have put in place to reasonably ensure that the project is operated in accordance with the regulatory agreement, applicable laws, and other HUD requirements.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Significant Weaknesses

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

- The owner had not established or did not provide and follow policies and procedures to control compliance with HUD requirements (see finding 1).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS

Recommendation number	Ineligible 1/	Unsupported /2
1B	$90,000	
1C	$3,692	
1D		$12,994
Total	$93,692	$12,994

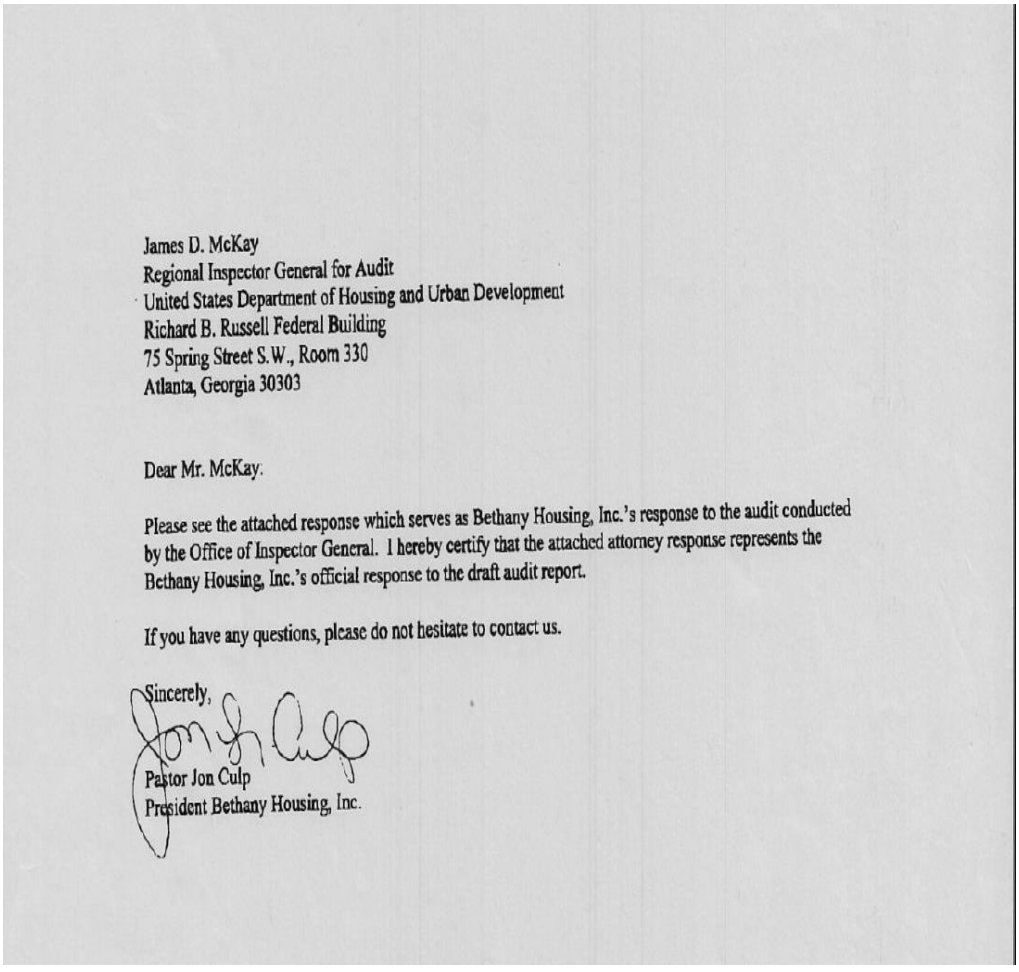
1/ Ineligible costs are those that are questioned because of an alleged violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the expenditure of funds.

2/ Unsupported costs are those for which eligibility cannot be clearly determined during the audit since such costs were not supported by adequate documentation. A legal opinion or administrative determination may be needed on these costs.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**



James D. McKay
Regional Inspector General for Audit
United States Department of Housing and Urban Development
Richard B. Russell Federal Building
75 Spring Street S.W., Room 330
Atlanta, Georgia 30303

Dear Mr. McKay:

Please see the attached response which serves as Bethany Housing, Inc.'s response to the audit conducted by the Office of Inspector General. I hereby certify that the attached attorney response represents the Bethany Housing, Inc.'s official response to the draft audit report.

If you have any questions, please do not hesitate to contact us.

Sincerely,

Pastor Jon Culp
President Bethany Housing, Inc.

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August 15, 2008

James D. McKay
Regional Inspector General for Audit 4AGA
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Atlanta GA 30303-3388

RE: Audit Report
Bethany Housing, Inc.

Dear Mr. McKay:

Our firm represents Bethany Housing, Inc. (Bethany) in regards to the above audit. They have asked us to provide a response to the audit report delivered to Bethany on August 11, 2008. Below are specific responses to the allegations made in the audit report.

Comment 1

Response to recommendations

The imposition of double damages is not appropriate in this situation. The board of directors as it currently exists, is not the same board that authorized the sale and allowed the management company to create the situation that was the subject of your audit. The current board has an agreement sell the property to a group that will have the funds to substantially improve the project; this agreement has been submitted to HUD for approval and a verbal approval was obtained earlier this week now they are simply waiting on the finalized written approval. The imposition of these double damages against Bethany would not only penalize a board of directors who was not in place at the time of the alleged action but it would also penalize the residents of Bethany Towers. If double damages are imposed there would not be enough funds to pay for all of the costs of closing, accounts payable, and the audit penalties Additionally, the process for

imposing double damages will cause a lengthy delay with respect to the closing contemplated by Bethany. This will cause the closing to fall through. That would leave Bethany with no other viable options besides foreclosure, and no funds to repair the air conditioning equipment, which is tenuous at best. This would harm the residents the most.

If any extra penalties are imposed it should be against the management company that caused these problems and not Bethany. Bethany truly felt and trusted that the management company was looking out for the best interest of the project. It has now become apparent that this trust was misplaced. All Bethany was trying to accomplish was to improve the project for the benefit of the residents by entering into an agreement that would become final after the mortgages had been paid in full. There was never any intent to harm the residents or the project. Furthermore, as stated below, double damages would be inappropriate for diversion of funds because the sale was undone and the funds were never part of project funds.

Comment 2

Response to allegation that owner entered into an unauthorized sales agreement.

The previous agreement in question was contingent upon certain events happening, mainly that the HUD regulations were followed and that the final mortgage payment was made. The agreement was to become final after all mortgages were paid in full. The interest would not have been conveyed until HUD approval plus the mortgages were paid in full. As soon as it became apparent that HUD had issues with the contract, the sale was immediately undone by Bethany and the Purchaser. Additionally, there is a

Comment 3

factual inconsistency regarding the ministry agreement. Appendix C mentions the ministry agreement and alleges that it makes no mention of the sales agreement when in fact the sales agreement is mentioned and attached to and made a part of the ministry agreement.

Comment 4

Furthermore, the management company had several meetings with [redacted], a HUD representative, regarding the project. It has been alleged that [redacted], through those meetings was aware of the situation at Bethany Towers. We are currently in the process of obtaining those records and will provide those to HUD once received.

Comment 2

Response to allegation that owner diverted or allowed the diversion of $120,000.00

The audit report states the sales agreement was unauthorized and cancelled. When Bethany was informed that the sale must be undone, Bethany complied with that request. Since the contract was not authorized, the contract can be said to be an invalid contract and of no force or effect. Additionally, the contract clearly states that it is contingent upon complying with HUD regulations. The HUD regulations were not complied with and as such the contract was void. Consequently, for many reasons the contract in question is void, invalid and unenforceable. Since the contract was void, invalid and unenforceable there was not to be any project funds or payments paid to Bethany. Since Bethany was not to receive project funds or payments, any repayment of money paid under to the contract would result in an unjust enrichment to Bethany and possibly open Bethany up to an unjust enrichment lawsuit.

Under Florida law when a contract is "tainted with the vice of such illegality, no alleged right founded on such contract can be enforced in a court of justice." Local No. 234 of United Associations of Journeymen and Apprentices of Plumbing and Pipefitting Industry of United States and Canada v. Henley & Beckwith, Inc. 66 So. 2d 818 (Fla. 1953). The contract between Bethany and the Purchaser was illegal. The contract in question did not get the approval of HUD as required by HUD. Therefore no rights can be enforced. HUD is attempting to enforce the alleged right of the project to receive said funds from the sale. Under Florida law this is not allowed.

Moreover, to the extent the contract is void ab initio the contracting party has a claim to return of its funds.

If HUD had not forced the sale to be undone and declared the sale invalid, then there may be an argument that the funds must go to the project. However, no HUD regulations state that all sales proceeds are considered project funds; these funds were not considered project funds and hence they did not need to be used in accordance with the regulatory agreement. HUD may require the funds to be placed into a trust if HUD approves a prepayment of the mortgage. In this case there was to be no pre-payment of the mortgage. Additionally, the funds went to a tax exempt purpose which is required when a not for profit sells its property. No for profit entity benefited from this proposed sale.

If any funds are to be recovered, they need to be recovered from the entity that benefited from the receipt of the funds, which is [redacted] and by extension, the [redacted] which is the surviving entity of the defunct Church, not Bethany Housing. It is now clear that the Church received benefit of the funds, not Bethany Housing, Inc., therefore the Church or its successors should disgorge the funds it received.

Comment 5

Response to allegation that owner allowed an undisclosed purchase to select an affiliate as the project's management agent.

As previously stated, the board of directors today is not the same board of directors that was in place during these events. The current board had no involvement and has no knowledge of this event and these documents. Therefore, we would request an opportunity to review the documents in question before providing a response to this allegation.

Comment 6

Response that project was financially harmed by actions of undisclosed purchaser.

Bethany has no proof that the project would have been financially better off if the actions of the purchaser never occurred. However, these actions were not the actions of Bethany, but were rather the actions of the Purchaser. Bethany did not control the Purchaser and cannot make any statements regarding their actions. There are no guarantees and no evidence that the said assistance would have helped cure the financial problems of the project. The economy also took a downward turn during this time and it is impossible to state with certainty that the vacancies were a result of not obtaining the assistance and it is impossible to state with certainty whether the assistance would have prevented the financial difficulties now experienced by Bethany. The vacancies may very well be attributed to the economy and not to any one action. The board inherited a

project with inadequate reserves and enormous deferred maintenance, which also played a large role in the current financial problems of Bethany Housing

Bethany Housing did have a meeting with the county regarding additional funding and it was determined that the funding would not have been appropriate for Bethany Housing. It was not appropriate due to percentage requirements. Bethany Housing then attempted to obtain private funding and were turned down We are in the process of providing documentation regarding the loans and will provide this as soon as we have it.

Comment 7

Response to questioned costs.

1. Legal costs. Our firm represented Bethany regarding several evictions and some issues with mold litigation. We use very generic billing codes in order to protect attorney client privilege. While it may be impossible to state exactly what occurred during the meetings, it is possible to learn from the dates what was discussed. All of the unsupported charges were due to mold issues and evictions. We strongly feel that resident safety is a project expense and the funds expended relating to mold issues were expended to protect the residents. We provided a response to the auditor's questions explaining each and every charge made by our firm. I have attached that letter to this response as Exhibit "A" In Exhibit "A", there was one misstatement regarding the $15,000.00 that was deposited in our escrow account. This was a good faith deposit for the purchase of the property, however when it appeared the transaction was not to occur, we reissued a check for the deposit. We inadvertently returned the check to wrong entity. That entity then signed the check over to the Purchaser. We provided a copy of the back of the check to the auditors as proof of that transaction and are attaching that check hereto as Exhibit "B". Additionally, we offered to let the auditors examine our records if they signed a confidentiality agreement. The auditors stated that that was not necessary. We again offer to let you examine our files to support those charges that remain unsupported. Our client has agreed to forgo a confidentiality agreement. However, you will be responsible for any damage that arises from the release of attorney client privileged material. Please let us know if you would like to examine the files at our office or if you would like copies made and forwarded to you.

Comment 8

Comment 9

2. The holiday meals were provided to the residents as a good will gesture. With all the vacancies it made good business sense to make the current residents feel special with holiday parties. It follows that if the residents feel cared about they will stay in the premises and not move, which results in less vacancies.

3. The office and travel expenses were legitimate costs. These costs were used to reimburse the previous manager. As the manager, it was her responsibility to ensure the costs were properly documented. Our clients used their best efforts to locate the previous manager to obtain the proof requested by the auditors. However, they were unable to locate the previous manager.

Comment 10

4. Appendix D the auditors have added in an accounts payable amount into the total that you are requesting be re-paid. The transaction date is July 15th, 2007 in the

amount of $10,191.00. This amount was never paid and hence should not be included in the amount you are requesting be re-paid to the project.

Comment 11

Response to inadequate books and records.

All of the auditor's requests were complied with. Bethany changed auditors and accountants several times and as such not all of the books were kept in excel format. The latest change in managers was to retain the firm which received the highest reference from the local HUD office, and that is the management company in place presently.

Some of the records were more difficult to locate, but everything was located and provided to the auditors. All bookkeeping issues have been resolved and the books and records are now properly kept and easily accessible.

Conclusion

Comment 1

In conclusion Bethany disagrees with the auditor's finding and their recommendations including any assessment of damages. Furthermore, double damages are not appropriate in this situation due to the fact that the current board of directors is not the same board that was in place when these events occurred.

Please feel free to contact me with any questions

Sincerely,

George K. Rahdert

OIG Evaluation of Auditee Comments

The owner generally disagreed with the finding and recommendations, as indicated below.

Comment 1 The owner stated that the imposition of double damages is not appropriate because the board of the directors' as it currently exists, is not the same board that authorized the sale. We disagree with the owner's comment. The project's ownership entity, Bethany Housing Inc., and its board were responsible for compliance with HUD requirements and the consequences associated with violations, such as the cited statute for double damages. Periodic changes in the composition of the board of directors did not alter or excuse the owner's responsibility to ensure compliance with HUD requirements.

HUD and enforcement officials will make the decision on double damages considering, among other factors, the impact the violations had on the project and its tenants.

Comment 2 The owner's response to the draft report was the first time it raised a legal question about the sales agreement being invalid and unenforceable. The owner is correct in its claim that the sales agreement contained a provision that stated it was contingent upon certain events happening, mainly that HUD regulations were followed and that the final mortgage payment was made. The owner maintained that since the agreement was not authorized, it was invalid and of no force or effect and that any repayment of money paid under the agreement would result in an unjust enrichment to Bethany. During the audit we consulted with HUD's Regional Counsel Office and were informed that the funds forfeited through the sales agreement were project funds. However, the owner's response raised a new legal question about the enforceability of the sales agreement. Based on the owner's comments we revised our recommendations, where appropriate, to recognize the need for a legal interpretation concerning the validity and enforceability of the sales agreement.

We noted, however, that the owner's position that the agreement is not enforceable is not consistent with their past actions on issues governed by the agreement. The owner and purchaser implemented the agreement without seeking and obtaining HUD's prior approval and they concealed the agreement from HUD who did not learn of it until almost three years later. By that time the purchaser had paid $90,000 towards the acquisition to the project's now defunct church sponsor. On April 11, 2008, the owner wrote the parent organization of the church recognizing the cash they received from the sale and invited them to redirect the funds to meet the project's financial needs. The owner provided no evidence of a response. Also, on April 4, 2008, the owner wrote a letter to the purchaser that stated

> "While there are a variety of legal issues surrounding this agreement, we believe that in the most fundamental form of analysis, substantial and

repeated failure to pay option payments when due constitutes a breach of the option agreement and voids the further obligations of that agreement, Stoltz v. Truitt 940 So.2d 521 (Fla. App. 1st Dist. 2006); *see also* Paragraph 2 of Addendum to Purchase and Sales Agreement. Moreover, by their very nature, options payments rendered prior to the option holder's cessation of payments remain the property of the optionee."

Based on the above, until our review, the owner operated on the basis that the sales agreement was a binding contract and enforced it against the purchaser. This is demonstrated by the above April 4, 2008, letter where the owner asserted its right to keep option payments forfeited under the agreement. The forfeited payments were made to and retained by the project's now defunct church sponsor and are the subject of discussion in the above April 11, 2008, letter to the church's parent organization. Also, pursuant to the alleged void sales agreement and contrary to the project's regulatory agreement, the owner allowed the purchaser and the IOI agent selected by the purchaser to mismanage and cause financial harm to the project. These two conditions are discussed on pages 8 to10 of the report.

Comment 3 We agree with the owner's comment and we revised the report to delete the statement that the ministry agreement made no mention of the sales agreement.

Comment 4 The owner implied but provided no support to show that a HUD official was aware of the sales agreement prior to the date we cite in the report.

Comment 5 The owner restated that the current board of directors had no involvement and had no knowledge of the owner selecting a management agent that had a prior interest through an undisclosed agreement to purchase the project. As stated in comment 1 above, periodic changes in the composition of the board of directors did not alter or excuse the owner's responsibility to ensure compliance with HUD requirements.

Comment 6 The owner commented that (a) they had no proof that the project would be financially better off if the actions never occurred, (b) the actions were not those of the owner but were rather the actions of the purchaser, and (c) the economy took a downturn and it is impossible to state with certainty that the vacancies resulted from them not obtaining the assistance mentioned in the report. The owner further commented that the board inherited a project with inadequate reserves and enormous deferred maintenance.

We recognize that we could not determine the full adverse impact the violations had on the project although we identified a funding restriction that harmed the project. The unauthorized purchase agreement, executed in December 2004, prohibited the owner from seeking other funding without the purchaser's approval. The restriction violated the project's regulatory agreement which prohibited the assignment of management to another party without HUD's approval and which the owner did not did seek or obtain.

We identified an instance where the purchaser prevented the owner from following through on an effort to obtain public funding through a local government entity. As stated in the report, the funding amount was not certain but HUD officials stated the project was almost certain to receive funding approval. The project needed and would have benefited from any approved funding. In this instance, the owner complying with the sales agreement restriction financially harmed the project although the extent of the harm is not quantifiable. A HUD legal representative stated that the owner selling the future ownership of the property took away the right of the owner to refinance and gave away its ability to obtain funds to correct physical deficiencies or other problems by refinancing. This was significant considering the owner's recognition that the project had limited reserves and enormous deferred maintenance coupled with increasing vacancies detected by past independent audits and our review. In addition, the nonprofit project owner was eligible to receive HUD assistance and could have made annual applications for such assistance through a local government entity. The owner files contained no documentation to show it sought to obtain such funding.

Comment 7 The owner stated that generic billing codes were used to protect client attorney privilege and all of the unsupported legal charges were due to mold issues and evictions. The owner provided additional documentation following the exit conference to support some of the transactions. Based on that documentation, we revised the report to allow $4,383 of the legal fees. The owner did not provide documentation needed to resolve our concerns about inadequate support for the remaining legal fees.

Comment 8 We reviewed and assessed the owner's explanation for the escrow deposit. We agree that the $15,000 payment mentioned in the response and the additional $15,000 escrow payment questioned in the draft report were both separate and apart from the sales proceeds paid under terms of the December 2004 sales contract. We revised the report to delete the two $15,000 escrow payments and we reduced the diverted fund amount from $120,000 to $90,000.

Comment 9 The owner commented that the holiday meals provided to the residents were a goodwill gesture which made good business sense considering the project vacancies. The meals were not necessary project costs.

Comment10 We agree with the owner's comment that the $10,191 was an accounts payable. We revised our recommendation to recognize this fact.

Comment11 The owner commented that all the auditor's requests were complied with and that everything was located and provided to us. As stated in the report, the owner did not locate and provide all requested records for the period the project was managed by a prior IOI agent.

Appendix C

SCHEDULE OF DIVERTED PURCHASE PROCEEDS

Check Number	Date	Recipient	Amount	Notes
001981*	Feb. 3, 2005	Nonprofit sponsor church	$15,000	A, B
002123*	May 3, 2005	Nonprofit sponsor church	$15,000	A. B
Wire transfer	July 28, 2005	Nonprofit sponsor church	$15,000	A, C
Wire transfer	Oct. 12, 2005	Nonprofit sponsor church	$15,000	A, C
Wire transfer	Apr. 17, 2006	Nonprofit sponsor church	$15,000	A, C
Wire transfer	Dec. 19, 2006	Nonprofit sponsor church	$15,000	A, C
		Total	$90,000	

* Cashier checks with the purchaser shown as the remitter of the funds.

Notes

A. These payments, though due to the project, were diverted and paid to the project's now defunct church sponsor who was not authorized to receive them. We obtained a record of the payments from the project's escrow agent. According to the agent, the payments were made by the purchaser toward the acquisition of the project. However, we found no record of the payments in the project's general ledger. Section 10(g) of the regulatory agreement provides that all rents and other receipts of the project shall be deposited in the name of the project and used in accordance with the provisions of this agreement for expenses of the project and remittances to the commissioner. In each instance, the remitted funds were paid directly from the purchaser's bank account or by cashier's checks that show the purchaser as the remitter of the funds.

   The owner violated requirements by arranging for the project's church sponsor to receive all of the proceeds from the project's sale. To accomplish this, the president of the project's ownership entity executed a "ministry agreement" between the project and the church sponsor. The agreement required the project to make seven $60,000 annual payments (payable in quarterly installments of $15,000) to the church ($420,000 in total) and a final $1 million payment at the closing of the sale in 2012. The ministry agreement stipulated that the payments were for ministry services provided to the project over the past 40 years. Such services, even if supported, are not eligible under the regulatory agreement. The president of the ownership entity, who was also the pastor of the now-defunct church sponsor, signed the project sales agreement and the ministry agreement.

   The owner and the purchaser either knew or should have known that the payments belonged to the project. The payments should have been paid to the project or held in trust as required by section 10(g) of the project's regulatory agreement. We determined that two principals of the purchasing entity later represented themselves as principals in two separate management firms that the owner submitted to HUD for approval to manage the

project. In both instances, each certified (one on April 14, 2005, and the other on June 22, 2005) that they would comply with the project's regulatory agreement and other HUD requirements. The management firms' certifications to be approved as the project's management agent show that they either knew or should have known HUD requirements for recognizing and accounting for project assets. They and the owner should have known that all payments made toward the purchase of the project should have been payable to the project only.

B. These payments were made payable to the project but were endorsed and deposited to the account of the project's now-defunct church sponsor.

C. Documentation accompanying the wire transfers showed the purchaser as the originator and the project's now-defunct church sponsor as the recipient.

Appendix D

SCHEDULE OF INELIGIBLE AND UNSUPPORTED COSTS

						OIG's position	
Transaction date	**General ledger ID**	**Cancelled check provided**	**Expense type**	**Total Amount**	**Allowed**	**Ineligible**	**Not properly supported**
Mar.13, 2006	1015	No	Legal	$ 2,460	$1,158	$ 838	$ 464
Oct. 4, 2007	273	Yes	Legal	5,000	3,150		1,850
July 15, 2007	10092006	n/a *	Legal	10,191			10,191
Dec. 15, 2006	3201	No	Meal	609		609	
Nov. 15, 2005	12237	No	Meal	575		575	
Dec. 14, 2005	12258	No	Meal	501		501	
Nov. 17, 2004	11831	No	Meal	581		581	
Dec. 15, 2004	11852	No	Meal	588		588	
Aug. 15, 2006	3061	No	Reimbursement	311			311
Aug. 15, 2006	3061	No	Reimbursement	118			118
Aug. 15, 2006	3061	No	Reimbursement	60			60
Total				$20,994	$4,308	$3,692	$12,994

* This amount was recorded as accounts payable.

Appendix E

OTHER MATTER FOR CONSIDERATION INVOLVING TAX ISSUES

The cancelled sales agreement for Bethany Towers Apartments involved tax considerations that may be of concern to the Internal Revenue Service (IRS), although the tax issues may not involve a direct violation of HUD's multifamily program requirements. The issue is whether a 501(c)(3) tax-exempt owners of a HUD-insured multifamily project may sell the project to a for-profit owner without an appraisal to support that the sale occurred at the project's fair market value and whether the profits from the sale must be retained by the tax-exempt owner for dedicated exempt purposes. This issue came to our attention from the cancelled sales transaction that involved the project. We observed that the sale

- Provided for a $1.42 million sales price to a for-profit purchaser without obtaining or documenting an appraisal to establish the project's market value. IRS Publication 557, Tax-Exempt Status for Your Organization, paragraph 501(c)(3), Excess Benefit Transaction, provides that organization assets must be disposed of at fair market value. The sales agreement provided that the official transfer would coincide with the project's 2012-scheduled mortgage maturity and payoff date of the project's HUD-insured loan. The sales price appeared low, considering that in 2004 the project's tax value was more than $6.8 million. Based on past tax valuations, we estimated that the project would be worth more than $10 million by the 2012 date scheduled to close the transaction. The for-profit purchaser would reap a windfall from the purchase based on the project's 2004 tax value and would profit even more based on our estimate of the project's 2012 tax value.

  The prior president of the ownership entity stated that the purchaser's offer appeared to be reasonable. The president signed the sales agreement on behalf of the project's owner and was the minister of the project's now-defunct church sponsor.

- Allowed a potential windfall to the profit-motivated purchaser that would deprive the project's ownership entity of assets that should have been permanently dedicated to exempt purposes. IRS Publication 557, Tax-Exempt Status for Your Organization, paragraph 501(c)(3), Dedication and Distribution of Assets, provides that assets of an organization must be permanently dedicated to an exempt purpose. This means that should an organization dissolve, its assets must be distributed for an exempt purpose described in the chapter or to the federal government or to a state or local government for public purpose. If the assets could be distributed to members or private individuals or for any other purpose, the organizational test is not met.

These conditions, though no longer an issue because the sale was cancelled, should be considered during the owner's ongoing negotiations to possibly sell the project to another for-profit entity. According to HUD officials, there are many 501(c)(3) tax-exempt owners of multifamily projects with mortgages that will be paid off within a few years that may be

prospects for purchase by for-profit entities. We recognize that the associated IRS issues may not involve a direct violation of HUD requirements. HUD should be mindful of the IRS requirements and take appropriate measures to ensure that when approving such sales, it does not inadvertently authorize sale transactions that allow 501(c)(3) tax-exempt owners to violate IRS requirements.