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Audit Report Number	2011-NY-1006
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TO: Teresa Bainton, Director, Office of Multifamily Housing, New York,
2AHMLAP

FROM: *Edgar Moore*
Edgar Moore, Regional Inspector General for Audit, New York/New Jersey
Region, 2AGA

SUBJECT: Financial Management and Procurement Controls at Westbeth Artists Houses,
New York, NY, Did Not Always Comply With Regulations

HIGHLIGHTS

What We Audited and Why

We audited Westbeth Artists Houses (auditee) in response to a complaint submitted to the Office of Inspector General (OIG) hotline alleging that project funds were used to pay an executive director in violation of U.S. Department of Housing and Urban Development (HUD) regulations. Our audit objectives were to assess the merits of the complaint and determine whether project operations generally complied with HUD regulations pertaining to financial, procurement, and tenant certification processes.

What We Found

The complaint had merit because the duties of the executive director position for which project funds were disbursed were not adequately supported. In addition, although tenant certifications were properly performed, the project's financial management and procurement processes did not always comply with HUD regulations. Specifically, project funds were used to pay expenses that were inadequately supported, deemed unnecessary and unreasonable, and ineligible. In addition, auditee officials did not always follow prudent procurement practices

when executing contracts. These conditions occurred because auditee officials believed that the funds used to pay for the executive director's position were not subject to HUD regulation and weaknesses existed in the project's financial and procurement controls. As a result, auditee officials lacked assurance that (1) \$304,485 expended for an executive director's position and \$28,351 disbursed for other expenses were properly supported, (2) \$7,030 expended was for necessary and reasonable project- or housing-related costs, (3) \$37,650 expended was for eligible expenses, and (4) services were obtained at the most economical price.

What We Recommend

We recommend that the Director of HUD's New York Office of Multifamily Housing instruct auditee officials to (1) provide justification for the \$304,485 expended for the costs related to the executive director's position so that HUD can determine whether it is justified and provide documentation to substantiate the \$28,351 in unsupported expenses, (2) reimburse the project from non-federal funds, \$7,030 in expenses deemed unnecessary and unreasonable, along with the ineligible expenses of \$37,650, and (3) ensure that controls over financial management and procurement processes are strengthened.

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 discussed the results of the audit with auditee officials during the audit and provided a draft report on January 21, 2011, which was discussed at an exit conference on January 31, 2011. Auditee officials provided written comments and exhibits on February 14, 2011 as requested in which they disagreed with the findings and recommendations. The complete text of the auditee's response, except for the exhibits, which were too voluminous to include in the report, along with our evaluation of that response, can be found in appendix B of this report. The exhibits will be provided to the HUD field office.

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BACKGROUND AND OBJECTIVES

Westbeth Artists Houses (auditee), which is located at 463 West Street, New York, NY, and is the site of a former industrial building abandoned in 1966, opened in 1970 as the first federally subsidized artists' housing. In addition, there is an easement agreement relating to an abandoned railway line running through the development. The development is a 384 residential and 106 commercial unit Section 221(d)(3) multifamily building owned by the Westbeth Corporation Housing Development Fund Company, Inc., a not-for-profit housing company. The 384 residential units are to be provided at below-market rent to those performing or participating in a wide range of artistic activities, and the 106 commercial units and artists' studios are to be provided at market rent. The development is governed by an uncompensated board of between 3 and 15 directors.

The U.S. Department of Housing and Urban Development (HUD) entered into a regulatory agreement with the owners in 1968 in connection with a Section 221(d)(3)-insured mortgage. The provisions of this regulatory agreement were extended to cover a supplemental insured mortgage obtained on August 7, 1970. HUD's financial interest in the property ended on August 26, 2009, when it entered into a loan sale agreement to sell the mortgage loan to the New York City Housing Development Corporation. The development continues to be subject to a HUD Section 8 housing assistance contract for which it provides project-based housing assistance for 77 apartment units.

Section 221(d)(3) of the National Housing Act allows HUD to insure mortgage loans to facilitate new construction or substantial rehabilitation of multifamily rental or cooperative housing for moderate-income families, the elderly, and the handicapped. Property owners are ultimately responsible for ensuring that HUD-subsidized properties are operated in an effective and efficient manner. The regulatory agreement between the property owner and HUD specifies that the responsibilities of an owner are to maintain the development and its records in accordance with HUD requirements. However, property owners may contract with a management agent through a management agreement to oversee the day-to-day operations of the property and maintain the financial and accounting records. The property owner executed a project owner's/management agent's certification in January 2008 with Phipps Houses Services to serve as the management agent. The project owner's/management agent's certification provides that the agent and owner will comply with HUD requirements and contract obligations, that all expenses of the development are reasonable and necessary, and that the development's accounts and records are established and maintained in accordance with HUD requirements.

We initiated an audit in response to a complaint submitted to the Office of Inspector General (OIG) hotline alleging that project funds were used to pay an executive director in violation of HUD regulations. Our audit objectives were to assess the merits of the complaint and determine whether project operations generally complied with HUD regulations pertaining to financial, procurement, and tenant certification processes.

RESULTS OF AUDIT

Finding 1: Financial Management and Procurement Controls Did Not Always Comply With Regulations

Tenant certifications complied with HUD regulations; however, auditee officials did not always administer financial management and procurement controls in accordance with HUD regulations. Specifically, project funds were used to pay compensation for an executive director's position, the duties of which were neither adequately supported nor considered necessary by HUD, and other expenses that were inadequately supported, deemed unnecessary, and ineligible. In addition, auditee officials did not always follow prudent procurement practices. These conditions occurred because auditee officials believed that the funds used to pay expenses for the executive director were not subject to HUD regulation and weaknesses existed in the auditee's financial and procurement controls. As a result, auditee officials lacked assurance that \$304,485 expended for an executive director's costs and \$28,351 for other expenses were properly supported, \$7,030 expended was for necessary and reasonable project- or housing-related costs, \$37,650 expended was for eligible expenses, and services were obtained at the most economical price.

Executive Director Position Not Adequately Supported

Disbursements on behalf of an executive director were unsupported because the duties assigned to that position were those normally expected of the management agent or the board of directors or had not been performed. While the project was reported to have been without an executive director since sometime in the 1970s, the board of directors authorized filling such a position during its June 29, 2006, board meeting. After conducting an executive search, auditee officials hired an individual on September 11, 2006, to serve as executive director for 1 year but did not renew the contract upon its expiration. On January 28, 2008, a member of the board of directors resigned and was hired as the executive director under a 1-year term of employment. Although the contract had not been renewed, the individual continued to serve in that position. Auditee officials had expended \$304,485 through August 26, 2009,¹ for compensation and the reimbursement of expenses related to this position as follows:

¹ No exception is taken for payments related to the executive director's position after this date because after HUD executed the loan sale agreement, it had no further financial interest in the project. However, section 2.10 of the agreement provides that assignment of the regulatory agreement does not affect any recourse HUD may have for breach of the regulatory agreement that occurred before the closing date.

Table 1: Expenditures related to the executive director position

Calendar year	Salary and benefits	Bonus	Other	Grand total
2006	\$38,394	\$1,000	\$366	\$39,760
2007	\$85,775	\$0	\$1,920	\$87,695
2008	\$94,364	\$5,000	\$1,223	\$100,587
2009	\$69,521	\$5,000	\$1,922	\$76,443
Total	\$288,054	\$11,000	\$5,431	\$304,485

The auditee structured the executive director’s position as an employee of the project, which operated under a 1-year employment contract, subject to renewal.² The employment contract included an exhibit which detailed the duties expected of the executive director. Auditee officials maintained that such a position was needed due to the complex issues facing the development. However, analysis of these duties (see appendix C) disclosed that most of them were responsibilities that might normally be expected of the management agent and/or the board of directors and were tasks for which the owners contracted with other entities or that were not performed by the incumbent.

For instance, the functions assigned to the executive director to oversee the management of all residential and commercial benefits, including admissions, in-house moves, studio, gallery, and community spaces, as well as managing the day-to-day operations of the development are functions normally expected of a management agent. The Project Owner’s/Management Agent’s Certification (form HUD-9839-B) provides that, among other duties, a management agent selects and admits tenants, computes tenant rents and assistance payments, recertifies tenants, and performs other subsidy contract administration responsibilities in accordance with HUD regulations. In addition, while the executive director was expected to develop and execute a strategic plan for the project’s future, auditee officials enlisted a consultant to develop a detailed guide outlining future possibilities for the development. Further, while fundraising was a duty assigned to the executive director’s position, the current executive director said that he had not engaged in any fundraising activity.

**Costs of the Executive Director
Not Accurately Classified**

HUD Handbook 4370.2 provides that office salaries should be recorded under administrative expenses; however, \$85,775 of the \$304,485 in costs associated with the executive director’s position were misclassified in the calendar year 2007

² This arrangement complies with HUD regulations because, while the regulatory agreement, paragraph 7(i), prohibits the owners from paying any compensation or making any distribution of income or other assets to any of its officers, directors, or stockholders, such prohibition does not extend to an employee, which was the status of the executive director.

financial statements filed with HUD. This statement did not present an accurate accounting to HUD of how project funds were being expended and may have caused HUD to not be aware of the extent to which expenses were being paid for an executive director. For instance, the \$85,775 paid in 2007 as executive director compensation was reported as an operating and maintenance expense. In addition, the bonuses paid to the current executive director in 2008 and 2009 were reported as miscellaneous office expenses. When HUD became aware, through disclosure in the project's 2009 budget-based rent application, that funds were being allocated to the executive director's position, it disallowed the expense as a factor in determining the allowed rent because the development already had a management agent.

Costs of the Executive Director Paid From Arbitration Funds

The costs for the subject expenses were paid from funds awarded through arbitration relating to an easement through the project property. The award was compensation for damage to property owned by the project due to the failure of the easement grantee to meet certain maintenance obligations. The project owners deposited these funds into a segregated bank account administered by the owners and not the management agent. Auditee officials believed that these funds were not subject to HUD regulation because the funds were neither generated from the project's business of providing housing nor from property subject to the project mortgage. However, guidance from HUD's Regional Counsel concluded that the award of these funds did relate to the project, which is subject to the HUD-insured mortgage and, therefore, should be regarded as project income.

Funds Expended for Inadequately Supported Costs

Section 10(c) of the regulatory agreement provides that the books, contracts, records, documents, and other related papers must be maintained in reasonable condition for proper audit and subject to examination and inspection by HUD or its duly authorized agents. However, auditee officials lacked adequate support to substantiate \$28,351 disbursed from project funds for legal and consulting costs. For example, auditee officials expended \$12,445 for legal services without an invoice or written documentation of the service performed and \$9,501 for consulting services related to mission and planning work, for which there was no written report or other documentation of the benefits received. This condition occurred due to weaknesses in financial management controls. As a result, auditee officials lacked assurance that \$28,351 in project funds was properly supported in accordance with HUD regulations.

Funds Expended for Unnecessary Costs

Section 7(b) of the regulatory agreement requires that project funds be used only for reasonable operating expenses and necessary repairs. Auditee officials expended \$7,030 for three events that were deemed unreasonable and unnecessary. In the first instance, \$5,773 was expended for food and liquor at a reception held for the executive director hired in 2006; in the second instance, \$1,110 was expended for food, liquor, and a gift for a security guard's retirement party; and in the third instance, \$147 was expended for food for a board meeting. This condition occurred because of auditee official's unfamiliarity with HUD regulations. As a result, \$7,030 in project funds was unnecessarily used for nonproject- or housing-related expenses.

Ineligible Expenses

Auditee officials expended \$37,650 from project funds for the following ineligible expenses:

- \$31,840 for commercial leasing brokerage commissions,
- \$5,000 for legal fees associated with the selling/refinancing of the property,
- \$510 for legal fees associated with establishing a related nonprofit fundraising entity, and
- \$300 to purchase a personal item from a tenant.

Auditee officials explained that the \$31,840 brokerage commission was compensation for leasing the project's commercial space. However, paragraph 1(b) of the project owner's/management agent's certification requires that the agent manage the project for the term and fee described on the certification and that fee changes be made only with HUD approval. HUD officials further stated that a fee for commercial space leasing can be earned but only if approved by HUD as a special fee documented in the project owner's/management agent's certification. Nevertheless, no such approval was requested. The legal fees and personal item are not project-related expenses but are owner and tenant expenses, respectively. These conditions occurred due to auditee official's unfamiliarity with HUD regulations. Consequently, the project was deprived of \$37,650 that was spent on these ineligible items.

Prudent Procurement Practices Not Followed

Auditee officials did not always solicit written or verbal cost estimates or execute written contracts as required by HUD regulations and the auditee's own policy. HUD Handbook 4381.5, REV-2, section 6.50(a), provides that when an owner/agent contracts for goods or services, an agent is expected to solicit written cost estimates from at least three contractors or suppliers for any contract or ongoing supply or service that is expected to exceed \$10,000 per year. Section 6.50(b) provides that for any contract or ongoing supply or service estimated to cost less than \$5,000 per year, the agent should solicit verbal or written cost estimates, to ensure that the project obtains services, supplies, and purchases at the lowest possible cost, and should make a record of any verbal estimates obtained. Additionally, section 6.50(c) prescribes that documentation of all bids should be retained as part of the project records for 3 years following the completion of the work. In addition, the management agent's bidding procedures require the purchasing department to bid purchase requisitions for all services/materials in excess of \$2,000 and any individual item costing more than \$1,000.

Of 18 procurement actions reviewed, there was no evidence of written solicitations or verbal cost estimates for 15 actions or that a written contract had been executed in 3 cases. For instance, an architect was hired for \$1,540, and services were procured to perform lead paint clearance testing for \$21,658 without evidence that written or verbal cost estimates were obtained or that a written contract was executed. Without soliciting cost estimates and documenting work expected via a written contract, auditee officials lacked assurance that the most economical and efficient price was obtained for these services.

Conclusion

While the project is a complex operation that faces major challenges which may warrant approval of special management fees, the use of project funds for an executive director was not adequately supported as not being duplicative of other services obtained. In addition, weaknesses existed in the financial management and procurement controls of the project. These weaknesses occurred because of the project owners' unfamiliarity with HUD regulations. Consequently, the project owners incurred unsupported, unnecessary, and ineligible expenses and did not administer procurement controls in accordance with HUD regulations. Therefore, the auditee lacked assurance that project funds were expended for reasonable and necessary costs, thus depriving the project of funds to pay for necessary expenses.

Recommendations

We recommend that the Director of the HUD New York Office of Multifamily Housing instruct auditee officials to

- 1A. If the arbitration award funds are deemed subject to HUD regulation, provide justification for the \$304,485 expended for an executive director's position and, if adequate justification is not provided, reimburse the project from non-Federal funds.
- 1B. Provide adequate documentation for the \$28,351 in unsupported expenses and, if adequate documentation cannot be provided, reimburse the project from non-Federal funds.
- 1C. Reimburse the project from non-Federal sources the \$7,030 in expenses deemed unreasonable and unnecessary.
- 1D. Reimburse the project from non-Federal sources the \$37,650 expended for the ineligible costs.

SCOPE AND METHODOLOGY

The review focused on addressing whether the project inappropriately used funds to pay an executive director and generally complied with HUD regulations pertaining to financial and procurement processes. To accomplish the objectives, we

- Reviewed the regulatory agreement executed between HUD and the project owners in 1968; HUD Handbooks 4350.3, REV-1, 4370.2, REV-1, 4381.5, REV-2, which serve as guidance for the administration of projects such as the auditee; the loan sales agreement executed by HUD in 2009; and the project owner's/management agent's certifications approved by HUD on March 17, 2006, May 2, 2007, and April 18, 2008.
- Reviewed the project's corporate by-laws, board meeting minutes, executive director's employment contract, and procurement policy for the audit period to determine whether project policies complied with HUD regulations.
- Interviewed HUD Office of Multifamily Housing field office, Enforcement Center, and Regional Counsel staff to identify and obtain guidance on issues pertaining to the project.
- Interviewed management agent and independent public accountant officials to obtain an understanding of the project's management controls and procedures.
- Analyzed the project's audited financial statements and applicable financial records, including general ledgers, check registers, bank statements, expenditure vouchers, and supporting documentation for the audit period, to gain an understanding of the project's financial operations.
- Obtained an understanding of the management agent's structure and reviewed the organizational chart and duties of the project staff.
- Selected a sample of five Section 8 program tenant files to test whether the project properly recertified and determined tenant eligibility in accordance with HUD regulations.
- Selected a sample totaling \$281,536, or 32 percent, of reported expenditures for professional fees and administrative, operating, and maintenance supply costs incurred during the audit period to assess compliance with HUD regulations.

The audit period was from January 1, 2006, through June 30, 2008, and was expanded when necessary. We performed audit fieldwork from June through October 2010 at the project located at 463 West Street, New York, NY, and at the management agent's office located at 902 Broadway, New York, NY.

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

INTERNAL CONTROLS

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

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

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

Relevant Internal Controls

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

- Effectiveness and efficiency of operations: Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.
- Reliability of financial reporting: Policies and procedures that management has in place to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.
- Compliance with applicable laws and regulations: Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations and its procurement practices comply with HUD requirements.

We assessed the relevant controls identified above.

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

Significant Deficiency

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

- Auditee officials lacked adequate controls to ensure the reliability of financial reporting and compliance with HUD regulations when they did not maintain documentation to support expenses and disbursed funds for unsupported, unnecessary and unreasonable, and ineligible expenses. In addition, auditee officials did not comply with HUD's and its own procurement regulations.

APPENDIXES

Appendix A

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

Recommendation number	Ineligible 1/	Unsupported 2/	Unreasonable or unnecessary 3/
1A		\$304,485	
1B		28,351	
1C			\$7,030
1D	<u>\$37,650</u>	_____	_____
Total	<u>\$37,650</u>	<u>\$332,836</u>	<u>\$7,030</u>

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.

3/ Unreasonable/unnecessary costs are those costs not generally recognized as ordinary, prudent, relevant, and/or necessary within established practices. Unreasonable costs exceed the costs that would be incurred by a prudent person in conducting a competitive business.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

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February 14, 2011

Mr. Edgar Moore
Regional Inspector General for Audit
New York/New Jersey Region, 2AGA
U.S. Department of Housing and Urban Development
26 Federal Plaza - Room 3430
New York, New York 10278-0068

Re: Westbeth Corp. Housing and Development Fund, Inc. ("Westbeth")

Dear Mr. Moore:

We are writing in response to your Draft Audit Report 2011-NY-100X, dated January 21, 2011 ("Draft Findings"), in which you described certain matters considered by your audit team during its inspection of Westbeth's records. We are taking this opportunity to address each of your findings and to hopefully provide some additional information that will assist in their resolution. We apologize in advance if some of the information is duplicative of that already submitted to HUD. However, we differ on several, if not all of the points contained in your draft findings, and believe that, upon review, the information provided below will be the basis on which your conclusions can be modified. Please note that your Draft Findings present serious matters that require comprehensive responses.

Finding 1: Financial Management and Procurement Controls Did Not Always Comply with Regulations

1. Background Surrounding Westbeth's Hiring of the Executive Director

As set forth more fully below, the controlling New York case law and statutory authority demonstrate that Westbeth properly created the position of Executive Director, that there are no United States Department of Housing and Urban Development ("HUD") prohibitions against paying a salary or other benefits to an "Executive Director" of a corporation, and that the compensation paid is not otherwise objectionable as constituting an improper, excessive or wasteful expenditure of corporate funds. Moreover, Westbeth's Board of Directors was entirely

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Comment 1

within its rights, and in fact had a duty to create the Executive Director's position. In doing so, Westbeth did not violate the Regulatory Agreement between Westbeth and HUD or any state law, and HUD has conceded that no specific statute, regulation or policy was violated.

Westbeth, the world's largest artist community, is a not-for-profit corporation that serves as a community and city-wide center for the arts and provides housing to low- and middle-income artists. It is organized under and governed by the New York Not-for-Profit Corporation Law, and is overseen by a volunteer Board of Directors, whose members are not compensated for their time or work, but sit on the Board of Directors out of their dedication to Westbeth and what the project represents.

The original financing of the project included participation in the mortgage insurance program under Section 221(d)(3) of the National Housing Act of 1961, as amended by 12 U.S.C. §1715l (d)(3)¹. The 221(d)(3) program was established to encourage the production of housing for low- and moderate-income families, and in Westbeth's case low- to moderate-income artists and their families. In exchange for the mortgage insurance, Westbeth entered into a Regulatory Agreement with HUD, by which HUD oversaw the general operation of the corporation, including approving its budget and determining its residential rents.²

Comment 3

HUD's involvement pursuant to the 221(d)(3) program terminated in August 2009 when it sold the note and mortgage (which it had acquired in 1975) and assigned the Regulatory Agreement to the New York City Housing Development Corp. ("HDC"). Under the terms of the assignment, HDC, and not HUD, "will continue to be responsible for the monitoring and enforcement of the terms of the Regulatory Agreement.."

It is an extremely unique and complicated project in that Westbeth owns and operates both the residential and commercial portions of the building. Despite the fact that commercial rent income provides much of the additional funds necessary to meet Westbeth's operational expenses, it has always been Westbeth's primary mission to promote the arts. It has been the creative home to Merce Cunningham, Gil Evans, Diane Arbus and Moses Gunn, to name a few. Vin Diesel was born at Westbeth. Westbeth includes performing and visual arts studios; a gallery; theaters; film, photography, and recording studios; a communal print shop; sculpture video; and a community space used for performances, concerts, lectures, videos and meetings of community groups.

Comment 2

¹ The program under which the audit was conducted, Section 221(d)(3) of the National Housing Act, is, as the auditors note, an insurance program under which the Secretary insures a private-market mortgage, enabling the owner to obtain a below-market interest. In the 1980s, the Secretary assumed the note and mortgage and became, in effect, the mortgagee. At no time has Westbeth received any funds through the 221(d)(3) program. The auditors' notion that Westbeth "reimburse" HUD the sums noted in its report is therefore fallacious because no funds were advanced.

² Westbeth also receives a subsidy in the form of a real-estate tax abatement from the City of New York, and has 77 residential units that participate in the Section 8 rent-subsidy program, also overseen by HUD.

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Westbeth, as a federally regulated non-profit artists' residence, has had a complex and contentious existence since it was converted 40 years ago from the Bell Laboratories industrial buildings to a landmark center for the arts. Since its inception, its unpaid and volunteer Board of Directors have worked tirelessly for the benefit of Westbeth. During the last ten years, the Board of Directors has constantly had to balance maintaining affordable rents against insuring the integrity of the structure of the building, including the roofs, windows and elevators. The Board of Directors has also had to factor in the rising prices for fuel, energy, electricity, supplies, wages, and taxes, all of which impact Westbeth as well as its unique regulatory and financing issues. In addition, the Board of Directors has had to make its decisions based upon the long-term well being of Westbeth rather than the residents' immediate preferences in order to preserve Westbeth's primary art mission for future generations.

Comment 4

In 2006, Westbeth came to the decision to restore the office of Executive Director.³ As has been explained numerous times in the course of this audit, Westbeth is an unusual, if not unique, institution. Its mission entails not only providing remarkably inexpensive housing for practicing artists but providing space for arts institutions to grow and flourish, while it operates in an environment regulated by not-for-profit law and HUD regulations.

Comment 5

In 2007, a fundamental issue arose regarding how to assist the Board of Directors in making decisions with a view toward the long-term well-being of Westbeth while at the same time protecting the residents from the pressures of real estate development and the changes that were taking place throughout the West Village at the time. The impetus was the fact that Westbeth's mortgage was expiring in July 2011 and the Board of Directors needed to devise a five-year plan ("Five Year Plan") to facilitate Westbeth's period of significant transition. As was previously submitted, Westbeth engaged the Community Resource Exchange, a respected advisor to not-for-profit organizations in New York City, to assist it in dealing with the significant challenges facing Westbeth. With the help of the Community Resource Exchange, the Board of Directors formulated a series of goals for Westbeth including:

- extending its New York City real estate tax abatement (or face a trebling of its real estate tax payments, threatening its fiscal solvency);
- financing required for capital renovations and improvements;
- establishing relationships with regulatory agencies supportive of the corporation's goals;
- achieving financial stability and sustainability;
- improving communications with tenants and addressing the issues presented by an aging population;
- beginning overall planning to ensure the viability of the arts-oriented portion of the corporation's mission;
- devising a master plan to maximize the use and value of the corporation's physical plant;

Comment 4

³ Westbeth previously had an Executive Director through the 1970's.

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- finding means to strengthen and sustain the board of directors itself, including determining how to oversee the building management team, various advisors (including those related to the legal, fiscal, engineering and community and public relations aspects of the corporation's activities); and
- Handling legal issues and some in-house legal work.

Comment 5

The complexity of these tasks forced the Board of Directors to rethink its concept of what an Executive Director's role should be. The Board of Directors came to the decision that the complexity of the regulatory scheme and financing issues, among other things, warranted the full time dedication of an Executive Director. This decision was based in part, on the fact that none of the tasks fell within the scope of the duties of the Management Company and therefore there was no person or entity who could actually facilitate the Five Year Plan. It should be noted that to date, the Executive Director has accomplished most, if not all, of the goals established by the Board of Directors.

Comment 6

Accordingly, Westbeth strongly disagrees with HUD's Draft Findings regarding this issue. The Executive Director has, in fact, worked with the Board of Directors to develop a strategic plan for Westbeth's future which included working with the Community Resource Exchange. There is no statute or regulation which would require the Board of Directors to accomplish this feat on its own, nor is there anything in the By-Laws which would prevent the Board of Directors from retaining an Executive Director and outside consultants. In addition, although the Executive Director has not yet had the time or resources to actively engage in fundraising, that is one of Westbeth's long term goals.

Comment 7

Ironically, HUD Office of the Inspector General (OIG) auditors have failed to consider the fact that Westbeth has been dealing with governmental inquiries from the New York State Office of the Attorney General, the HUD field office, the HUD OIG, and other government entities almost non-stop for the last 10 years. Basically, as confirmed by the auditors at the exit conference, since Westbeth operates a housing operation with 384 tenants, any tenant at any time, with or without basis, can file a complaint with the HUD "hotline," despite the fact that HUD's jurisdiction ended in August 2009. As discussed at the exit conference, an Executive Director has been necessary simply to ensure regulatory compliance and to organize and respond to the various inquires and document requests of these overseers.

By way of example, in October 2009, despite the clear language of the agency's assignment granting all of HUD's oversight authority to the city Housing Development Corp., regardless of whether an action which might trigger an inquiry took place before or after the assignment, HUD's New York field office commenced an inquiry alleging "unauthorized project expenses" had been incurred prior to the assignment, expressly claiming that payment of an Executive Director violated the Regulatory Agreement's prohibition against paying "any compensation or mak[ing] any distribution of income or other assets to any of its officers, directors, or stockholders." (emphasis added) This inquiry was launched even though the "Executive Director" is not an officer of the corporation nor a member of its Board of Directors,

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and there are no shareholders in a not-for-profit corporation. The inquiry also included other queries about Westbeth's use of outside professional consultants and "miscellaneous expenses," all of which had been reported to HUD in Westbeth's 2006, 2007 and 2008 audited financial statements. Westbeth cooperated to the fullest extent possible, despite its belief that HUD lacked jurisdiction and all such inquiries should come from the current Regulatory Agreement party, the New York City Housing Development Corp.

Comment 8

In April 2010, eight months after HUD assigned the Regulatory Agreement to HDC, Westbeth was contacted by HUD OIG and advised that it intended to investigate Westbeth's compliance with the Regulatory Agreement (despite its assignment), as well as compliance with the Section 8 rent subsidy contract between Westbeth and HUD. Westbeth employees were told this inquiry was based on the receipt of an anonymous complaint to the HUD hotline, the nature and specifics of which HUD declined to share. Over the last 10 months, Westbeth again cooperated in good faith with the inquiry, despite the time, expense, and redundancy of this inquiry. It now appears, based on HUD's Draft Findings, that the OIG inquiry was merged with the field office investigation, which just added more cost to Westbeth and HUD. To the extent that addressing the issues raised by HUD OIG requires Westbeth to expend employee time and program funds, it hampers Westbeth's mission to provide the Westbeth community with quality affordable housing, and wastes money that could be better spent achieving that goal.

1A. Executive Director Position Not Adequately Supported

Comment 6

Included in its Draft Findings is a claim that the Executive Director's salary was "unsupported" because HUD's analysis of these duties disclosed that most of them were responsibilities that might normally be expected of the Management Company and/or the Board of Directors and were tasks for which the owners contract with other entities or that were not performed by the incumbent." (Emphasis added.) Attached to the Draft Findings, as Appendix C, is a chart depicting the duties of the Executive Director, taken from Westbeth's job description for the position, which is labeled HUD's "Analysis of Executive Director Functions." The chart contains separate columns for the duties HUD supposedly "expected" of a Management Company and duties of Boards of Directors (and one for duties not performed). As a threshold matter, Merriam-Webster Dictionary defines the word "might" as (the past tense of may) "used to indicate possibility" and the word "expected" as "to anticipate or look forward to the coming or occurrence of." It is thus the auditors' position that since there was a possibility that the Management Company or the Board of Directors might perform these duties, an Executive Director was unnecessary. However, the auditors' logic is completely flawed for numerous reasons.

Comment 9

First, [REDACTED] the HUD OIG auditor who performed this investigation, confirmed at the exit conference that this "analysis" was not based on anything in the Regulatory Agreement, nor could he provide any authority for HUD's conclusion that only the Board of Directors or Management Company should perform the listed functions. [REDACTED] further admitted that there was nothing in any statute, regulation, HUD Handbook or policy directive to support the "analysis." Instead, [REDACTED] stated that his analysis was based solely upon his reading of the duties and responsibilities set forth in the Management Agreement and the Westbeth By-Laws.

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Comment 9

████████ analysis is not only unsupported, but it is also incorrect. Absent specific limitations, the By-Laws are simply the general governing document for a corporation. Under New York State law, there are no set criteria for the contents of By-Laws, but they typically set forth the internal rules and procedures.

Second, Westbeth's By-Laws allow for the delegation of duties to an Executive Director. Article III specifically states that the:

'Board of Directors shall have full power to manage and control the affairs of the Corporation.'

Comment 10

There is no restriction or prohibition on the Board of Directors of any kind as to how they, in their good faith judgment, manage and control Westbeth. In light of the foregoing language, the Board of Directors has the authority to delegate his duties to an Executive Director. Where By-Laws are silent as to specific duties, they do not act as a limit on corporate governance. *Kirsch v. Holiday Summer Homes, Inc.*, 143 A.D.2d 811, 812 (2d Dep't 1988) (granting summary judgment to a housing cooperative's Board of Directors and holding that the Board's decisions fell within the protections of the Business Judgment Rule); see *Brodsky v. Board of Managers of Dag Hammarshjold Tower Condominium*, 1 Misc. 3d 591, 594-95 (N.Y. Sup. Ct., N.Y. Cty 2003) (holding that where By-Laws are "completely silent," courts will defer to the general rule requiring "fairness and good faith"); see also, *Board of Managers of the First Avenue Condominium v. Shandel*, 143 Misc. 2d 1084, 1087 (N.Y.C. Civ. Ct. 1989) ("Absent a showing of fraud, self-dealing or a violation of the bylaws the courts will not interfere with the business judgment of the Board with respect to its management or maintenance of the building.") (citing *Schoninger v. Yardarm Beach Homeowners' Assn.*, 134 A.D.2d 1 (2d Dep't 1987)).

In *Kirsch*, the Second Department noted that "[The] court's inquiry is limited to whether the board acted within the scope of its authority under the bylaws and absent a showing of fraud, self-dealing or unconscionability, will not call into question the wisdom or soundness of the business decision." (Emphasis added.) *Kirsch*, 143 A.D.2d at 812. In *Brodsky*, the New York Supreme Court recognized that in the absence of an "express regulation or bylaw", a board requirement regarding voting by proxy would be upheld. *Brodsky*, 1 Misc. 3d at 594.

Simply stated, in New York corporate directors and officers are entitled to act without being, in essence, "second guessed" by courts and other supervisory authorities as to the decisions they make in good faith as corporate officers.

The New York Court of Appeals defines the Business Judgment Rule, as it applies to corporate governance and management, in saying it:

bars judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes. 'Questions of policy of management,

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expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to their honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient' (*Pollitz v Wabash R. R. Co.*, 207 NY 113, 124.) (Emphasis added.) *Auerbach v. Bennett*, 47 N.Y. 2d 619, 629, 419 N.Y.S. 2d 920 (1979).

The Court went on to state:

the authority and responsibilities vested in corporate directors both by statute and decisional law proceed on the assumption that inescapably there can be no available objective standard by which the correctness of every corporate decision may be measured, by the courts or otherwise. Even if that were not the case, by definition the responsibility for business judgments must rest with the corporate directors; their individual capabilities and experience peculiarly qualify them for the discharge of that responsibility. Thus, absent evidence of bad faith or fraud (of which there is none here) the courts must and properly should respect their determinations.

Id.

The Business Judgment Rule is also applicable to the decisions made by corporate officers under the N-PCL, both by the terms of the statute and judicial decisions, as demonstrated in an action brought by the state Attorney General to challenge the compensation the board awarded the chairman and chief executive officer of the New York Stock Exchange when the exchange was a not for profit corporation. While the action was dismissed on other grounds, the Court in *Grasso* applied the Business Judgment Rule to limit the authority of the Attorney General to challenge decisions made by Directors of not for profit corporations pursuant to N-PCL§ 717. *People v. Grasso* 11 N.Y. 3d 64, 70, 862 N.Y.S. 2d 828 (2008).

It is well established law that the management of a not-for-profit corporation in New York is delegated to its Board of Directors. N-PCL§701 (McKinney's 2010). A board's decision in authority in that capacity are entitled to the presumptions and protections of the "Business Judgment Rule" as codified in N-PCL§717 (McKinney's 2010). See, *Consumers Union v. State of New York*, 806 NYS 99 (2005).

Section 717(a) states:

[d]irectors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions."

Comment 11

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Comment 11

From the clear wording of N-PCL§717, the only duty imposed by law on a Board of Directors is that it exercises good faith, diligence, care, and skill which ordinary prudent men would exercise under similar circumstances in the performance of its duties. *Gillman v. Pebble Cove Home Owners Assoc., Inc.*, 154 A.D.2d 508, 508-09 (2d Dept' 1989) ("In reviewing the reasonableness of the board's exercise of its rule-making authority, 'absent claims of fraud, self-dealing, unconscionability or other misconduct, the court should apply the business judgment rule and should limit its inquiry to whether the action was authorized and whether it was taken in good faith and in furtherance of the legitimate interests' of the corporation."); *see also People v. Lawrence*, 74 A.D.3d 1705, 1707 (4th Dept 2010) (citing N-PCL§717 and rejecting the contention that "respondents [director and officers] acted in bad faith" where respondents submitted evidence through By-Laws that the Board of Directors had authority to expend funds) ("Because officers of a not-for-profit corporation are protected by the business judgment rule, liability requires a showing that the officer or director lacked good faith in exercising duties").

In *Gillman*, the Second Department recognized that, "[p]ursuant to the bylaws of the defendant corporation, the board of directors has broad authority to enact reasonable rules and regulations." *Gillman*, 154 A.D.2d at 508. The court granted summary judgment to the defendant corporation because there was no "evidence in the record" that the Board's "regulations are unreasonable or that they were enacted by the board of directors in bad faith."

Similar to the By-Laws of the corporation in *Gillman*, Article III of Westbeth's By-Laws specifically grants the Board of Directors of Westbeth broad authority to manage the affairs of the corporation: "The Board of Directors shall have full power to manage and control the affairs of the Corporation."

Additionally, Section 6.2 of Westbeth's By-Laws provides for indemnification of officers and directors as long as

"such Director or officer acted in good faith, for a purpose and in a manner which such Director or officer reasonably believed to be in the best interest of the Corporation and where such Director or officer had no reasonable basis for believing was unlawful."

Comment 12

In the present case, the Westbeth Board of Directors decided that the interests of Westbeth would best be served by reestablishing the post of Executive Director. The delegation of day-to-day operating authority is clearly proper as a matter of law and is in accordance with Westbeth's By-Laws. "Although the law clearly places authority and responsibility for managing corporate affairs in the Board of Directors, neither law nor custom in the United States has looked to the directors, as such, to carry on the day-to-day business of the corporation." 6-7 *White, New York Business Entities P N712.01, see also 14A NY Jur Business Relationships* §596 "In addition to the delegation of authority to committees, the directors may . . . appoint the

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necessary agents to carry on the ordinary business of the corporation and delegate authority to them in such respect; this is true whether the person so appointed or clothed with authority was theretofore a member of the Board of Directors, or an officer or agent of the corporation, or a stranger, whose action within the scope of his or her authority will now bind the corporation."

The appointment, employment and compensation of an Executive Director is not open to challenge absent a showing that the Westbeth board did not act in good faith in creating or employing an Executive Director or in setting the director's compensation (See *People v. Grasso*, 11 N.Y.3d *supra*, at 71). This is all the more so where the agency cannot show any violation of a statute, regulation, or policy, or of the Regulatory Agreement itself, limiting the board's discretion to administer its assets (even were the issue properly reviewable by HUD).⁴

Furthermore, the OIG's analysis of the Executive Director's 'expected' duties clearly establishes that while the auditors may be well versed in their discipline, they are not front line or operational supervisory personnel with the experience necessary to understand the issues involved in this audit. The position of the Executive Director was reinstated, in part, to fill in the gaps between the contractual duties and actual duties that Westbeth needed to be performed.

The list below reflects the duties that the auditors have decided 'might normally be expected to be performed by the Board of Directors' (Appendix C to Draft Findings). These are duties that are not contractually assigned to the Management Company or any outside consultant, nor are they enumerated in Westbeth's By-Laws. In reality, and contrary to the auditors' unsubstantiated claim of what 'might normally be expected,' the Executive Director performs these duties and then reports to the Board of Directors which is allowable under Westbeth's By-Laws. The following items listed on HUD's 'Analysis of Executive Director Functions' chart are performed by the Executive Director:

⁴ In addition, HUD regulations do not imply or otherwise pre-empt state law regarding the Business Judgment Rule. It is recognized under the Supremacy Clause of the United States Constitution (U.S. CONST., art VI, cl [2]), that federal law will preempt state law only where Congress intends to do so, either explicitly, or implicitly if: (1) federal legislation is so comprehensive in scope that it can be inferable that Congress intended to occupy the "field" of its subject matter, such that no room for additional state regulation exists; or (2) federal law and state law are in direct conflict. *Perez v. Mini-Max Stores*, 231 A.D.2d 162, 163 (2d Dep't 1997) (declining to find preemption).

There is an established presumption in New York against a finding of federal preemption. The New York Court of Appeals recognizes that "Congress does not intend to supplant State law, and a claim traditionally within the domain of State law will not be superseded by Federal law" "unless that was the clear and manifest purpose of Congress'." *Nealy v. US Healthcare HMO*, 93 N.Y.2d 209, 217 (N.Y. 1999) (declining to find preemption of state law). In *Rollin*, the First Department recognized that "[a] finding of 'preemption of State law by Federal statute or regulation is not favored.'" *Rollin v. Frankel & Co.*, 290 A.D.2d 368, 369 (2d Dep't 2002) (holding preemption under a federal scheme inapplicable and stating that the movant in that case "did not present grounds to overcome this judicial disinclination").

HUD has failed to identify any controlling federal law by which Congress intended to preempt New York's Business Judgment Rule. In fact, by [redacted] own admission at the exit conference, there is no controlling statute or HUD regulation with respect to Westbeth's governance. Because it is HUD's burden to rebut the disinclination against preemption in New York, the Business Judgment Rule must stand.

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- 3 - Liaison between onsite and offsite property management office and board of directors;
- 4-Review Property Management and Fiscal Reports;
- 5-Oversee Property Manager's compliance with regulatory and licensing authorities;
- 6-Oversee the development and adherence to operational and capital improvement budgets with fiscal officer, property management office, and finance committee;
- 8-Liaison with tenant organizations and oversight of contractual obligations, risk management and communications;
- 9-Represent and promote Westbeth to external stakeholders;
- 10 - Ensure that all materials representative of Westbeth, reflect a high level of professionalism; and
- 11-Develop the organization's annual fundraising strategy.

Comment 13

The auditors' also rely on the Management Agreement for guidance regarding the duties which "might normally, be expected to be performed by the Management Company" (none of which are listed above). However, they failed to consider Section 1.5 of the Management Agreement which explicitly sets forth the services that the Management Company does not provide. Section 1.5 of the Management Agreement provides:

- (v) Agent's services under this Agreement shall specifically not include the performance of any actions relating to any of the following ("Exclusions"):
 - (1) Certiorari, real estate tax exemptions or abatements;
 - (2) Matters concerning construction, rehabilitation, demolition, financing, or refinancing of any of the Project including, but not limited to, supervision of contractors, architects, and other professionals involved in any of the Project's construction or post-construction aspects, guarantees, warranties, delay claims, mortgage financing or closings, original installation of utilities, or any items contained on construction punch lists;
 - (3) Supervising professional services, including auditing services, although Agent shall cooperate with such professionals;
 - (4) Unless specifically requested by the Owner, the establishment of any insurance programs for the Project or with respect to Owner's other risks or exposures;
 - (5) Supervising the installation or maintenance of telephone or cable television services, although

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- Agent shall cooperate with the providers of such services;
- (6) Acting as Owner's construction representative in the event that extraordinary repair or maintenance of mechanical system or capital work is needed. Agent shall, at Owner's request, assist in identifying and contracting with consultants and professionals to perform such work and shall assist the Owner and its representatives in facilitating the conduct of such work in the Project;

The aforementioned services—which are exempt from the Management Agreement—are also duties that are performed by the Executive Director. Notwithstanding the foregoing, without any basis, the auditors have simply decided in their “Analysis of Executive Director Responsibilities” that any duties not attributable to the Management Company must fall within the purview of the Board of Directors. Interestingly, the OIG provides no support or any authority for its conclusion that these are duties that “might normally be expected” of the Board of Directors.⁵

Had the auditors taken their analysis to the logical conclusion, they would have seen from a comparison of the list of duties assigned to the Executive Director's position against the duties of the Management Company set forth in the Management Agreement and the By-Laws that a gap existed in the responsibilities that needed to be filled in order to properly manage and operate Westbeth. Thus, the Board of Directors' good faith decision to reestablish the position of Executive Director was prudent and necessary.

More importantly, as discussed during the exit conference, the position of Executive Director has provided Westbeth with substantial value, far in excess of the economic cost of the salary and benefits paid to the Executive Director.⁶

A comparison between the salary and benefits paid to ██████████ and similar compensation packages paid to the Executive Directors of other not-for-profit entities in the New York area shows both that it is customary for Nonprofit Housing Corporations in New York City to appoint

⁵ In previous conversations, the auditors admitted that their issue with Westbeth's allocation of responsibilities between itself, its Executive Director and its hired agents and consultants had no basis. While there may be a body of knowledge in the HUD OIG concerning how projects are “normally” run, it is difficult for Westbeth to respond to the auditors' claims regarding how it should perform its administrative, legal, and fiduciary duties under state law without knowing the basis for HUD's determination.

⁶ ██████████ among his other accomplishments as Executive Director, negotiated Westbeth's tax abatement, oversaw the budget rent increase, implemented strategic planning regarding zoning and development rights, helped prepare the 2009 and 2010 budgets, settled multiple litigations, and has been investigating future financing for Westbeth.

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Executive Directors and that the compensation packages offered to such Executive Directors are comparable to that paid to ██████████.

Here, ██████████ compensation package is comparable or less than that paid to other similarly situated executive officers in this region and, as is shown above, reflects the employment of an individual whose labors confer a substantial benefit to Westbeth. Accordingly, under applicable law, such an expenditure would not be subject to challenge by HUD and/or the Attorney General under the provisions of the N-PCL.

Comment 11

In short, the Business Judgment Rule precludes a challenge to ██████████ compensation package by HUD and/or the Attorney General in the absence of a showing that the Board did not act in good faith in setting such compensation. See, *People v. Grasso*, 11 N.Y. 3d, *supra*, at 71.

First, the decision of the Board of Directors of Westbeth to restore the office of the Executive Director is clearly within the purview of the Board's decision-making capacity under the By-Laws' broad grant of authority. Second, the Board's decision is consistent with the deference granted to the Board of Directors under the Business Judgment Rule. Third, as stated herein, the objective of the Westbeth Board in restoring the Executive Director post was to fill a clear gap in responsibilities left between the Management Agreement and the By-Laws. Finally, the compensation made to ██████████ as Executive Director is on par with comparable not-for-profit corporations. The Westbeth Board's desire to resurrect the position in order to advance its corporate purpose is clearly in good faith as well as in furtherance of Westbeth's legitimate interests. The Board's decision therefore warrants protection against scrutiny.

Comment 9

HUD OIG's "Analysis of Executive Director Functions" is, as the auditors have admitted, without any legal basis, and apparently is not even based on the agency's own auditing standards. While the auditors "might have expectations" of duties assignable to a Management Company or to a Board of Directors (albeit, we are not aware of the authority), they clearly have no legal or accounting basis for contradicting the otherwise valid business judgment of those charged with oversight of the corporation.

⁷ For example:

- The Fordham Bedford Housing Corp. employs an Executive Director at a total compensation package of \$153,939;
- The Highland Park Community Development Corporation employs an Executive Director at a total compensation package of \$122,585, and;
- Although not an Executive Director, Bailey House, Inc. employs a Chief Executive Officer at a total compensation package of \$190,620.

See *Nonprofit Comparables Assessor & Tax-Exempt Survey for Tax Exempt U.S. Entities, Comparable Peer Analysis*, attached hereto as Exhibit "A."

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Comment 14

1B. Costs of the Executive Director Not Accurately Classified

Preliminarily, there is no contention that Westbeth failed to record or report the Executive Director salaries in its annual audited findings with HUD. Instead, the auditors for the first time have alleged that the costs of the Executive Director were not accurately classified.

Westbeth disputes that its financial statements did not present an accurate accounting to HUD of how project funds were being expended. Westbeth further disputes that the inadvertent misclassification "may have caused HUD not to be aware of the extent to which expenses were being paid for on executive director." However, as discussed at the exit conference, Westbeth has offered to correct the classification error with REAC.

Comment 15

1C. Costs of the Executive Director Paid From Arbitration Funds

Westbeth disagrees with HUD's regional counsel's opinion that "the arbitration award flowed from property subject to the HUD insured mortgage and so was required to be placed into a project account." HUD was unable to cite any authority for this proposition and although we could not find anything in the HUD regulations directly on point either, we did find relevant information in the Regulatory Agreement, the mortgage title insurance, and the HUD Glossary.

As HUD is aware, in 2005, Westbeth successfully concluded litigation with the Consolidated Rail Corp. and the Rockrose Corp., under which it was awarded more than \$700,000 due to the defendants' failure to restore the old New York Central Rail Road easement through Westbeth's property. The Highline arbitration award was released from escrow in 2006 and placed in a segregated account by Westbeth. Thereafter, the Board of Directors created the position of Executive Director of Westbeth, and decided to use the Highline, nonproject funds, to pay for that position.

Section 14(c) of the original Regulatory Agreement defines "Mortgage Property" as "include[ing] all property, real, personal or mixed covered by the mortgage or mortgages securing the note endorsed for insurance or held by the Commissioner." HUD's mortgage was secured by the Westbeth building and property as collateral. The HUD Glossary defines "collateral" as security in the form of money or property pledged for the payment of a loan. Westbeth's property did not include the Highline Easement because it was not insured as part of the mortgagor's title insurance policy. Indeed, the Highline Easement was specifically exempt from that coverage. Thus, it could not possibly be considered "Mortgaged Property" under the Regulatory Agreement because it did not secure "the note endorsed for insurance." Nor was it collateral for the Mortgage and therefore HUD has no jurisdiction over either the Highline Easement or any funds derived from the Highline Easement. As such, the arbitration award cannot merely be considered project funds because HUD determines that the funds are nefariously "related" to the project.

It is also worth noting that pursuant to the HUD Glossary, an easement is defined as a "legal right" that gives someone other than the owner access to the property. This "legal right"

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belonged to New York Central Railroad and its various successors. If Westbeth had defaulted and HUD had foreclosed and sold the 'Mortgaged Property', the right-of-way would have survived for the benefit of Penn Central Railroad or Conrail (or Rockrose, after Conrail). Thus, since HUD did not insure the Highline Easement, the arbitration award did not flow from the property and cannot be considered project funds.

ID. Funds Expended for Inadequately Supported Costs

Westbeth disagrees with the HUD OIG finding that states that Westbeth lacked adequate support to substantiate \$33,093 disbursed from project funds for legal and consulting costs. In light of the fact that Westbeth was not provided with detail regarding this until after the exit conference, Westbeth's responses include additional documentation attached hereto in response to [REDACTED] detailed requests.

Comment 16

1. Account Number 8450 - LEGAL EXPENSES,
STEVEN LEVITT & ASSOCIATES, P.C., Paid 06/23/06, CK022027, \$12,444.88

Comment 17

A copy of the minutes from Westbeth's May 25, 2006 Board of Directors' meeting approving payment as well as copies of Steven L. Levitt & Associates, P.C.'s detailed time slip listing which comprised the \$12,444.88 invoice is annexed hereto as Exhibit 'B'.

2. Account Number 6301-0000 LEGAL FEES,
Post Month: 9/08, Trans Date: 8/31/08, Ctrl: P42751, Payee: STEVEN LEVITT &
ASSOCIATES, P.C., \$78,018.84.

The auditor stated that [REDACTED] from Phipps Houses Services, Inc. (PHSI), Westbeth's Management Company, was able to provide support for \$73,785.41, but has not provide the support for the remaining balance of \$4,233.43 (the difference between \$78,018.84-\$73,785.41)

Comment 18

The remaining amount of \$4,233.43 was part of a \$14,000 partial payment made by Westbeth on January 22, 2008 which was credited by Steven L. Levitt & Associates, P.C. to outstanding fees as follows:

1. \$4,233.43 to pay off the remaining balance of the February, 2007 invoice
2. \$9,059.41 as full payment of March, 2007 invoice
3. \$707.16 as partial payment of April, 2007 invoice

3. Account Number 6301-0000 LEGAL FEES,
Post Month: 9/08, Trans Date: 8/31/08, Ctrl: P42701, Payee: GUTMAN MINTZ BAKER &
SONNENFELDT P.C., \$5,373.77.

Comment 19

Copies of the schedules, checks and invoices are annexed hereto as Exhibit 'C'.

Ref to OIG Evaluation

Auditee Comments

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4. COMMUNITY RESOURCE EXCHANGE
Account Number 6310-0000 OTHER CONSULTING EXPENSE, Post Month: 9/08, Trans Date:
8/31/08, Ctrl: P42662, Payee: COMMUNITY RESOURCE EXCHANGE, \$5,650.50

Account Number: 8475 - CONSULTATION FEE, Transaction Date 11/2/07, CK023032,
\$3,850.00

Comment 20

Copies of the schedules, checks and invoices are annexed hereto as Exhibit'D'.

1E. Funds Expended for Unnecessary Costs

Comment 11

Westbeth disagrees with HUD's finding that the amount of \$7,030 was unnecessarily used for non-project or housing related expenses because the Business Judgment Rule precludes a challenge to the Board of Directors' decisions absence of a showing that the Board of Directors did not act in good faith. A copy of the November 16, 2006 Board of Directors' minutes approving the costs is annexed hereto as Exhibit'E'.

Comment 21

1F. Ineligible Expenses

Comment 11

Westbeth disagrees with HUD's finding that the amount of \$37,650 was used for ineligible non-project or housing related expenses because the Business Judgment Rule precludes a challenge to the Board of Directors' decisions absence of a showing that the Board of Directors did not act in good faith. Notwithstanding the foregoing, Westbeth submits the following:

\$31,840 for commercial leasing brokerage commissions:

Comment 22

The brokerage fee was inadvertently left off of the management certification that was submitted to HUD, but which is included on other HUD supervised properties that PHSI is the Management Company for. In equity, PHSI should not be punished because it is both the Management Company as well as the commercial broker. At the exit conference, the auditors acknowledged that if the commissions were paid to any other commercial brokerage firm in New York, this would be a non-issue. Brokerage commissions are not customarily governed by HUD so it seems unfair to penalize Westbeth because its Management Company also serves as its commercial broker which is not related to its management functions.

\$5,000 for legal fees associates with the selling/refinancing of the property:

Comment 23

The Westbeth Board of Directors is of the opinion that it would be negligent if Westbeth did not try to understand the post-HUD

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environment, and there is nothing else but project funds to pay for it.

\$510 for legal fees associated with establishing a related nonprofit fundraising entity:

These expenses were incurred to set up a not-for-profit entity for fund raising.

\$300 to purchase a personal item for a tenant:

This was a good will gesture by the Board of Directors which involved compensating a tenant for a bicycle pod (which the tenant had purchased) and which Westbeth determined was an "eye-sore" and removed from Westbeth's property.

Conclusion

Westbeth strongly disagrees with this conclusion for the aforementioned reasons as well as those set forth below:

1. The auditors fail to explain the basis of the recommendations.

The relationship between the Westbeth and HUD is governed by the Regulatory Agreement between the two parties. The only remedy contained in the agreement is in Paragraph 11 of the Regulatory Agreement, under which the Secretary can ask the current holder of the mortgage and note to declare a default in the mortgage. When asked for the basis of the recommendation that the Westbeth pay to HUD the same sums as it allegedly "misspent," the auditors replied that this recommendation was simply "HUD boilerplate" and could not supply any other authority in fact or law.

In addition, the auditors could point to no statute, rule, or handbook directive that gives HUD the right to require this reimbursement. Furthermore, HUD never advanced any funds to Westbeth under the 221(d)(3) program, and under the auditors' own analysis there are no "nonproject" funds with which to reimburse HUD.

Lastly, reimbursement implies that a party is being made whole. However, since HUD has not granted any funding to Westbeth, HUD would actually receive a windfall while the tenants who pay rent are penalized and deprived of funds that could and should be spent more productively.

2. The auditors failed to apply New York State Law.

HUD has failed to address the inherent conflict between the New York State Business Judgment Rule which expresses deference to board managerial decisions by examining the

Comment 23

Comment 3

Comment 24

**Comment 11
Comment 25**

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process of decision making (i.e.--whether it was it in good faith) and the HUD OIG auditors who only opine upon the result. Additionally, HUD OIG has not provided any authority which would allow HUD policy to preempt the New York Business Judgment Rule. We respectfully submit that this type of determination should be made at the Field Office level by personnel with legal experience and expertise.

Recommendations

Recommendation 1A:

Comment 5

Westbeth disagrees with recommendation 1A requesting further justification for the \$304,485 expended for an Executive Director's position and if justification is not provided, for reimbursement to HUD from non-federal funds.

Recommendation 1B:

**Comment 16
to 20**

Westbeth has provided further documentation to support the \$33,093 found to be inadequately supported.

Recommendation 1C:

Comment 21

Westbeth disagrees with recommendation 1C that Westbeth reimburse HUD from non-federal sources the \$7,030 in expenses deemed unreasonable and unnecessary.

Recommendation 1D:

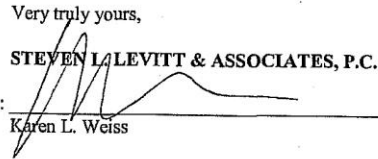
**Comment 22
to 23**

Westbeth disagrees with recommendation 1D that Westbeth reimburse HUD from non-federal source the \$37,650 expended for the ineligible costs.

Very truly yours,

STEVEN L. LEVITT & ASSOCIATES, P.C.

By:


Karen L. Weiss

KLW:rg
Enclosures

CC: Jack Harrison, Inspector, HUD-OIG
Steven L. Levitt, Esq.
Steve Neil, Executive Director, Westbeth
Matthew Russas, On-Site Property Manager

OIG Evaluation of Auditee Comments

- Comment 1** The issue is not whether the board of directors was within its rights to create an executive director position but, rather, whether the costs incurred for the executive director position were adequately supported and complied with section 7(b) of the Regulatory Agreement for Non Profit and Public Mortgagors Under Section 221(d)(3) of the National Housing Act, As Amended (FHA Form No. 1733), which provides that the project owners “shall not without the prior written approval of the Commissioner . . . pay out any funds, except for reasonable operating expenses and necessary repairs.” Therefore, payment of other than reasonable operating expenses or necessary repairs without prior HUD approval would violate the regulatory agreement executed between HUD and the project.
- Comment 2** Section 221(d)(3) of the National Housing Act insures mortgage loans to facilitate the new construction or substantial rehabilitation of multifamily rental or cooperative housing for moderate-income families, the elderly, and the handicapped, and the terms of the regulatory agreement executed between HUD and the project owners provide that project funds must be used to maintain the project and for reasonable and necessary expenses. Expenses incurred that are determined to not be reasonable and necessary are to be repaid to the project from nonfederal funds unless previously approved by HUD.
- Comment 3** Section 2.10 of the loan sale agreement provides that the assignment of the regulatory agreement from the seller (HUD) to the purchaser (Housing Development Corporation) shall not affect any right that the seller has to seek recourse for a breach of the regulatory agreement, which occurred before the closing date. Accordingly, after the closing date, the seller may pursue claims against any person who violated or caused a violation of the regulatory agreement, and any funds recovered in settlement of any such claim will be retained by the seller. In this case, any recovered funds should be repaid to the project from nonfederal funds.
- Comment 4** While no specific documentation was provided for the existence or removal of an executive director, it is reported in an oral history of Westbeth that the executive director position was eliminated in the 1970s based upon HUD’s conclusion that it was an unnecessary project expense. No documentation was found to evidence that the project had later sought HUD’s approval for an executive director position.
- Comment 5** While we acknowledge that Westbeth is a complex, if not unique, project, the project owners did not request that HUD reconsider its previous denial of an executive director position as being unnecessary, nor have any special fees or add-on fees been requested from HUD as allowed by HUD Handbook 4381.5, REV-2, sections 3.6 and 3.7, respectively. Analysis of the 15 functions assigned to the executive director position, as detailed in the incumbent’s employment contract, disclosed that many of the duties are those normally expected of others. For instance, while overseeing the management of all residential and commercial benefits, including admissions, in-house moves, studio space, gallery space, and community space, as well as managing the day-to-day operations of the

development, are functions assigned to the executive director position, these are functions expected to be carried out by the management agent. Further, a consultant was reportedly hired to develop a detailed guide outlining future possibilities for the project's development; however, the specifics of this plan or any other outcomes of this procurement were not provided during the audit. In addition, the incumbent stated that 5 of the 15 expected functions had not been performed. While no attempt was made to identify how much of the annual salary is attributable to each function, the costs incurred for the executive director position are considered unsupported since adequate justification for such a position has not been provided to HUD.

Comment 6 Analysis of the duties assigned the executive director position disclosed that many are functions assigned by contract or internal project operating procedures to other officials. For instance, the project owner's/management agent's certification provides that, among other duties, a management agent selects and admits tenants, computes tenant rents and assistance payments, recertifies tenants, and performs other subsidy contract administration responsibilities in accordance with HUD regulations. In addition, Westbeth's by-laws assign the president general supervision over the affairs of the project. Accordingly, OIG's analysis was not based upon the possibility that others might perform duties assigned to the executive director position but, rather, that others were officially tasked with these duties. Consequently, the potential duplication of duties and prior and current HUD disapproval of an executive director position as unnecessary leads to a conclusion that the position is inadequately supported.

Comment 7 As mentioned previously, section 2.10 of the loan sale agreement, dated August 26, 2009, between HUD (the seller) and the New York City Housing Development Corporation (the purchaser) specifies that "the assignment of the Regulatory Agreement from the Seller to the Purchaser shall not affect any right that the Seller may have to seek recourse for a breach of the Regulatory Agreement, which occurred prior to the Closing date." The OIG review was initiated under this authority, and that is why any findings or recommendations from that review do not extend beyond August 26, 2009, the date of the sale, at which time HUD's financial interest in the property ended.

Comment 8 Project and management agent officials were advised of the nature and specifics of the complaint at the May 14, 2010, entrance conference. At that time, OIG stated that the review was initiated as a result of a complaint to the OIG hotline and a HUD field office request, both of which related to payment for an executive director, and that the complainant's name would remain anonymous. Further, auditee officials have a fiduciary responsibility to address the complaint allegation.

Comment 9 The OIG analysis was based upon and supported by a review and comparison of the duties assigned to the executive director's position as documented in the employment contract for the position, the functions assigned to the management agent according to the project owner's/management agent's certification, and the board of directors' responsibilities as noted in Westbeth's by-laws. These three documents are the authority upon which the analysis was based. Further, the

regulatory agreement, as mentioned in comment 2, gives HUD the authority to declare a breach of agreement as a result of any unreasonable and unnecessary expenses incurred without prior HUD approval.

- Comment 10** While the board of directors has the authority to delegate its responsibilities, section 7(b) of the Regulatory Agreement for Non Profit and Public Mortgagors Under Section 221(d)(3) of the National Housing Act, As Amended (FHA Form No. 1733), provides that the project owners “shall not without the prior written approval of the Commissioner . . . pay out any funds, except for reasonable operating expenses and necessary repairs.” HUD reportedly determined in the 1970s that the costs of an executive director were an unnecessary expense, and when HUD became aware through disclosure in the project’s 2009 budget-based rent application that funds were being allocated to the executive director’s position, it disallowed the expense as a factor in determining the allowed rent. For this reason and our analysis that disclosed possible duplication among and nonperformance of duties assigned the executive director, we have recommended that the project provide HUD documentation to properly support the need for and costs associated with the executive director’s position.
- Comment 11** The authority of the board of directors is not being challenged, but, rather, additional support is requested for the necessity of incurring costs from project funds subject to section 7(b) of the Regulatory Agreement for Non Profit and Public Mortgagors Under Section 221(d)(3) of the National Housing Act, As Amended (FHA Form No. 1733), for the payment of the expense for an executive director’s position. Further, the specific compensation package is not being challenged but, rather, the need to adequately support the costs incurred to ensure compliance with the regulatory agreement. This is all the more imperative due to HUD’s prior and more recent determination in its review of a rent increase request that such a position is not warranted.
- Comment 12** In light of HUD’s prior and continued disapproval of costs incurred for an executive director position and our analysis of the position’s duties, which disclosed duplication with other officials’ duties, the project owners have not adequately supported the need or obtained the approval of HUD as required for an executive director’s position. Thus, this expense does not appear to be reasonable or necessary according to section 7(b) of the regulatory agreement.
- Comment 13** While the functions listed may be actual functions carried out by the executive director, these functions were not enumerated in the current employment contract for the position (which had expired and not been renewed), and our analysis was limited to the 15 tasks enumerated in the incumbent’s employment contract and confirmed by the incumbent as duties of the position. If these additional tasks are being conducted by the incumbent, the auditee should present them to HUD to further support its opinion that an executive director’s position may be needed. However, based upon the analysis of the employment contract, it is our position that there is a duplication of duties, which, absent further support, results in an unnecessary expense.

- Comment 14** HUD Handbook 4370.2 provides that office salaries should be recorded under administrative expenses; however, \$85,775 paid in 2007 as executive director compensation was reported as an operating and maintenance expense, and bonuses of \$10,000 were misclassified as miscellaneous office expenses; therefore, as discussed with auditee officials during the audit and at a preexit conference on October 25, 2010, these expenses were misclassified; nevertheless, auditee officials acknowledge the misclassification and have offered to properly classify the expenses.
- Comment 15** The auditee disagrees with HUD regional counsel's opinion on the classification of funds from the arbitration award as project funds; however, the auditee has not provided additional information to refute counsel's opinion. Therefore, this issue will need to be addressed from a legal standpoint during the audit resolution process.
- Comment 16** During the audit and at a preexit conference on October 25, 2010, we discussed with auditee officials the tentative observations based upon our review, which included \$177,745 in costs considered inadequately supported. After this conference, we reclassified \$3,570 as costs associated with the executive director's position, and auditee officials provided support for \$141,082 but were unable to provide supporting documentation for the \$33,093 cited in the draft report. Consequently, auditee officials were provided the detail of the \$33,093 before the exit conference. Documentation submitted after the exit conference on February 14, 2011, with the auditee's official comments provided additional support for \$4,742 in costs, leaving \$28,351 still being considered unsupported.
- Comment 17** Auditee officials did not provide support for \$12,444 in legal fees paid on June 23, 2006. In their response to the draft audit report, auditee officials provided a copy of the May 25, 2006 board of directors' minutes, annexed as exhibit B, as support of the approval to pay the \$12,444, as well as a detailed time slip documenting the hours billed that totaled \$12,444 during October 2005. However, while the detailed time slip accounts for the hours billed, the board of directors' minutes document approval to pay \$13,941 in legal fees incurred in March and April 2006, not October 2005. Therefore, the costs will continue to be regarded as unsupported.
- Comment 18** Auditee officials explained that the \$4,233 represented the remaining balance of a February 2007 invoice and was part of a \$14,000 payment made on January 22, 2008 to pay off the February 2007 invoice, full payment of a \$9,059.41 March 2007 invoice, and partial payment of \$707.16 for an April 2007 invoice; however, the February 2007 invoice was not provided. Therefore, the \$4,233 is still considered unsupported.
- Comment 19** The documentation annexed as exhibit C supports \$4,740 of the \$5,373 OIG considered to be unsupported costs. Accordingly, we have revised the report to reflect that \$4,740 is considered supported, but, absent further supporting documentation for the remaining \$632 (\$206 and \$426 from the February 2008 invoice), this amount is still considered unsupported.

- Comment 20** The documentation annexed as exhibit D refers to various invoices amounting to \$9,500 for “mission and planning work with Board and ED [executive director], admin support, and food for retreat.” However, since there was no contract that detailed what was to be provided by this procurement or any written report or other product to evidence the services received, these costs are still considered unsupported.
- Comment 21** The attached November 16, 2006, board of directors’ minutes support board approval of \$5,000 to be spent for a holiday reception but do not document approval of the \$7,030 expended for the three events questioned in the report. Accordingly, absent further supporting documentation, the \$7,030 is still considered an unnecessary expense.
- Comment 22** The management agreement, section 6 - Leasing and Renting, provides that the agent use all reasonable effort to keep the project rented by procuring tenants using resident selection criteria and leasing guidelines approved by the owner. Further, the project owner’s/management agent’s certification, paragraph 1(b), requires that the agent manage the project for the term and fee described on the certification and that fee changes be made only with HUD approval. Further, while the management fee being charged is a flat fee, as opposed to a percentage of rents collected as stipulated in the certification, there is no mention of a commercial leasing brokerage fee. Therefore, the \$31,840 is still questioned as unsupported and should be repaid unless auditee officials request and receive HUD’s retroactive approval for a special fee, which can be allowed in special circumstances.
- Comment 23** Adequate support has not been provided to conclude that \$5,000 of legal fees associated with selling/refinancing the property, \$510 of legal fees for establishing a nonprofit fundraising entity, and a \$300 purchase of a personal item for a tenant are reasonable and necessary project expenses in accordance with Section 7(b) of the Regulatory Agreement for Non Profit and Public Mortgagors Under Section 221(d)(3) of the National Housing Act, As Amended (FHA Form No. 1733). Therefore, these costs are still questioned.
- Comment 24** Since the funds expended for unsupported, unnecessary and ineligible costs deprived the project of the use of these funds, we have changed recommendations 1A through 1D to read that reimbursement be made to the project so that the funds may be spent for the benefit of the tenants.
- Comment 25** We sought the advice of HUD’s regional counsel, who concluded that the New York State Business Judgment Rule is not applicable to the condition questioned. As noted in comment 11, the authority of the board of directors is not being questioned but, rather, whether there is a breach of the regulatory agreement between HUD and the auditee. Therefore, this issue will be addressed during the audit resolution process with the HUD field office.

Appendix C

ANALYSIS OF EXECUTIVE DIRECTOR RESPONSIBILITIES ACCORDING TO EMPLOYMENT AGREEMENT

Duties assigned to the executive director's position	Duties expected of a management agent	Duties expected of the board of directors	Duties expected of consultants	Duties not performed
1) Manage day-to-day operations: planning and oversight of operational activities, human resources, fundraising, financial management, internal systems, and external relations.	✓			
2) Develop and execute a strategic plan.		✓	✓	
3) Liaison between onsite and offsite property management office and board of directors.		✓		
4) Receive/review property management and fiscal reports.		✓		
5) Oversee property manager's compliance with regulatory and licensing authorities.		✓		
6) Oversee the development and adherence to operational and capital improvement budgets with fiscal officer, property management office, and finance committee.		✓		
7) Oversee management of all residential and commercial benefits amenities: admissions, in-house moves, studio, gallery, community spaces.	✓			
8) Liaison with tenant organizations and oversight of contractual obligations, risk management, and communications		✓		

Duties assigned to the executive director's position	Duties expected of a management agent	Duties expected of the board of directors	Duties expected of consultants	Duties not performed
9) Represent and promote Westbeth Corp., Housing Development Fund Company, Inc., to external stakeholders.		✓		
10) Ensure that all materials representative of Westbeth Corp., HDFC, Inc., reflect a high level of professionalism.		✓		
11) Develop the organization's annual fundraising strategy.		✓		✓
12) Hire and oversee staff and consultants to execute fundraising activities.				✓
13) Identify funding trends; cultivate potential funders; and solicit grants, contracts, gifts, and other resources.				✓
14) Plan and execute fundraising activities; e.g., fundraising events, newsletters, press releases, etc.				✓
15) Develop and expand relationships with nonprofit, private, and public sectors to attract resources.				✓