



U.S. Department of Housing and Urban Development

Office of Inspector General

Region IX

611 West Sixth Street, Suite 1160

Los Angeles, California 90017-3101

Voice (213) 894-8016

Fax (213) 894-8115

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Audit Memorandum Number

2010-LA-0801

MEMORANDUM FOR: Kelly Boyer, Multifamily Housing Director, 9DHML
Joan S. Hobbs

FROM: Joan S. Hobbs, Regional Inspector General for Audit, 9DGA

SUBJECT: HUD Needs to Make a Final Determination on Whether San Diego Square Subleased Property is HUD Insured Under Section 202 of the Housing Act of 1959 San Diego, California

INTRODUCTION

We performed a review of the San Diego Square (Square) project in response to a hotline complaint. The complainant stated that San Diego Kind Corporation (Corporation) misappropriated a lease prepayment of \$480,060 and the U.S. Department of Housing and Urban Development (HUD) failed to enforce program rules and regulations after detecting the misappropriation. Our objective was to determine whether the complaint was valid.

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 review.

SCOPE AND METHODOLOGY

The scope of our review was limited to addressing the hotline complaint by determining whether the Corporation misappropriated the lease prepayment and whether HUD failed to enforce program requirements. To accomplish our review objective, we

- Obtained an understanding of the Section 202 program by reviewing the regulatory agreement, applicable HUD handbooks, and other program requirements;

- Interviewed the former HUD employee who initiated the complaint;
- Corresponded with the Corporation's owner, chief financial officer, management agent, and attorney;
- Examined relevant records provided by the Corporation, Office of Multifamily Housing, and Departmental Enforcement Center;
- Interviewed the San Diego Senior Community Center's (Community Center) president; and
- Performed a site visit to the project and the City of San Diego's (City) recorder's office.

Our review generally covered the period July 20, 1978, through July 9, 2009. We conducted our review from March 17 through July 24, 2009.

BACKGROUND

The Corporation was formed as a nonprofit entity in October of 1972 to provide assistance to the elderly. In 1979, it entered into an agreement with HUD to construct and operate the Square, a 156-unit high-rise apartment complex for San Diego's elderly located at Tenth and "C" Streets in downtown San Diego, California. The Corporation received a loan of more than \$7.4 million from HUD under Section 202 of the National Housing Act of 1959 to construct the complex. The 2007 and 2008 audited financial statements reported that there was a remaining balance of more than \$4.7 million on the loan, which will mature in May 2021. In addition, a Section 8 new construction housing assistance payments contract was to provide affordable housing for elderly and handicapped residents in 154 units at the complex. The Square was built on leased land from the City for an annual rent of \$1 through the term of the lease ending in 2029. On March 30, 1988, the Corporation entered into an agreement with the Community Center to sublease for a period of 20 years a portion of the Square's premises, also known as the Broadway Center, located at 928 Broadway. The Corporation received a \$480,060 prepayment for the entire term of the sublease, which it recognized as its own entity's income, as opposed to the Square's income.

The complainant (a former HUD employee) contended that the regulatory agreement between HUD and the Corporation defined the \$480,060 lease payment as project income. Therefore, the complainant stated that HUD accounting regulations required that the lease payment be amortized and reported in the annual financial statements, which the Corporation failed to do from 1986 to 2005. HUD became aware of the lease and lease payment in 2005 and allowed the Corporation to resubmit its 2006 annual financial statements to disclose the proper information. However, HUD decided not to pursue reimbursement because the payment was received in 1988, which was determined to be "legally and administratively well outside an appropriate time frame to secure recovery." The complainant believed that HUD improperly failed to enforce program requirements by not seeking reimbursement of the prepayment funds, which could be used to fund the Section 8 contract and would reduce the cost of providing affordable housing.

RESULTS OF REVIEW

We were unable to determine whether the allegations were valid. The sublease transaction occurred over 20 years ago, so many of the project records could not be located or are no longer available. As a result, we only reviewed documents that were retained by the Los Angeles Office of Multifamily and Departmental Enforcement Center such as the regulatory, master, and sublease agreements. In addition, we performed a site visit to obtain a better understanding of the project's layout. We also went to the City recorder's office to locate other relevant records. Despite our efforts, there does not appear to be sufficient evidence to show exactly what the Section 202 loan went to pay for and whether HUD intended the Center to be part of the Section 202 insured project. Therefore, we could not make a final determination as to whether the hotline complaint was valid. As a result, it is incumbent upon HUD to resolve this matter by making a final determination on whether the subleased area was or was not built and insured under the Section 202 loan.

Present Situation at the Square

According to the Community Center's president, the Corporation refused to negotiate with the Community Center after the sublease expired on March 30, 2008. Therefore, the Community Center had been mailing the Corporation monthly rental checks in the amount of \$3,506 from May 2008 through July 2009. It will continue to mail the checks through January 2010, at which time, it will move its operation to another facility. Because the checks were sent by registered mail, the Community Center was aware that the checks, for a total of \$52,586, covering the period May of 2008 through July 2009, had not been cashed by the Corporation. Given that the Corporation believed the subleased portion of the property was distinct from the project, it was probable that it would not recognize the \$73,621 (sum of \$52,586 for the period May of 2008 through July of 2009 and \$21,035 for the projected period August of 2009 through January of 2010) in rental income as part of the project's residual receipts account once it cashed the checks. The Corporation had not responded to our query regarding its reason for not cashing the checks.

In consultation with our general counsel, we concluded that HUD could not pursue other actions with regard to the \$480,060 lease prepayment because the statute of limitations had passed, despite discovery of the issue only a few years ago. However, if HUD makes a final determination that the subleased area of the Square is considered part of the Section 202-insured project, the rental income from May 2008 to the present should be recognized as project income.

RECOMMENDATIONS

We recommend that the Director of the Los Angeles Office of Multifamily Housing

- 1A. Make a final determination and provide official written notification to the Corporation as to whether the subleased area of the Square is considered part of the Section 202-insured project and, therefore, rental revenue it received for use of space on the project must be recognized as project income.

- 1B. If HUD determines the subleased area to be part of the project, require the Corporation to cash the checks and record more than \$73,621 in rental income for the Community Center's occupancy of the Square's premises between May 2008 and January 2010 as part of the project's residual receipts account. This measure will ensure that these funds will be put to better use in the future.

AUDITEE'S RESPONSE

We provided a discussion draft report to the auditee on August 26, 2009, and held an exit conference on August 28, 2009. The auditee declined to provide written comments, but informed us that it agreed with the results and recommendations.

APPENDICES

Appendix A

SCHEDULE OF FUNDS TO BE PUT TO BETTER USE

Recommendation number	Funds to be put to better use <u>1/</u>
1B	\$73,621

- 1/ 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, if HUD determines the subleased area to be part of the project, it will ensure that the Corporation recognizes program funds in accordance with HUD rules and regulations. These funds may be expended to fund the Section 8 contract and would reduce the cost of providing affordable housing.