



U.S. Department of Housing and Urban Development

Office of Inspector General

Region IX

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Issue Date

December 18, 2009

Audit Report Number

2010-LA-1802

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

Joan S. Hobbs

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

SUBJECT: Review of Lutheran Gardens Corporation Trust Fund Account
Compton, California

INTRODUCTION

We performed a review of the Lutheran Gardens Corporation (Corporation) trust fund account in response to a U.S. Department of Housing and Urban Development (HUD) request, dated March 30, 2009. HUD believed that as much as \$2.72 million was withdrawn from a trust account in violation of a trust agreement (agreement) with HUD, dated April 22, 2005, and questioned certain disbursements. Our objective was to determine whether the Corporation withdrew and expended trust funds in accordance with the agreement with HUD.

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 HUD's request by determining whether the Corporation withdrew and expended trust funds in accordance with the agreement with HUD. To accomplish our objective, we

- Interviewed the HUD multifamily project manager, the president of the Corporation, and the project development manager of Barker Management, Inc. (management company for the Corporation);

- Obtained an understanding of the agreement and the applicable laws and HUD guidance, including HUD's regulations at 24 CFR [Code of Federal Regulations] Part 265 (4-1-95 edition, reinstated by section 236.1.c); and
- Examined documents related to the agreement and financial records supporting the expenditures that were provided by the Los Angeles Office of Multifamily Housing, the Corporation, and Barker Management, Inc.

Our review covered the period April 2005 through June 2009. We performed our review from July through September 2009. This was a limited scope review; therefore, our work was not performed in accordance with generally accepted government auditing standards.

BACKGROUND

Lutheran Gardens Apartments is a 76-unit multifamily project located in Compton, California. It was financed in 1974 by a Section 236 National Housing Act-insured mortgage. The Corporation (a nonprofit corporation) sold the project to Lutheran Gardens LP (a profit-motivated corporation) in 2005. The sale involved the prepayment of a HUD-insured mortgage, continuation of the interest reduction payments, and preservation of the project as a low-income housing resource. On April 22, 2005, HUD and the Corporation entered into an agreement.

The sale of a multifamily property with a HUD-insured mortgage from a nonprofit to a for-profit entity is governed by 24 CFR Part 265 (appendix C, paragraph 3) to ensure that the needs of the project are met and that the nonprofit owners selling the project do not receive remuneration. HUD incorporated the CFR requirements in its Handbook 4350.1 (appendix C, paragraph 2), which requires that net proceeds from sale be placed in a trust with a third-party trustee and the funds be used to promote the expansion of low- and moderate-income housing. HUD entered into the agreement with the Corporation so that the more than \$2.8 million in net proceeds from the sale and replacement reserves of \$461,325 would be placed in a trust fund with HUD as the trustee and, therefore, controlled and expended according to the regulatory requirements.

RESULTS OF REVIEW

Our review found that the Corporation expended the trust funds according to the eligible uses described in the agreement. However, it did not comply with the agreement when depositing and withdrawing trust funds. This condition occurred because the Corporation did not set up a trust account with HUD as the trustee nor did it obtain HUD's approval to use the funds. With \$918,307 in trust funds still subject to the agreement as of June 17, 2009, HUD and the Corporation were at risk of not complying with the regulatory requirements to ensure that the trust funds were used to promote the expansion of the supply of low- and moderate-income housing.

To comply with the HUD and regulatory requirements, the agreement requires the Corporation to (1) deposit the sale proceeds and replacement reserves into a trust account with HUD named as the trustee and provide signature cards for a HUD representative to sign, (2) obtain HUD approval before withdrawing trust funds, and (3) use the trust funds to promote the expansion of the supply of low- and moderate-income housing (appendix C, paragraph 1).

Although the Corporation set up a separate account for depositing and withdrawing the trust funds, it did not

- Establish the account with HUD named as the trustee with appropriate signature cards,
- Obtain HUD authorization to withdraw subject funds, and
- Deposit \$87,076 of the replacement reserves into the separate account.

Trust Account Not Established

The Corporation did not set up the trust account with HUD as the trustee according to the agreement. We reviewed bank statements and signature cards for the account the Corporation used for depositing the trust funds and found that the Corporation set up a bank account under the name “Lutheran Gardens Corp. Trust Account,” not “Secretary of Housing and Urban Development, U.S. Department of Housing and Urban Development, as Trustee for the Lutheran Gardens Corp.” as required (appendix C, paragraph 1.b). In addition, the Corporation did not provide HUD the signature cards for a HUD representative to sign. The signature cards showed only the signatures of officers/employees of Barker Management, Inc.

Unauthorized Withdrawal of Trust Funds

The Corporation used trust funds without obtaining withdrawal approval from HUD as required by the agreement. We examined all nine trust fund authorizations totaling more than \$2.7 million and found that none was signed by a HUD representative as required. Two of the nine authorizations were stipulated in the agreement: one for nearly \$1.2 million that was to be deposited into a construction escrow with the new lender and another for \$350,000 for a loan to the Corporation from Lutheran Gardens LP. The escrow settlement statement showed that the amounts were paid out of escrow and disbursed without using trust fund authorization forms signed by a HUD official as required. We also examined the expenditures of the trust funds and found, along with the trust authorization amounts, other withdrawals not approved by HUD.

Replacement Reserves Still Owed the Trust Fund

The Corporation did not deposit \$87,076 in replacement reserves required by the agreement. The agreement required the Corporation to deposit the existing replacement reserves of \$461,325 into the required trust account (appendix C, paragraph 1.a). Our review of the bank statements and deposit documents showed that the Corporation deposited only \$374,249 of the required reserves.

RECOMMENDATION

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

- 1A. Establishes the required trust account with HUD named as the trustee and provide signature cards for a HUD representative to sign.
- 1B. Deposits the balance of the trust funds subject to the agreement held in a Wells Fargo Bank account, along with \$87,076 in replacement reserves due the trust.
- 1C. Submits trust fund authorization forms to HUD for signature and approval before withdrawing trust funds from the trust account.

AUDITEE'S RESPONSE

We provided a discussion draft report to your office on November 25, 2009, and held an exit conference with the Corporation on December 2, 2009. The Corporation provided its written comments on December 11, 2009. The Corporation agreed with the results and had already started implementing corrective action.

The complete text of the Corporation's response, along with our evaluation of that response, can be found in appendix B of this report. We did not include the enclosures to the Corporation's response because it included sensitive bank account information.

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	\$87,076

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.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Lutheran Gardens Corporation
2431 El Segundo Boulevard
Compton, CA 90222

December 7, 2009

U.S. Department of Housing and Urban Development
Office of Inspector General
Region IX
611 West 6th Street, Suite 1160
Los Angeles, CA 90017-3101

RE: Draft Review Findings Dated December XX, 2009

Dear Ms. Hobbs;

We are in receipt of your letter dated the 24th day of November 2009 which contained a copy of the draft findings report related to the recent review of the Lutheran Gardens Trust Account by your office. This letter is intended to acknowledge the following findings indicated in your report and establish measure(s) taken or proposed to be taken related to same;

i. **Trust Account Not Established**

Measure(s) taken to correct:

Existing Account (#7038960873) has been renamed and the signature card changed to reflect HUD's role as sole Trustee. A copy of the correspondence transmitted to LA/HUB regarding same is attached as evidence.

Comment 1

ii. **Unauthorized Withdrawal of Trust Funds**

Measure(s) taken to correct:

All future withdrawal requests will be transmitted to Mr. Harvey Friedberg, or other LA/HUB staff, as instructed, in accordance with disbursement requirements as stipulated in the Trust Agreement

Comment 2

iii. **Replacement Reserves Still Owed to Trust Fund**

Measure(s) taken to correct:

The funds have been reimbursed to the trust account in accordance with the finding. A copy of the check is being included with this letter as evidence.

Please feel free to contact our management company, Barker Management, for further questions related to this issue.

Lutheran Gardens Corporation
2431 El Segundo Boulevard
Compton, CA 90222

Sincerely,

LUTHERAN GARDENS CORPORATION



James Merritt,
President

Enclosures

Cc:
Peter Barker Kris Graham
Main File w/o Encl.

OIG Evaluation of Auditee Comments

Ref to OIG Evaluation

Auditee Comments

Comment 1 Contrary to the Corporation's claim, we do not agree that sufficient evidence was provided to support that the existing trust account was renamed and the signature card was changed to reflect HUD as the trustee. The Lutheran Gardens Corporation should provide the required documentation to HUD during the review resolution process.

Comment 2 We concur that recommendations 1B and 1C have been satisfactorily implemented and we will close the recommendations upon issuance of the report.

Appendix C

CRITERIA

1. Housing Trust Fund Agreement:

a. “Recital of Facts,” paragraph I: “As a condition of the HUD Secretary’s prepayment approval, the Owner has agreed to deposit (i) one hundred percent (100%) of the net proceeds of the sale, approximately \$2,816,902 and (ii) \$461,325 of the Property’s existing replacement reserves (collectively, the “Trust Amount”) into a housing trust fund (the “Trust Account”) to be used in accordance with the terms of this Agreement.”

b. Paragraph B.2: “The Owner shall open the Trust Account with the Depository Bank in the name of the “Secretary of Housing and Urban Development, U.S. Department of Housing and Urban Development, as Trustee for the Lutheran Gardens Corp.” The Owner shall deliver to the Los Angeles Multifamily Hub Director, evidence of the deposit of the Trust Amount with the Depository Bank, together with authorized signature(s) withdrawal cards for the HUD Secretary, acting by and through his authorized agent, to complete and return to the Depository Bank.”

c. Paragraph E.2: “Using the Trust funds Authorization Form...or similar form approved by the parties to this Agreement, the HUD Secretary shall instruct the Depository Bank to disburse funds from the Trust Account only upon and in accordance with a written request from the Owner, which has been approved by the HUD, Los Angeles Director of Multifamily Housing.”

d. Paragraph C.4: “The Owner may use the Trust Account for any expenses related to the predevelopment, acquisition, development, preservation, construction and/or rehabilitation of units intended to be developed as Affordable Housing Units, which may include, but shall not be limited to the following:

- Predevelopment and development costs
- Application fees, loan fees and discounts
- Appraisal, consultant, legal, architectural and engineering fees
- Rental subsidies
- Reasonable administrative and office overhead and expenses
- Reasonable insurance costs
- Fees for consultants assisting in evaluating affordable housing opportunities, including investment proposals and administering loans and grants
- Corporate filing fees and other fees related to administration of the Trust Account, including the fees described in Section G.2”

2. HUD Handbook 4350.1, REV-1:
 - a. Paragraph 13-2: “The Regional Office must approve, prior to the Field Office granting preliminary approval, any proposal exhibiting the following characteristics:” Par. 13-2-F: “The transaction involves a transfer from nonprofit to profit motivated or limited distribution ownership and calls for remuneration to the seller.”
 - b. Paragraph 13-19.C: “Any remuneration accruing to the nonprofit seller must be placed in a trust with a third party trustee. The trust funds must be disbursed in accordance with the terms of a trust agreement which has been approved by the HUD Field Office, for a public purpose approved by the HUD field Office that promotes the expansion of the supply of low and moderate income housing.”
 - c. Paragraph 13-19.D: “No remuneration may pass to any individuals connected with the nonprofit seller.”
3. 24 CFR Part 265 (4-1-95 edition, reinstated by reference in 24 CFR 236.1.c):
 - a. Section 265.1: “This part governs the transfer of physical assets from nonprofit to profit-motivated ownership of certain multifamily housing projects with HUD-insured or HUD-held mortgages. It provides for the orderly processing and approval of these transfers and assures HUD that the physical, financial and management needs of the projects are met through the change in ownership.”
 - b. Section 265.2: “These regulations apply to each nonprofit owned multifamily housing project with a finally endorsed HUD-insured or HUD-held mortgage which is assisted under...(a) Section 236 of the National Housing Act.”
 - c. Section 13: “The nonprofit owner selling the project shall not receive any remuneration in any form.”