Issue Date
February 9, 2005
Audit Report Number
2005-SE-1003

TO: Renee′ D. Greenman, Director, Multifamily Housing Hub, 0AH

FROM: Frank E. Baca, Regional Inspector General for Audit, Northwest/Alaska Region, 0AGA

SUBJECT: Oregon Housing and Community Services, Salem, OR, Did Not Ensure That $1.4 Million in Project Funds Were Used in Accordance with HUD Requirements

HIGHLIGHTS

What We Audited and Why

We audited Oregon Housing and Community Services (Oregon Housing) as a followup to our recent audit of Uptown Tower Apartments (report number 2004-SE-1003, dated March 26, 2004), which found that, with Oregon Housing's approval, the owner and/or management agent engaged in many practices HUD considers unallowable. Oregon Housing allowed excessive distributions of project funds through a revaluation of the commercial portion of the project, excessive management fees, and a management fee split between the agent and the owner.

Our overall audit objective was to determine whether Oregon Housing fulfilled its monitoring duties under the terms of the Annual Contributions Contract and Risk-Share Agreement and ensured that distributions of project funds conformed to HUD requirements.

What We Found

Oregon Housing did not ensure that $1,392,995 of project funds distributed to owners conformed to HUD requirements. Oregon Housing inappropriately approved or allowed

- Unreasonable Management fees for 17 projects totaling $614,260 from January 1, 2001, through December 31, 2003.
- The owners and management agent of three projects to split management fees. The owners received a combined total of at least $150,203 of the management fees paid from project funds over the 4-year period January 1, 2000, through December 31, 2003.
- The revaluation of commercial space at one project, resulting in excess retroactive and current distributions of $405,005 to the owner.
- The owner of the same project to receive $161,421 of unreasonable interest payments on income from commercial space that had been loaned to the project.
- Projects to distribute a total of $62,106 of residual receipts from January 1, 2001, through December 31, 2003, when surplus cash was not sufficient to pay owner distributions.

In each case cited above, these funds should have been deposited to the (1) limited distribution and nonprofit projects' residual receipts accounts to be used for project purposes, or (2) risk-share project's operating account to be used in the operations of that project.

Funds inappropriately paid to the owners or management agents reduce the amount of money available for deposit into the residual receipts accounts. The funds in these accounts are to be available for legitimate project purposes with the balance returning to HUD upon termination of the subsidy contracts.

Oregon Housing allowed the inappropriate payments because it misinterpreted or did not fully consider the applicable Federal requirements. In some instances, it determined unreasonable payments were reasonable and lacked adequate internal and management controls. Consequently, if Oregon Housing does not take the appropriate corrective action, it should be required to reimburse HUD from nonfederal funds for any portion of the $1.98 million in administration fees earned from 2001 to 2003 that HUD determines to be ineligible.

What We Recommend

We recommend that the Director of the Multifamily Housing Hub require Oregon Housing to reimburse the projects a total of $1,392,995 for the fees and payments it inappropriately authorized. We also recommend that the Director require Oregon Housing to immediately reduce the excessive management fees to a reasonable level, stop allowing projects under its jurisdiction to split management

fees, and discontinue allowing projects under its jurisdiction to pay owner distributions from the residual receipts fund when surplus cash is not sufficient. Oregon Housing should also be required to recalculate owner distributions, using the original value of the commercial portion of the project, and implement controls to ensure that fees and distributions to owners and management agents are reasonable. Finally, the Director should make a determination of substantial default in accordance with 24 Code of Federal Regulation 883.607(b) if Oregon Housing does not take the appropriate corrective action.

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

Oregon Housing provided its response to the draft report on December 6, 2004, disagreeing with the audit results. We evaluated Oregon Housing's written comments and made appropriate changes to the report based on their response. The complete text of the auditee's response, along with our evaluation, can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVES

Oregon Housing and Community Services (Oregon Housing) is Oregon's housing finance agency. It was formed to provide financial and program support for the creation and preservation of quality affordable housing for low- and moderate-income residents. Oregon Housing's Asset and Property Management Division performs regulatory analysis, technical assistance, administration, and enforcement of restrictive documents through its three sections. The division's Housing Programs Management section oversees the operations of multifamily housing projects that are financed by Oregon Housing. This function includes ensuring the projects are in regulatory compliance with regard to project finances and Federal and State occupancy requirements. The Housing Programs Management section also performs physical inspections of individual units, common areas, building exteriors, roofs, and landscaping.

Oregon Housing has an Annual Contributions Contract with the U.S. Department of Housing and Urban Development (HUD) under which it monitors projects that receive Section 8 subsidies but are not insured by HUD. There are 122 of these projects with ownership structures in three categories. There are 13 limited distribution projects, 91 profit-motivated projects, and 18 nonprofit projects. Oregon Housing received $1.98 million in 2001-2003 as an administrative fee for monitoring the 122 projects. For more information on these projects, see the Scope and Methodology section on page 19.

Oregon Housing also has a Risk-Share Agreement with HUD, under which it monitors 27 projects. It financed these projects by issuing bonds and shares the insurance risk with HUD.

Our overall audit objective was to determine whether Oregon Housing fulfilled its monitoring duties under the terms of the Annual Contributions Contract and Risk-Share Agreement and ensured that distributions of project funds conformed to HUD requirements. We wanted to determine

- The extent to which Oregon Housing allows management agents to receive excessive fees;
- Which owners are receiving a portion of the management fees and the amount of owner's share of the fees;
- Whether Oregon Housing can justify allowing owners to be paid their limited distribution from project residual receipts;
- Whether Oregon Housing required cost certification data to support the devaluation of commercial space at Uptown Tower Apartments, leading to an increased owner distribution, and whether the change in valuation was appropriate; and
- Whether Oregon Housing allowed Uptown Tower Apartments to reimburse the owner for interest related to commercial income from surplus commercial cash.

RESULTS OF AUDIT

Finding 1: Oregon Housing Did Not Ensure That $1.4 Million in Project Funds Were Used in Accordance with HUD Requirements

Oregon Housing inappropriately permitted projects to use operating funds or residual receipts for ineligible or unreasonable/unnecessary expenses. Oregon Housing inappropriately allowed the

- Management agents of 17 projects to receive excessive management fees,
- Owner and management agent of three projects to split the management fee,
- Owner of one project to receive excessive distributions because of an inappropriate revaluation of commercial space in the project,
- Owner of one project to receive excessive interest on a loan made to the project, and
- Owners of four projects to receive distributions from residual receipts when surplus cash was insufficient to cover the payment of owner distributions.

Description	Ineligible Payments	Unreasonable/ Unnecessary Payments	Total
Excessive management fee		$614,260	$614,260
Management fee split	$150,203		150,203
Excessive distributions	405,005		405,005
Excessive interest		161,421	161,421
Distributions from residual receipts	62,106		62,106
Total	**$617,314**	**$775,681**	**$1,392,995**

This occurred because Oregon Housing misinterpreted or did not consider a number of Federal requirements and lacked adequate internal and management controls. As a result, the residual receipts account for each limited distribution and nonprofit project is underfunded, and funds are not available for use in the operations of a risk-share project. Consequently, we believe that Oregon Housing did not fulfill its monitoring responsibilities under its Annual Contributions Contract with HUD and question whether it earned the $1.98 million in administration fees from 2001 to 2003.

Oregon Housing Allowed Management Agents for 17 Projects To Receive $614,260 in Excessive Management Fees

A review of Oregon Housing's audit files, loan files, and working files for 28 projects monitored by Oregon Housing revealed that it inappropriately allowed the management agents of 17 projects to receive excessive management fees totaling $614,260 from January 1, 2001, to December 31, 2003.

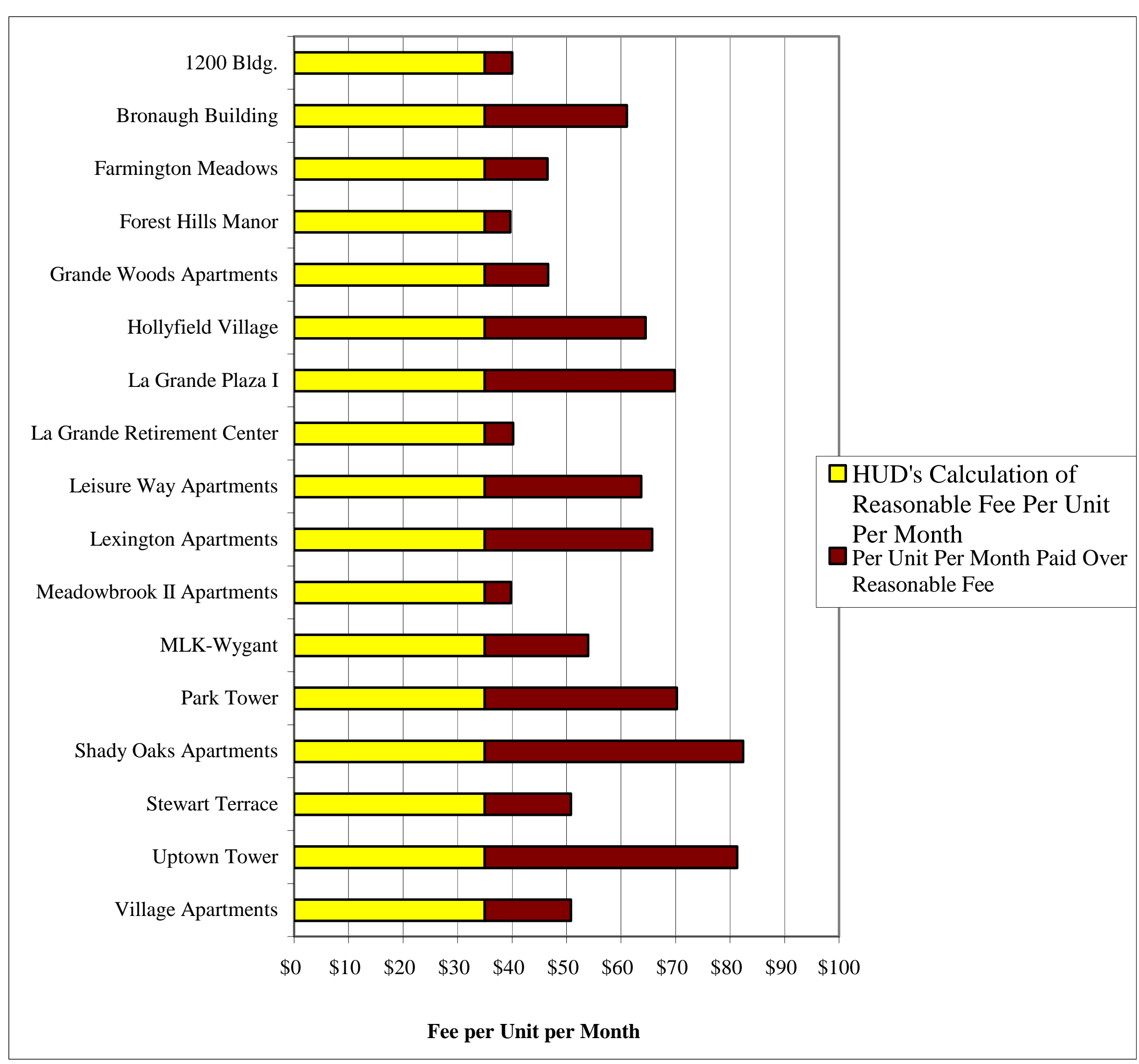
HUD's Maximum Residential Management Fee Per-Unit-Per-Month for Oregon Is $35

HUD Handbooks 4590.1 and 4381.5 state that it is the housing finance agency's responsibility to ensure that projects are maintained in good financial condition. Under Handbook 4381.5, Oregon Housing is further required to perform a management fee review when a project owner or agent requests an increase in the management fee percentage. This is to ensure that approved fees do not significantly exceed the amount that independent agents and owners would ordinarily negotiate for comparable services at projects in the same geographic/cost area, except as justified by conditions that require more time and effort on the part of the management agent.

The maximum residential management fee range for projects in Oregon, as computed by HUD for 2001-2003, is $35 per-unit-per-month. Although Oregon Housing is not required to use HUD's computed management fee range, it must use some range. It must follow the same procedures HUD uses to determine the maximum fee range (i.e., the procedures in chapter 3 of HUD Handbook 4381.5). Since Oregon Housing did not compute its own residential management fee range, it should have used HUD's maximum residential management fee of $35 per-unit-per-month.

17 Projects Are Receiving Excessive Management Fees

We compared the actual management fees paid for 28 selected projects to HUD's computed maximum residential management fee of $35 per-unit-per-month. We found that 17 (61 percent) of the 28 projects are receiving excessive management fees.



Lack of Management Controls Contributed to the Excessive Management Fees

Oregon Housing's lack of adequate management controls contributed to the excessive management fees. Although Oregon Housing did not have specific written policies and procedures to ensure that management fees were reasonable, it created a written policy in response to our audit work. However, even this new written policy is not adequate. The new policy states that management fees must be assessed for reasonableness but does not explain how this is to be done and only appears to apply to Section 8 New Construction projects. Further, the new policy fails to establish a maximum residential management fee range as required by HUD Handbook 4381.5.

Although Oregon Housing told us it evaluates requests for increases in the management fee percentage by comparing the proposed percentage to the percentage received by the management agents of other properties of similar size and type, it is not consistent in this practice. Additionally, comparing percentages instead of the per-unit-per-month dollar amount is misleading. Projects that receive the same or similar percentage management fees can actually range widely in the number of units served and in the per-unit-per-month dollar amount received for management fees. For example, we found that the number of units served for Oregon Housing projects that are receiving an 8-percent management fee range from 20 to 71, and management fees for the same projects range from $46 to $81 per-unit-per-month.

Oregon Housing Inappropriately Allowed Projects To Pay $150,203 To Owners for Management Fee Splits

Oregon Housing inappropriately allowed the management agent and three different owners of projects to split the management fee, with $150,203 going to the owners of the projects from January 1, 2000, to December 31, 2003. The owners were to provide services generally described as asset management services. In two of the cases, Oregon Housing's financial review specialist told us that he found no indication that Oregon Housing ever questioned this fee split arrangement, and in one case, Oregon Housing specifically approved the management fee sharing.

Only the Approved Management Agent May Receive Management Fees

According to HUD Handbook 4381.5, management fees may be paid only to the approved management agent. Payment of management fees to the owner of the project is not allowed unless the owner is the approved management agent. Additionally, the Handbook says that asset management costs must not be billed to the project's operating account but may only be paid from funds available for distributions to owners in accordance with the Regulatory Agreement.

Oregon Housing allowed the following management fee splits:

Project	Ineligible Management Fees
Uptown Tower Apartments	$108,076
1200 Building Apartments	30,000
Village Apartments	12,127
Total	**$150,203**

Uptown Tower Apartments

On October 1, 1991, Guardian Management, the approved management agent for the project, and the general partner signed a Letter of Understanding in which the management agent agreed to give the general partner a portion of the 5.5 percent management fee. The agreement states, in part, "It is recognized that there is significant work to be performed by the General Partner as an asset manager and thereby a justification for the payment of 1.5% from Guardian Management Corporation on a monthly basis out of the 5.5% management fee that was paid to Guardian Management."

On October 16, 1991, Guardian Management sent a letter to Oregon Housing requesting permission to split the management fee with the general partner. According to the letter, the purpose of the fee split was to reimburse the general partner for some of his partnership management responsibilities. On October 24, 1991, Oregon Housing approved the fee split as long as the agreed-upon management fee percentage, specified in the management agreement, was not exceeded.

On February 11, 1994, Guardian Management and the general partner signed an amendment to the October 1, 1991, Letter of Understanding. The amendment stated that if the general partner of Uptown Tower Apartments obtained approval to increase the management fee percentage to 7 percent, the management agent would split the fee, with 2.4 percent going to the general partner and 4.6 percent to Guardian Management. On February 14, 1994, the general partner sent a formal request to Oregon Housing to increase the management fee to 7 percent. Oregon Housing approved this increase on March 7, 1994.

On June 25, 1997, Guardian Management sent a letter to Oregon Housing, requesting an increase in the management fee to 8 percent. On August 3, 1997, Oregon Housing approved this increase. In September of 1997, Guardian Management and the general partner signed a second amendment to the October 1, 1991, Letter of Understanding. According to the amendment, Guardian Management agreed to split the 8 percent management fee, with 2.75 percent going to the general partner and 5.25 percent to Guardian Management.

1200 Building Apartments

In an October 21, 1987, letter, the general partner of 1200 Building Apartments informed Oregon Housing that a $10,000 management coordination fee had been paid to the general partner every year since 1985. The letter also states, "The 1200 Building management coordination fee is typical and provides '[the general partner] shall receive annually from the Partnership a Management Coordination Fee of $10,000 to compensate him for the continued management of the Property and the supervision and coordination of any professional managers and other

personnel under his control as the General Partner with responsibility for day-to-day operations of the Project.'"

With Oregon Housing's knowledge, the management coordination fee continues to be paid to the general partner. According to the 1200 Building Apartments' audited financial statements for years ending June 30, 2003, and 2002,

"In accordance with the Partnership Agreement, the General Partner was paid $10,000 per year for partnership management fees. Such amount is included in management fee expense."

Village Apartments

On December 23, 1992, Guardian Management sent a letter to Oregon Housing stating its intention to split the management fee with the general partner. According to the letter, the fee is to compensate the general partner for his work as the "...Asset Manager for the Village Apartments partnership."

The audited financial statements for the Village Apartments for the years ending December 31, 2002, and 2001, states:

"The Partnership has engaged the services of a property management company to manage the daily operations of the low-income housing project. Under this agreement, the Partnership has agreed to pay a management fee equal to 7% of gross rents collected. The property management company reimburses the General Partner 2% of the 7% for the General Partner's services as the Asset Manager."

Oregon Housing Officials Thought Management Fee Splits Were Allowable

Oregon Housing officials informed us that they believed management fee splits were allowed as long as the total amount paid from project funds for management fees did not exceed the management fee percentage specified in the management agreement for the property. Even though HUD Handbook 4381.5, section 3.1, states that management fees may be only paid to the approved management agent, Oregon Housing officials stated that since HUD regulations allow owners and independent management agents to manage properties independently, they assumed that a hybrid system, in which the management agent and the owner comanage the property, also would be allowed.

Oregon Housing Allowed the Owner of Uptown Tower Apartments To Receive $405,005 in Excessive Distributions Because of an Inappropriate Revaluation of Commercial Space in the Project

We calculated excessive distributions of $405,005 inappropriately paid to the owner of Uptown Tower Apartments due to the revaluation of the commercial space in the project. The change in value of the commercial space was inappropriate as it resulted in per-unit replacement costs that exceed Federal limitations. Additionally, the change in value was not supported by the required cost certification documentation.

Owner Distributions Are Based on Equity and Require Cost Certifications to Justify Higher Equity Contributions

Federal regulations at 24 Code of Federal Regulations 883.306 and the Housing Assistance Payment Contract explain that owner distributions are calculated based on equity attributable to the dwelling use or residential portion of the project. Therefore, any change in the value of the residential portion of the project will result in a corresponding change in the distributions paid to the owner.

Further, 24 Code of Federal Regulations 883.306(c) states that an increase in equity contribution may be justified by the project owner only through cost certification data accepted by the Housing Finance Agency. Accordingly, if Uptown Towers' owner wanted to justify an increase in equity contribution, it should have provided cost certification data to Oregon Housing to support this justification.

The Owner Requested That the Value of the Commercial Space Be Decreased

The HUD-approved proposal for Uptown Tower Apartments shows an approved per-unit replacement cost of $50,000 and commercial space value of $400,000. In 1995, the owner requested that Oregon Housing decrease the value of the commercial portion of the project, thereby increasing the value of the residential portion of the project. This resulted in an increase from $400,000 to $730,000 in owner equity for the residential portion. The increase in owner equity allowed the annual owner distribution limit to increase from $24,000 to $43,800. The owner asked that this change be made retroactively to the inception of the project. Oregon Housing approved the revaluation of the commercial space. Consequently, the $54,583 replacement cost attributable to each dwelling unit is

now above the $50,000 per-unit HUD-approved replacement cost and above the $50,075-per-unit Federal limitation.

In addition, when we asked Oregon Housing for the cost certification data that supports this increase in equity contribution, we received a copy of the request from the general partner of the ownership entity. This request included various documents attempting to justify the increase in equity. However, the request from the owner did not include cost certification documentation to support the change in value.

Oregon Housing Did Not Consider the Effect of a Change of Commercial Space Value

Oregon Housing staff did not consider that the change in value of the commercial space would affect the limitation on replacement cost attributable to the dwelling space. Additionally, Oregon Housing ignored requirements that a higher equity contribution be justified through cost certification documentation.

Oregon Housing Allowed the Owner of Uptown Tower Apartments To Receive $161,421 in Unreasonable Interest Payments from the Project

We determined that interest payments to the owner of the Uptown Tower Apartments project exceeded a reasonable amount by $161,421. The project owner received interest payments on income generated from the commercial portion of the project that the owner left in the project. For the first several years of the project's operations, the owner did not know it was entitled to the income generated by the commercial portion of the project. When the owner found out that it was entitled to this money, it designated the funds as a loan to the project.

Commercial Income Was "Loaned" to the Project, and the Owner Received Interest

In 1984, the commercial portion of the project was leased to a convenience store at a rate of $3,000 per month. The $3,000 monthly commercial rent payments were effectively "loaned" to the project by the owner since the funds were not withdrawn but were used for residential project operations. The project's December 31, 1991, audited financial statements disclosed a $384,313 note payable to the owner partnership, consisting of $267,000 in accumulated commercial rent loaned for residential operations and $117,313 in accrued interest. In 1992, the partnership began withdrawing the $3,000-per-month commercial income rent payments. Meanwhile, the note payable continued to accrue interest. Beginning in March 1994, project surplus cash funds from residential operations were used to pay off the

note. The note, including $432,906 of accrued interest, was finally paid off in March 2002.

According to the December 31, 1991, financial statements, the interest accrued on the total balance of the note was payable at a rate equal to "…the average annual rate the partners were charged on the partners' third-party loans." In addition, on January 28, 1994, Oregon Housing approved an interest rate of prime plus 2.5 percent. However, we found that interest calculated this way was not reasonable. It is not likely that a partnership that is an entity independent of the project would earn the same rate of return as that charged by banks. Further, it is not likely that the owner would receive a rate as high as prime on any other investment in which it was not a related party.

Costs Should Not Exceed Those Ordinarily Paid

The Regulatory Agreement between Oregon Housing and this project states in section 9 that the borrower covenants and agrees

"...(h) That payment for services, supplies or materials for the Development shall not exceed the amount ordinarily paid for such services, supplies or materials in the area where the services are rendered or the supplies or materials are furnished."

Thus loans made to a project by an owner could generate interest, but the interest should not exceed the rate which the owner could earn elsewhere in a reasonably safe security. We calculated reasonable interest by using the historical 10-year Treasury rates from the Federal Reserve Web site and applied those rates to the money "loaned" to the project, taking into account the payments made to the owner. The rates charged by the partnership varied over the note period and were significantly higher than the published 10-year Treasury rates. For example, on January 3, 1986, the partnership charged a 13.25-percent rate while the 10-year Treasury rate was 9.03 percent. Using the 10-year Treasury rates, we determined the owner should have received $271,485 instead of $432,906, a difference of $161,421.

Oregon Housing Thought the Owner Should Receive a Higher Rate

Oregon Housing officials told us they thought the owner should receive the higher interest rate because investment in a project such as this was a risky venture and the rate of return should reflect the risk. Therefore, officials did not think the rate received was excessive.

Oregon Housing Inappropriately Allowed Four Projects To Distribute $62,106 of Residual Receipts When Surplus Cash Was Not Sufficient To Pay Owner Distributions

Oregon Housing improperly allowed four projects to make owner distributions of $62,106 from the projects' residual receipts accounts from January 2001 through December 2003. These distributions were to pay owners when there was a shortfall of surplus cash.

	2003	2002	2001	Total
Bronaugh Building	$7,656	$41,061		$48,717
Leisure Way Apartments	1,001	258		1,259
Shady Oaks Apartments	2,441	1,583	$2,441	6,465
Golden Age Apartments (the Village)			5,665	5,665
Total	**$11,098**	**$42,902**	**$8,106**	**$62,106**

Residual Receipts Are Only To Be Used for Project Purposes

Oregon Housing executed Regulatory Agreements with the projects that allow owner distributions to be paid with residual receipts when there is a shortfall in surplus cash. However, Federal regulations at 24 Code of Federal Regulations 883.702(e) and the Housing Assistance Payment Contracts between Oregon Housing and each limited distribution project state that funds deposited into the residual receipts account may only be used with Oregon Housing's approval and only for project purposes.

We reviewed residual receipts information included in the financial statements for the 13 limited distribution projects under Oregon Housing's jurisdiction. The financial statements for six of those projects stated that with the approval of Oregon Housing, if surplus cash was not sufficient, funds could be released from the residual receipts account to pay the limited distribution to the owner. Further review of these financial statements and inquiry of Oregon Housing staff revealed that four projects actually distributed funds under this scenario with Oregon Housing's approval (see appendix A for details). Payment of limited distributions to owners is not a project purpose.

In addition, on December 18, 1990, Oregon Housing asked HUD's opinion on the acceptable uses of project income in excess of owner distribution (i.e. surplus cash and residual receipts). HUD responded on January 3, 1991 stating that payments that benefit the owners would not be allowable.

Oregon Housing Misinterpreted HUD Requirements

Oregon Housing staff told us they thought that prior staff considered payments for owner distributions to be a project purpose, in that it benefits the project when the owner receives all of the distributions to which it is entitled.

Oregon Housing Did Not Fulfill Its Contract Responsibilities

Oregon Housing allowed the inappropriate payments to project owners because it misinterpreted or did not fully consider the applicable Federal requirements and lacked adequate internal and management controls. Consequently, we believe that Oregon Housing did not fulfill its monitoring responsibilities under its Annual Contributions Contract with HUD and question whether it earned the $1.98 million in administration fees from 2001 to 2003. Further, if Oregon Housing implements our recommendations, we estimate that $286,318 will be available in the next year for project purposes or to reduce housing assistance payments.

Oregon Housing's Responsibilities Under the Annual Contributions Contract

The Annual Contributions Contract requires Oregon Housing to supervise project operations to ensure conformance with Federal requirements. Part I, section 1.8, states, "RESPONSIBILITY FOR ADMINISTRATION OF CONTRACT. The HFA [Housing Finance Agency] shall assume responsibility for project development and supervision of the development, management and maintenance functions of the Owner, subject to review and audit by HUD to ensure compliance with Federal requirements and objectives."

Oregon Housing Did Not Think It Had To Follow HUD Handbook Requirements

Oregon Housing misinterpreted applicable Federal requirements and allowed inappropriate payments. For example, it allowed excessive management fees and management fee splits with owners. Chapter 3 of HUD Handbook 4381.5 specifies that housing finance agencies must determine the reasonableness of management fees and allow the management fees to be paid only to the approved management agent. Oregon Housing officials believed that they were not subject to the guidance in the Handbook since paragraph 2.2(b) states:

"As part of the approval process, the state/local agency must submit to HUD a Previous Participation Certification (Form HUD-2530) for the proposed management agent as described in paragraph 2-9a. With respect to all other

procedures discussed in this chapter, state and local agencies may develop their own criteria or elect to use the procedures established in this Chapter."

However, the paragraph cited specifically states that the freedom for agencies to develop their own criteria only applies to procedures listed in chapter 2 of the Handbook. Oregon Housing must follow the guidance in the rest of the Handbook, including the guidance relating to the management fees in chapter 3.

Improperly Used Funds Should Have Been for Project Uses or Returned to HUD

As a result of the above deficiencies, the residual receipts account for each limited distribution and nonprofit project is underfunded. Excessive funds being paid to the owners or management agents are not available, if needed, for use in the project, and HUD will not receive the full amount to which it is entitled at the termination of the Housing Assistance Payment Contract. In addition, these funds are not available for use in the operations of the risk-share project.

Recommendations

We recommend that the Director require Oregon Housing to

1A. Reimburse the applicable projects a total of $614,260 from nonfederal funds for excessive management fees paid from January 1, 2001 – December 31, 2003. Additionally, the Director should determine any excess fees that have been paid since December 31, 2003 and require Oregon Housing to reimburse the projects for these amounts from nonfederal funds as well. These funds should be deposited into the residual receipts account for each project that is required to maintain that account and into the operating account for the other projects. See Appendix A for details.

1B. Reimburse the applicable projects' residual receipts account $150,203 from nonfederal funds for management fees it allowed the management agent to split with the owner. Additionally, the Director should determine if project owners and agent are continuing to split the management fee and require Oregon Housing to reimburse the projects from nonfederal funds for any management fees paid to the owners under this scenario. See Appendix A for details.

1C. Reimburse the applicable project's residual receipts account $405,005 from nonfederal funds for excessive distributions it allowed from January 1, 2001 through December 31, 2003. In addition, the Director should determine if excess distributions have been made to the owner since December 31, 2003 and require Oregon Housing to reimburse the project from nonfederal funds for any excess distributions made. See Appendix A for details.

1D. Reimburse the applicable project's residual receipts account $161,421 from nonfederal funds for excessive interest it allowed. See Appendix A for details.

1E. Reimburse the applicable projects' residual receipts accounts $62,106 from nonfederal funds for distributions it allowed to be paid from this account when surplus cash was not sufficient from January 1, 2001 – December 31, 2003. In addition, the Director should determine if there have been inappropriate withdrawals from the residual receipts accounts since December 31, 2003 and require Oregon Housing to reimburse the projects from nonfederal funds for any inappropriate withdrawals made. See Appendix A for details.

1F. Implement controls to ensure that management fees are reasonable, including calculating a reasonable management fee range in accordance with the guidance provided in HUD Handbook 4381.5.

1G. Instruct the owner/management agent for the applicable projects to immediately reduce the management fee to a reasonable amount.

1H. Immediately stop allowing properties under its jurisdiction to split management fees.

1I. Recalculate allowable owner distributions at Uptown Tower Apartments, using the original value of the commercial portion of the project.

1J. Immediately stop allowing owners of limited distribution projects to take their limited distributions from the residual receipts account when surplus cash is not sufficient to pay those distributions.

We also recommend that the Director

1K. Assist Oregon Housing in obtaining needed training in the Federal regulations and guidelines necessary to perform monitoring of owners and management agents.

1L. Make a determination of substantial default in accordance with 24 Code of Federal Regulation 883.607(b) if Oregon Housing does not take corrective action per Recommendations 1A through 1J above. If a determination of substantial default is made, determine the ineligible portion of the $1,982,052 contract administrator fee paid to Oregon Housing during the period January 1, 2001, through December 31, 2003, and require Oregon Housing to reimburse HUD from nonfederal funds for that amount.

SCOPE AND METHODOLOGY

To achieve our audit objectives, we reviewed applicable Federal regulations and HUD Handbooks; Oregon Housing written policies and procedures, audit files, loan files, and working files; and the books and records of management agents for various projects. In addition, we interviewed local HUD staff, Oregon Housing staff, and various project owners and management agents. We performed audit work at Oregon Housing's offices in Salem, OR, and at the HUD Multifamily and Office of Inspector General (OIG) offices in Seattle, WA, from March through October 2004. Our audit generally covered the period January 1, 2001, through December 31, 2003, and was expanded as needed.

We selected for review 28 projects under Oregon Housing's jurisdiction for the years 2001-2003. Four types of projects were selected based on the following:

(1) Limited Distribution Projects - The owners of these projects receive a limited distribution if the project generates surplus cash. Any surplus cash over and above project expenses and the owner distribution is deposited to a residual receipts account that may be used, if necessary, for project purposes, with the balance returning to HUD at the termination of the Housing Assistance Payment Contract. We reviewed all 13 of these projects (Bronaugh Building, Carriage Court, Farmington Meadows, Hollyfield Village, La Grande Retirement Center, Leisure Way Apartments, Lexington Apartments, Park Tower Apartments, Shady Oaks Apartments, Stewart Terrace Apartments, 1200 Building Apartments, Uptown Tower Apartments, and Village Apartments).

(2) Profit-Motivated Projects - The owners of these projects receive all surplus cash after project expenses have been paid. If these projects have maintenance issues, funds going to the owner or management agent should have been kept in the project for maintenance and upkeep of the project. We reviewed all six projects that received Real Estate Assessment Center scores for physical condition below 70 out of a possible 100 in 2003 (Country Club Manor, La Grande Plaza I, Rose Apartments, Seneca Terrace, Stafford Square II, and Village East Apartments). When a property scores 60 or below, the Department of Multifamily Housing may refer the property to the Departmental Enforcement Center for review. The Departmental Enforcement Center will then take enforcement actions to bring the project up to acceptable physical condition or proceed with foreclosure or administrative sanctions.

(3) Nonprofit Projects - These projects are owned by nonprofit agencies. The owners of these projects are not entitled to surplus cash according to the November 1980 version of the Regulatory Agreement. All surplus cash must be deposited into a residual receipts account that may be used, if necessary, for project purposes, with the balance returning to HUD at the termination of the Housing Assistance Payment Contract. We reviewed all six nonprofit projects in which the owners are not allowed to retain surplus cash (Forest Hills Manor, Grande Woods Apartments, Holly Tree Village, Meadowbrook II Apartments, Owens-Adair Building, and Tarkington Square).

(4) Risk-Share Projects - The owners of these projects receive all surplus cash after project expenses have been paid. We reviewed all three risk-share projects in which we noted indications of financial difficulties (Fircrest Manor Apartments, MLK-Wygant Housing, and Troutdale Terrace). HUD is at risk because it insures a portion of the project mortgages.

We performed our review in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

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

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

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

Relevant Internal Controls

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

- Program Operations - Policies and procedures that officials of the audited entity have implemented to reasonably ensure that a program meets its objectives and that unintended actions do not result.

- Compliance with Laws and Regulations - Policies and procedures that officials of the audited entity have implemented to reasonably ensure that resources used are consistent with laws and regulations.

- Safeguarding Resources - Policies and procedures that officials of the audited entity have implemented to reasonably prevent or promptly detect unauthorized acquisition, use, or disposition of resources.

We assessed the relevant controls identified above.

Significant Weaknesses

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

Based on our review, we believe the following items are significant weaknesses:

We identified a significant weakness in Oregon Housing's management controls when it did not require its project managers to determine whether an increase in

management fee percentage would provide an unreasonable per-unit-per-month management fee. As a result, we found during our audit that controls did not reasonably ensure that all resources used were consistent with laws and regulations. Nor did management controls reasonably prevent or promptly detect unauthorized acquisition, use, or disposition of resources. Oregon Housing did not:

- Have specifically written policies and procedures for ensuring that management fees are reasonable.

- Have specifically established residential management fee ranges for its jurisdiction.

- Adequately document its management fee review process and its approval for increases in management fees.

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/	Funds To Be Put to Better Use 4/
1A			$614,260	$204,755
1B	$150,203			41,061
1C	405,005			19,800
1D			161,421	
1E	62,106			20,702
1L		1,982,052		
Total	**$617,314**	**$1,982,052**	**$775,681**	**$286,318**

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 polices 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 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.

4/ "Funds to be put to better use" are quantifiable savings that are anticipated to occur if an OIG recommendation is implemented, resulting in reduced expenditures at a later time for the activities in question. This includes costs not incurred, deobligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made, and other savings.

The table on the following pages shows a breakdown by project of the above schedule.

Recommendation 1A.

Oregon Housing allowed 17 projects to pay excessive management fees.

Excessive Management Fees

Project	Ineligible	Unreasonable /Unnecessary	Funds To Be Put to Better Use	Total
Bronaugh Building		$56,918	$18,973	$75,891
Farmington Meadows		30,899	10,300	41,199
Hollyfield Village		34,298	11,433	45,731
La Grande Plaza I		20,281	6,760	27,041
La Grande Retirement Center		9,836	3,279	13,115
Leisure Way Apartments		8,621	2,874	11,495
Lexington Apartments		62,604	20,868	83,472
MLK-Wygant		26,970	8,990	35,960
Park Tower Apartments		231,398	77,133	308,531
Shady Oaks Apartments		14,317	4,772	19,089
Stewart Terrace Apartments		14,235	4,745	18,980
1200 Building Apartments		26,706	8,902	35,608
Uptown Tower Apartments		46,307	15,436	61,743
Village Apartments		1,416	472	1,888
Forest Hills Manor		3,593	1,198	4,791
Grande Woods		22,456	7,485	29,941
Meadowbrook II		3,405	1,135	4,540
Total		**$614,260**	**$204,755**	**$819,015**

Recommendation 1B.

Oregon Housing allowed three projects to pay the owner in a management fee split situation.

Excessive Distributions

Project	Ineligible	Unreasonable /Unnecessary	Funds To Be Put to Better Use	Total
Uptown Tower Apartments	$108,076		$27,019	$135,094
1200 Building Apartments	30,000		10,000	40,000
Village Apartments	12,127		4,042	16,168
Total	**$150,203**		**$41,061**	**$191,262**

Recommendation 1C.

Oregon Housing allowed Uptown Tower Apartments to pay excessive owner distributions due to a change in the value of the commercial space of the project.

Excessive Distributions

Project	Ineligible	Unreasonable /Unnecessary	Funds To Be Put to Better Use	Total
Uptown Tower Apartments	**$405,005**		**$19,800**	**$424,805**

Recommendation 1D.

Oregon Housing allowed Uptown Tower Apartments to pay excessive interest.

Excessive Interest Project	Ineligible	Unreasonable /Unnecessary	Funds To Be Put to Better Use	Total
Uptown Tower Apartments		**$161,421**		**$161,421**

Recommendation 1E.

Oregon Housing allowed four projects to distribute residual receipts when surplus cash was not sufficient.

Excessive Distributions Project	Ineligible	Unreasonable /Unnecessary	Funds To Be Put to Better Use	Total
Bronaugh Building	$48,717		$16,239	$64,956
Leisure Way Apartments	1,259		420	1,679
Shady Oaks Apartments	6,465		2,155	8,620
Village Apartments	5,665		1,888	7,553
Total	**$62,106**		**$20,702**	**$82,808**

Recommendation 1L.

HUD paid Oregon Housing $1,982,052 in questionable contract administrator fees from January 1, 2001, through December 31, 2003.

Year	Unsupported Administrative Fees
2001	$ 682,962
2002	602,571
2003	696,519
Total	**$1,982,052**

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

Housing and Community Services
Street Address: 725 Summer Street NE, Suite B
Mailing Address: PO Box 14508
Salem, OR 97309-0409
(503) 986-2000
FAX (503) 986-2020
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December 6, 2004

RECEIVED
DEC 7

Frank E. Baca
Regional Inspector General for Audit
U.S. Department of Housing and Urban Development
Northwest/Alaska Region 10
909 First Avenue, Suite 126
Seattle, WA 98104-1000

RE: Response to 2004 OIG Review of Oregon Housing & Community Services Sent by E-mail and Federal Express

Dear Mr. Baca:

Enclosed is the formal response to the Draft OIG Audit Report of November 9, 2004. As the Director of Oregon Housing & Community Services I want to go on record and express how displeased we are at the treatment we have received in this report. This report is deceptive and misleading, which gives a false impression of our housing activities.

Our last Section 8 HUD Review was conducted in July 1997 and to quote Roberta Ando, the Asset Management Branch Chief at that time, "We were pleased with the overall results of our review and note that many areas of operation contained no findings. Our review determined OHCS is complying with HUD requirements except as noted on the enclosed "Monitoring Review Summary." We have not had an OIG or HUD audit since 1997 on our Section 8 Projects.

In April of 2000 HUD conducted a Risk Sharing monitoring review. The purpose of that review was to determine compliance with the regulations, handbook and OHCS Procedural Guide for the 542© Risk Sharing program. To quote Robert Stettner, Acting Director of the Portland Multi-Family Housing Program Center at that time, "We looked at both the development and management sides of the program. Overall, we are very satisfied with

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OHCSD's performance in implementing the Risk Sharing program for the State of Oregon.

OHCS has worked closely with HUD for approximately 30 years and we consider ourselves in a partnership to provide affordable housing to Oregonians. We work side-by-side with HUD asking advice or getting clarification when new rulings or procedures are released and feel that we can not accept a review which questions our integrity with which we enforce regulations and administer our housing responsibilities, without taking a firm stance.

If you have any questions please call me at (503) 986-2005.

Sincerely,

Bob Repine
Director

Cc: Anthony Freedman, Hawkins Delafield & Wood LLP
D. Kevin Carlson, Assistant Attorney General, Department Of Justice
Marlys Laver, Administrator, Asset & Property Management, OHCS
Dawn Voelker, Manager, Housing Programs Management, OHCS
Patrick Shea, Supervisory Project Mgr., Portland MFM Program Center

Ref to OIG Evaluation **Auditee Comments**

RESPONSE BY THE OREGON HOUSING AND COMMUNITY SERVICES DEPARTMENT (OHCS) TO AUDIT REPORT NUMBER ____ ISSUED BY THE U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT'S (HUD) OFFICE OF INSPECTOR GENERAL (OIG)

Introduction

OHCS is party with HUD to an Annual Contributions Contract (ACC) under which OHCS acts as the Housing Finance Agency (HFA) to monitor certain low-income multifamily housing projects for which OHCS provided the permanent loan financing. These ACC projects receive Section 8 subsidies from HUD under Housing Assistance Payment (HAP) Contracts executed with respect to each project. However, HUD does not insure these ACC projects. Thirteen of the 122 ACC projects monitored by OHCS are "limited distribution" projects.

OHCS also is party with HUD to a Risk-Share Agreement under which OHCS monitors an additional 27 low-income multifamily housing projects. As with the ACC projects, OHCS provided the permanent loan financing on the Risk-Share projects. HUD provides no direct subsidies to these projects, but HUD and OHCS do share the insurance risk on these Risk-Share Agreement projects.

Audit Report Number ____ summarizes the OIG's purported audit of the performance by OHCS under the above-described agreements. In fact, its scope is much narrower, focusing primarily on the 13 limited distribution projects. In the following pages, OHCS provides a detailed response to OIG's findings and recommendations. The response is to the draft as transmitted to us on November 9, 2004.

The OIG Report Generally

OHCS strongly disagrees with the findings and proposed remedies in the OIG preliminary audit report. The OIG report is a disappointing and inaccurate piece of work. This is not merely because of the numerous factual errors and misinterpretations of HUD requirements and materials that characterize and undermine the report, or because of OIG's apparent inability to draw a distinction between the opinions of its individual auditors and HUD policy. What makes the report particularly troubling are (i) its complete disregard for the regulatory structure of the State Agency Section 8 program, as established in HUD Regulations and documents, and implemented jointly and cooperatively by OHCS and HUD for more than 25 years, and (ii) the inaccurate manner in which certain

facts and HUD requirements are presented, or more accurately, misrepresented. As a result, the report tends to undermine the administrative structure that has served HUD's objectives and OHCS's tenants, projects and owners very well throughout the life of the Section 8 program, and lacks the most basic factual and legal credibility. Our response focuses on both the detailed errors in the draft report and these more fundamental deficiencies.

We are confident that a fair and competent review of the facts relevant to the OIG audit, together with an application of correct legal standards, reveals a reality far different from the conclusions presented by the OIG. It will demonstrate that not only has OHCS acted properly in the matters at issue, its administration of the State Agency Section 8 program has contributed to a superlative portfolio of low-income multifamily housing that, by any responsible measurement, sets the standard for Section 8 subsidized housing. Given this reality, we vehemently believe that OHCS does not deserve the misjudgments stated in the preliminary report, and moreover, that the proposed "remedies" are illogical, and entirely without basis in law or fact.

The OIG preliminary audit report is organized into a single finding with six subparts. For purposes of this response, OHCS will treat each of the six subparts as a separate finding and label them as such. However, before undertaking a more detailed response to each of these six OIG findings, we will address the OIG's disregard of the Section 8 administrative structure and identify some of its more serious misstatements.

Background

1. The Section 8 State Agency Program Confers Substantial Discretion Upon Housing Finance Agencies.

Since 1975, HUD has promulgated Regulations that set forth a separate set of rules under the Section 8 program for State housing agencies that "finance the construction and rehabilitation of housing and assume the risks of default and foreclosure on developments they finance." 24 C.F.R. § 883.101, as published April 15, 1975. The State agencies were given substantial flexibility in recognition of their assumption of financial responsibility for the projects and their experience in responding to local housing needs and conditions. As the Regulations explained, "[t]o allow these agencies flexibility in developing programs to meet housing needs, special policies and procedures are provided." *Ibid.*

The relative responsibilities of HUD and the State agencies were also set out in the Regulations and in the ACCs and other documents that were used in the State Agency Section 8 program. Thus, the current 24 C.F.R. § 883.106 provides:

> Subject to audit and review by HUD to assure compliance with Federal requirements and objectives, Housing Finance Agencies (HFAs) shall assume responsibility for project development and for supervision of the development, management and maintenance functions of owners.

That Regulation goes on to note:

> HUD will periodically monitor the activities of HFA's participating under this part only with respect to Section 8 or other HUD programs. This monitoring is intended primarily to ensure that certifications submitted and projects operated under this part reflect appropriate compliance with Federal law and requirements.

2. HUD Administration Of The Section 8 State Agency Program Allows For Corrective Action By The HFA Before Prospective HUD Remedial Action.

The Regulations and the ACCs do not envision the kind of "gotcha" administration of the program that the OIG report suggests, in which a "violation" is determined to exist many years after the fact and the State agency is penalized without notice. Instead, they anticipate that HUD will advise the agency of any violation and give it an opportunity to correct the problem. Thus, the Regulations, in their current form (as well as prior iterations) provide:

Comment 1

> The ACC will provide that, if the Agency fails to comply with any of its obligations, HUD may determine that there is a substantial default and require the Agency to assign to HUD all of its rights and interests under the Contract; however, HUD will continue to pay annual contributions in accordance with the terms of the ACC and the Contract. *Before determining that an Agency is in substantial default, HUD will give the Agency a reasonable opportunity to take corrective action.*

24 C.F.R. § 883.607(b) (emphasis added).

As is required by the Regulation, the OHCS ACC provides, at Section 2.16(b)(1):

If the HFA defaults in the observance or performance of … any … term, covenant, or condition of this ACC or of any term, covenant, or condition of any Contract … or fails to comply with the applicable provisions of the Act and the regulations issued pursuant thereto, the Government may, *after notice to the HFA giving it reasonable opportunity to take corrective action,* determine that the occurrence of any such event constitutes a Substantial Default hereunder as to the Project.

HUD Form 52643C (4/76) (emphasis added).

Comment 1

Finally, it is worth emphasizing that the remedy contemplated by the Regulations and the ACC for agency default - after notice and opportunity to correct - is termination of the agency's rights under the various contracts, which termination is to last for as long as the default continues. There is no discussion, anywhere in the HUD regulatory materials or documents, even in the event of continued, willful defaults by the State agency, of financial penalties or recoupment.

3. The OIG Disregards And Mischaracterizes The Administrative Process.

In our "exit interview" with the OIG staff responsible for the report, OHCS sought to obtain an explanation of the report and its findings and its recommendations within the context of the administrative structure contemplated by the Regulations and the ACC. Notwithstanding this effort, OHCS received little, if any, explanation for the OIG's divergence from apparent legal standards.

(a) The OIG Provided No Rebuttal To OHCS Corrections And No Authority For Its Recommended Penalties.

Comment 2

At the outset of the "exit interview" OHCS asked several direct questions of the OIG. Was HUD providing OHCS with formal notice in this OIG report of a violation of some sort that had to be corrected? OIG staff responded that these findings were only recommendations from OIG to the Office of Housing, recommendations which had not been accepted by the Office of Housing. OHCS also inquired as to how OIG could recommend the imposition of millions of dollars in financial penalties upon OHCS for alleged violations of which OHCS had never been given notice, indeed, as to which HUD had made no determination that such violations even existed. OIG had no response. We submit that it is both unlawful and professionally irresponsible for OIG to demand financial penalties in this context.

Comment 3

OHCS then identified factual and legal errors in each of the OIG's findings – errors that delegitimize each finding. The OIG neither justified its errors nor corrected any of our assertions. Indeed, it was essentially as if OHCS personnel were talking to a blank wall. As a consequence, OHCS found this audit experience, and especially the exit interview, to be quite frustrating.

(b) The OIG Ignores The History Of OHCS Administration In Close Cooperation With HUD.

Although OIG appears willing to disregard the administrative structure of the Section 8 program, HUD and OHCS have not. Instead, OHCS has a nearly three-

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decade history of close cooperation with HUD in administering the ACC and the Section 8 program. OHCS and HUD worked cooperatively during the 1970's and 1980's to establish the present ACC program. This cooperative relationship has continued through the years that the ACC has been in effect as OHCS and HUD have been in routine and regular contact over its administration. Telephone calls and other communications between the agencies are common and OHCS Section 8 project files have been, and remain, available to HUD for review at any time. Indeed, HUD and other appropriate federal entities have conducted at least seven formal audits/reviews of the OHCS ACC portfolio through the years since inception of the program. Thus, the monitoring process contemplated by the Regulations has been in place and working. The OIG simply ignores this reality.

In the performance of its monitoring responsibilities, HUD has agreed with or condoned all aspects of OHCS administration now under question by the OIG. Most, if not all, of the factual predicates for the findings in this audit reach back over many years – well beyond the stated 3-year scope of this audit. In all of that time, neither HUD in its years of regular communication with OHCS, nor any of the previous audits or reviews, took issue with respect to the matters now raised by the OIG.

Comment 4

All limited-distribution Section 8 ACC projects – together with proposed terms and documents - were submitted by OHCS to HUD in advance for, and received, HUD approval before being implemented. This HUD approval covered, *inter alia*, the form and substance of loan documents, management agreements, regulatory agreements and HAP contracts. In other words, the contract language dealing with the ability of the parties, e.g., to use residual receipts to cover shortfalls in limited distributions, to set and pay management fees, etc., were all approved by HUD. Indeed, HUD personnel and their legal counsel attended all such project closings and participated in the execution and preparation for recording of such documents.

OHCS has regularly communicated with HUD, particularly through HUD's Portland office, in administering the ACC portfolio. OHCS has always followed relevant HUD advice and guidance when given. In many instances, HUD has both acknowledged and advised OHCS to exercise its own discretion as the housing finance agency charged with administration under the ACC. OHCS has exercised this discretion carefully and effectively.

(c) The OIG Ignores OHCS Discretionary Authority As HFA.

Consistent with 24 C.F.R. § 883.101, HUD has consistently and properly acknowledged that under the Regulations and the ACC, OHCS is given discretionary authority to interpret and apply contract terms and relevant program standards. The ACC and relevant project documents approved by HUD give interpretative authority to OHCS to determine application of and compliance with the terms of the loan, regulatory and management agreements. As noted above,

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HUD has often acknowledged OHCS' discretionary authority and deferred to its administrative judgments. OHCS monitoring activity within areas of OHCS discretion is not subject to second guessing because the OIG would prefer a different exercise of that discretion – particularly one tied to HUD standards for other programs or developed after-the-fact. Rather, HUD (and OIG) review of OHCS discretion is confined to identifying whether or not OHCS abused its discretion, i.e., by acting in an arbitrary and capricious manner under the circumstances at the time.

(d) The OIG Does Not Justify Its Disregard of HUD Oversight Or Of OHCS Discretionary Authority.

The OIG report acknowledges none of the ongoing administrative activity and cooperation with HUD. It does not place its findings and recommendations in the context of the program legal requirements. It does not explain why it believes that nearly three decades of Office of Housing administration of the Section 8 program has been incorrect and why that alleged maladministration by HUD (which we do not believe occurred) should result in financial sanctions upon OHCS. Instead, it trumpets invented numbers as to misspent funds and suggests that they can and should be recovered. This is simply disceptive.

Misrepresentations of Facts and HUD Requirements

The detailed responses to the OIG findings include citations of numerous misstatements of fact and HUD requirements. However, some of these are so egregious as to raise questions not simply about the judgment of the OIG, but about its motives - particularly since a number of these instances were raised with OIG during the OHCS exit interview and yet OIG neither responded to OHCS comments nor agreed to change its report. The following are a few examples.

1. In discussing the revaluation of commercial space that led to increasing the owner's equity contribution and produced alleged "excessive distributions" to the owner of Uptown Tower Apartments, the report states:

> In accordance with 24 CFR 883.305(c), Oregon Housing was required to certify to HUD at the completion of the project that the replacement cost of each dwelling unit did not exceed Federal limitations. On the basis of this rule, as cited, the report concludes that the owner was credited with too large an equity contribution to the project, leading to the "excessive distributions."

Comment 5

The report, however, ignores 24 C.F.R. § 883.305(d), which explicitly permits per unit replacement costs to exceed the cost limitations of 305(c), as long as the excess amount over the replacement cost limits is not taken into account in determining and adjusting contract rents. This is precisely what OHCS did with

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respect to the project, and HUD approved it. To cite 24 C.F.R. § 883.305(c) and ignore the qualifying language in 24 C.F.R. § 883.305(d) is to make the OIG presentation simply not truthful.

That misstatement was repeated later in the same part of the report, with the incorrect observation that:

> Oregon Housing staff did not consider that the change in value of the commercial space would affect the limitation on replacement cost attributable to the dwelling space.

In fact, Oregon Housing had certified to HUD ten years earlier in the proposal for the project that the project exceeded the dwelling space replacement cost limits of (c), but that pursuant to 24 CFR 883.305 (d) the project was still within Regulations as the excess was not taken into account when setting contract rents. OHCS staff knew that revaluing the commercial space did not cause replacement costs attributable to dwelling space to exceed the limits of (c) because that limitation had been exceeded 10 years earlier at the time the proposal was submitted and approved by HUD.

Comment 6

2. In the same discussion, OIG cites 24 C.F.R. § 883.306(c) as stating that "an increase in equity contribution may be justified by the project owner only through cost certification data accepted by the Housing Finance Agency." The report cites the absence of cost certification data to support the increased equity as further justification for its finding of excessive distribution. As with the previous item, however, the report simply omitted other language from the Regulation which specifically authorizes the actions at issue. Thus, the cited provision from 24 C.F.R. § 883.306(c) goes on to add "or as specified in the Proposal." In other words, cost certification is not the only way to justify increased equity. Pursuant to 24 C.F.R. § 883.411(a) (which is cross-referenced in 306(c)), cost certification is not required for projects with rents that are equal to or less than comparable rents. The 20% equity contribution was also certified and approved in the proposal for the project. Again, the OIG report seems to intentionally misstate the regulatory requirement in order to bolster a false charge.

Comment 7

3. In asserting that interest credited to the owner of Uptown Apartments "exceeded a reasonable amount by $245,524" the report cites HUD Handbook 4350.1 Chapter 4 at 4-30 E. and says "interest should not exceed the rate that the owner could earn elsewhere in a reasonably safe security." It then states that the interest rate on a 6-month certificate of deposit is the appropriate measure of a reasonable interest rate. However, the report omits the remainder of the quoted provision, which goes on to say "such as a Certificate of deposit of the same duration as the loan to the project." Why did the OIG leave this part of the sentence out? Because the operating loan to the project was a 20-year loan, which would not support OIG's use of 6-month CD rates as a comparison. The rate the owners used was appropriate to a twenty-year commitment of funds, consistent

with the HUD guidance. The OIG selective quotation from that HUD guidance can only be viewed as an effort to mislead.

Response to Findings

OHCS does not question OIG's authority to review and evaluate its performance in administration of the State Agency Section 8 program. We welcome that review, as we have had periodic audits by HUD's Portland office throughout the past 29 years. We also recognize that there may be differences of opinion as to how particular HUD requirements should be interpreted and applied. We believe, however, that any such differences, as well as the underlying rules, should be honestly presented and fairly described. The OIG report falls short of this most basic requirement.

With this general background, OHCS now addresses in order the findings by the OIG. The arguments and exhibits provided in this response are illustrative and not intended to be exhaustive.

Finding 1: Oregon Housing Allowed Management Agents For 22 Projects To Receive $693,310 In Excessive Management Fees.

Response: OHCS Appropriately Exercised Its Contractual Discretion To Regulate Relevant Management Fees.

The OIG's first finding is fundamentally flawed. In reaching this finding, the OIG, among other things: (1) misconstrued the standards governing OHCS administration of management fees; (2) employs a management fee schedule that the OIG, itself, acknowledges does not apply to OHCS in the administration of its Section 8 portfolio; (3) incorrectly applies the improper schedule so as to "find" noncompliance by OHCS; (4) summarily ignores OHCS' own established practice approved by HUD in setting and monitoring management fees; and (5) misrepresents the beneficial effect of OHCS management fee administration.

1. The OIG Misconstrues The Standards That Govern OHCS Administration Of Management Fees.

Comment 8

The OIG states that under HUD Handbook 4381.5, OHCS is required to perform a management fee review on its projects. Although OHCS certainly does conduct management fee reviews of its projects, OIG is mistaken in applying HUD Handbook 4381.5, Chapter 3, and in particular the "per unit per month" (PUPM) fee schedule therein in assessing proper management fee administration by OHCS. The Chapter 3 standards are largely applicable to HUD-financed or insured Section 8 projects, not the Section 8 projects financed and administered by OHCS pursuant to the ACC. OHCS uses all HUD standards as guidance,

where useful, but as previously noted, 24 C.F.R. §883.106 specifically reserves, *inter alia*, the administration of management fees on such ACC projects to it as the HFA.

A correct reading of paragraph 3.1 of the Handbook, cited by the OIG, is totally consistent with the directive in 24 C.F.R. §883.106 that gives OHCS, as the HFA, discretionary authority to administer management fees in this State Agency Section 8 portfolio. In paragraph 3.1, the Handbook states, in pertinent part, as follows:

Comment 9

> Owners determine the actual amount of fee to be paid to the management agent. *As provided for in project Regulatory Agreements* and rental assistance contracts, *for certain projects* HUD determines the amount of fee that may reasonably be paid out of project funds.

Exhibit A (emphasis added).

Comment 8

It is obvious from this passage, that even if paragraph 3.1 was intended to embrace State Agency Section 8 projects, such projects would be exempt from having HUD set the management fees because the relevant regulatory agreements give that role to OHCS, and not HUD. In other words, HUD determines the amount of management fees that can reasonably be paid only for certain projects. What projects? Even where applicable, Chapter 3 of the Handbook indicates that HUD only sets management fees on those projects whose regulatory agreements or rental assistance contracts provide for HUD's determination of the management fee**.** OHCS loans are not HUD-held or HUD insured mortgages and are given by 24 C.F.R. §883.106 to HFA administration. Even if paragraph 3.1 were applicable, the relevant regulatory agreements and rental assistance contracts (many, if not all, specifically reviewed and approved by HUD) *do not reserve* management fee setting authority to HUD. Accordingly, the OIG cannot arrogate to itself the discretion reserved to OHCS to set appropriate management fees and most certainly cannot rely upon paragraph 3.1 for a contrary proposition.

Comment 10

Further support for our reading of Chapter 3 is manifest from the language used therein to describe the procedure to be used by HUD staff when relevant project regulatory agreements provide for HUD determination of management fees. This procedure is put squarely in the context of dealing with budget-based rental increases. Budget-based rental increases do not apply to the type of project included in the OHCS ACC portfolio, for example, because the loan documents for such projects mandate that their rents be established by employing an Annual Adjustment Factor (AAF) approach.

Comment 11

It is worthy of further note that Chapter 3 specifically excludes all "profit motivated Section 8 projects that have rents set through use of the Annual Adjustment Factor (AAF)" from its application. Handbook 4381.5, Chapter 3,

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Figure 3-5, Page 3-9, item #2 under 'No Review' (emphasis added). (Exhibit B.) By this provision alone, it is clear that unlimited distribution projects under question in this finding are exempt from application of the standard the OIG seeks to establish under paragraph 3.1. Therefore, even if the OIG had a basis to apply paragraph 3.1 to the limited distribution projects in question, it cannot apply paragraph 3.1 to the following profit-motivated Section 8 projects: (1) Country Club Manor; (2) Rose Apartments; (3) Seneca Terrace; (4) Stafford Square II; and (5) Village East.

2. By Its Own Admission, The OIG Employs A Management Fee Range Standard In This Report That Does Not Apply To The OHCS State Agency Section 8 Project Portfolio.

Comment 12

The OIG directly acknowledges in this finding that PUPM management fee maximums do not apply to the OHCS State Agency Section 8 Portfolio. Notwithstanding this disqualifying admission, the OIG proceeds to use that very standard to "determine" whether or not OHCS allowed excess management fees. There is no justifiable basis for such an inherently inconsistent rationale.

Comment 13

The OIG attempts to justify this absurdity by tacitly disqualifying OHCS' own policy of evaluating management fees for each project upon identifiably relevant factors, including considerations provided by HUD in Handbook 4381.5. To accomplish this leap of logic, the OIG ignores relevant project files – each documenting the OHCS practice of considering all relevant factors, e.g., local rates, size and location of a project, population needs, and even comparative HUD Section 8 rates. Essentially, it ignores OHCS policy because it does not find the details of that policy summarized in a single document and then states that

> Although OHCS is not required to use HUD's computed management fee range, it must use some range. It must follow the same procedures HUD uses to determine the maximum fee range (i.e. the procedures in Chapter 3 of HUD Handbook 4381.5).

So, first the OIG says that OHCS is not required to use PUPMs to set management fee standards, then it ignores the documented fact that OHCS uniformly has been applying management fee standards, and then reverses itself and applies the PUPM standards from Chapter 3 to "find" that OHCS owes $693,310 for management fees that exceed PUPM standards.

The OIG further states in this finding that "Under 4381.5, Oregon Housing is further required to perform a management fee review when a project owner or agent requests an increase in the management fee percentage." In fact, OHCS has always practiced management fee review when setting management fees or considering requests for increases to them. This is self-evident from OHCS project files and was explained in person directly to the OIG auditors by OHCS

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personnel. There has not been a time when a management fee review has not been the policy of OHCS under such circumstances.

Comment 14

Paragraph 3.12 of HUD Handbook 4381.5 (see Exhibit C) gives guidance as to what steps should be taken in the performance of a management fee review. These steps include: (a)determining if Hold-Harmless Provisions are applicable; (b) determining whether management fees are reasonable; (c) documenting the results of the review; and (d) notifying the owner and agent of the determination. OHCS practices a management fee review process that always has gone through these basic steps to determine the appropriateness of any management agent fee. Not only is there nothing in Paragraph 3.12 in contravention of OHCS practice, there is no authority in Paragraph 3.12, or otherwise, upon which the OIG can compel OHCS to apply PUPM standards as it seeks to do in this report.

Comment 15

PUPM fees are mentioned in Chapter 3 in connection with "add-on fees" used in special circumstances "only after computation of the permitted percentages for residential, commercial and miscellaneous income have been determined and approved by HUD" (Handbook 4381.5, Chapter 3.7)(Exhibit D). HUD does not determine and approve management fees for OHCS-funded projects and has never done so. This is more evidence from the Handbook that these aspects of Chapter 3 (including the PUPM standards) do not apply to the OHCS Section 8 State Agency projects. Because it understands this point, past reviews by HUD of OHCS procedures in this area have never included any suggestion that it abandon its management fee review policy in order to follow inapplicable standards from Chapter 3.

3. The OIG Misconstrues The PUPM Standards In Order To "Find" OHCS Noncompliance.

Comment 16

OHCS firmly submits that the PUPM standards do not apply to its administration of management fees under the ACC. However, even if the PUPM standards did apply, they would not justify the OIG's use of a $35 per unit maximum in finding noncompliance by OHCS. OIG states that "the maximum management fee range for properties in Oregon, as computed by HUD for 2001 - 2003 is $35 PUPM." That assertion is not true due to the fact that HUD Handbook 4381.5 Chapter 3 at 3.7 identifies "add-on fees" above the $35 per unit maximum used by the OIG that are allowable for circumstances applicable to the OHCS projects in question were they subject to the PUPM standards. Exhibit E.

The following are examples of where "add-on fees" would apply to OHCS projects in applying the PUPM standards - and thereby undo the OIG's findings of excess management fees.

(a) Remote Location Add-On Fees

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Under Handbook 4381.5, Chapter 3, at Paragraph 3.7, a fee in excess of the $35 per unit standard is allowed if: (1) no local management is available and agent will incur unusually high travel costs; or (2) special outreach is required to attract residents. Paragraph 3.7 (a) (2), Figure 3-4. This add-on allowance clearly would apply to the following projects cited in the OIG's finding: (i) La Grande Retirement Center (La Grande); (ii) La Grande Plaza (La Grande); (iii) Leisure Way (Wallowa); (iv) Shady Oaks Apartments (Trail); (v) Stafford Square II (Redmond); (vi) The Village Apartments (Monmouth); (vii) Meadowbrook II (John Day); and (viii) Grande Woods (La Grande).

(b) Scattered Site Add-On Fees

Paragraph 3.7 also allows for supplemental management fees for "scattered sites". It provides "[t]he agent may be paid additional compensation for the extra travel expenses incurred in overseeing several sites." Paragraph 3.7(a)(2), Figure 3-4. This add-on allowance clearly would apply to the following projects cited in the OIG finding: (i) Shady Oaks; (ii) Stewart Terrace; (iii) Forest Hills Manor; (iv) Grande Woods; and (v) Meadowbrook II.

(c) Adverse Neighborhood Conditions Add-On Fees

Paragraph 3.7 also allows for supplemental management fees for "adverse neighborhood conditions". The conditions may include high incidence of crime or vandalism, and large concentrations of deteriorated or substandard housing. The apparent basis for this add-on allowance is that such conditions tend to increase necessary maintenance and repair costs. They also contribute to higher resident turnover, vacancies, and rent collection losses. Applying the standards of this add-on allowance would justify higher management fees for the MLK-Wygant project cited in the OIG finding.

(d) Population Mix Add-On Allowance

The Handbook also allows for supplemental management fees for special targeted populations that require special management. Many of the OHCS-funded projects cited by the OIG in this finding include such populations. The Elderly and Disabled Bond Indenture from which such projects were funded was designed to address the needs of mentally disabled persons and the physically handicapped. Several of the projects named in this finding have tenants that are targeted toward this population. This is an extenuating circumstance and justifies additional "add-on" management agent fees, similar to the examples HUD gives in its handbook. High populations of mentally and physically disabled persons in the project intensifies every aspect of management and increases maintenance expense, repair problems, resident turnover, vacancies and rent collections, not to mention the added expense of managing those with special needs. The projects with special needs populations that would clearly qualify for this add-on allowance include:

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	(i) Bronaugh Building; (ii) Hollyfield Village; (iii) Park Tower; (iv) Lexington Apartments; and (v) Uptown Tower.
Comment 17	From the foregoing examples, it is abundantly evident that not only has the OIG applied the wrong standard in assessing OHCS' administration of management fees, but that it has misconstrued the incorrect standard that it seeks to impose in order to "find" excessive fees. The OIG offers no analysis or explanation for its failure to include consideration of appropriate add-on fees in the application of the PUPM standards. It also offers no rational justification for imposing the PUPM standards after its own admission that such PUPM standards do not apply to OHCS' ACC administration. Such fundamentally flawed findings are wholly without merit.
	4. The History Of HUD Supervision Demonstrates Its Recognition Of OHCS' Discretion To Establish Management Fees.
	The OIG makes no finding that HUD affirmatively directed OHCS to administer its review of management fees any differently that it has done over nearly the past three decades. This is because HUD has accepted and condoned OHCS policy and practice on this matter through the years and recognized OHCS' discretionary authority under the ACC.
	(a) HUD Recognizes OHCS Discretion To Administer Management Fee Rates.
Comment 18	OHCS has been told by HUD that HUD's guidelines governing management fees do not apply to OHCS projects (see Pauline Horseman's memo to Marsha Morey dated 4-15-85, Exhibit F). Rather, HUD has been explicit that "State agencies [such as OHCS in this context] are to develop their own policies and procedures relative to review of management agents and fees." (see Bonnie Billedeaux' letter to Maynard Hammer dated 8-28-86, Exhibit G). This specific instruction is consistent with the tender of discretion to the HFA under 24 C.F.R. 883.101 and with the statement in HUD Handbook 4381.5, Section 1.1, that "[m]ost of the activities discussed in this Handbook are the responsibility of the Office of Multifamily Housing Management" – and not, consequently, of HFA's.
Comment 19	OHCS personnel can find no historical written document, either regulatory or via HUD Notice or Advisory, directing OHCS to follow HUD Handbook 4381.5 REV - 2 procedures for management fee reviews or calculations - and the OIG certainly never identified any such direction.
	It is obvious that HUD has never expected OHCS to comply with the PUPM standards. For example, HUD Handbook Chapter 3 at 3.7 (a) (1) makes the following statement:

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"HUD Area Offices will establish a schedule of project characteristics/conditions that warrant add-on fees and a flat fee amount (PUPM) for each characteristic/condition (see paragraph 3.21). Area offices will make this schedule available to owners/agents of projects within its jurisdiction." Exhibit D.

If HUD believed that the OHCS projects were under its jurisdiction for application of PUPM standards, it would have made this schedule available to OHCS ACC-governed owners and agents. In fact, OHCS has no record of having received any such document, nor has it or any agent or owner in its portfolio been apprised by HUD of this schedule. The obvious reason HUD has not disseminated this schedule to OHCS for its ACC projects is because HUD area offices were aware that this regulation does not apply to OHCS-funded, non-insured projects. Indeed, when following up on this point, Pauline Horseman, an OHCS Housing Management Specialist, recorded being told by HUD that "the guidelines [HUD has on this matter] do not apply to [OHCS ACC-administered] projects". Exhibit F.

Comment 20

Through five successive HUD field office audits of OHCS procedures, and in routine communications over the years, HUD has given no correction of procedure or policy by OHCS in regulating management fees. There were HUD field office audits of OHCS on May 18, 1981; October 8, 1985; August 24, 1987; January 16, 1988; and July 23, 1997. Through five successive field office audits of OHCS's Management Function (see Andrew Hess' letter to Gregg Smith dated 12-20-80, Exhibit H) never has OHCS been informed that it is remiss in not "following the same procedures HUD uses" in the performance of Management Fee Reviews. HUD has conducted several field office audits of OHCS procedures over the past 20 years.

(b) OHCS Policy Values and Considers HUD Guidelines.

Comment 21

Although OHCS is not required under Handbook 4831.5, Chapter 3 to comply with the requirements that the OIG seeks to impose upon it, OHCS has developed a policy that closely follows relevant aspects of Chapter 3. Chapter 3, for example, directs that"[o]wners determine the actual amount of fee to be paid to the management agent" (Section 3.1). Chapter 3 also states that "[f]ees derived from project income (residential, commercial and miscellaneous) must be quoted and calculated as a percentage of the amount of income collected by the agent" (Section 3.2 (b)). It also states that HUD will allow management agents to earn fees higher than its normal standards under conditions such as remote locations, scattered sites, etc. E.g., Section 3.5 (a).

Additionally, HUD Handbook 4381.5 at paragraph 3.18 states the following:

> Goals of the Reasonableness Determination. The goals of HUD's review of management fees for reasonableness are to assure that fees approved for projects:

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1) Provide sufficient compensation to attract the quality of management needed to administer the project during the time period covered by the fee.

2) Do not significantly exceed the amount that HUD determines independent agents and owners would ordinarily negotiate for comparable services at projects in the same geographic/cost area, except as justified by conditions that require more time and effort on the part of the management agent.

Exhibit D.

OHCS policy conforms with relevant HUD guidance and includes all of the following elements:

Comment 22

1. Budget an amount sufficient to attract competent, professional management. This will allow for replacement of the current agent, if necessary, with superior management without breaking the budget (see Larry Leaches letter dated July 14, 1982, Exhibit J).

Comment 23

2. Look at the market for the project and determine what comparative projects are paying. Customary fees for similar projects may not be exceeded (see OHCS Standard Practices Manual Section 2.14 July 6, 1993 ed., Exhibit K).

Comment 22

3. Allow unfettered negotiations between owners and agents to allow competition to create market rates that would attract professional off-site management agents. Exhibit J.

Comment 24

4 Consider extenuating circumstances that may demand higher rates (i.e., remote location, travel expenses, population type). Exhibit I.

5. Require monthly replacement reserve deposits to assure adequate funds for project maintenance (Management Agreement).

6. Require Management Agents to submit a Plan and Qualification document for OHCS review prior to approval of any fee. Exhibit I.

7. Require Management Agents to agree to minimum levels of marketing and advertising (Management Agreement).

8. Conduct in-depth on-site inspections and financial reviews to monitor for adequacy of management. Exhibit L.

9. Increases in management fees must be approved by OHCS in writing before implementation. Exhibit K.

10. Only certain kinds of income may be used for the calculation of the management agent fee (Management Agreement).

Comment 25

Again, this detailed policy has been developed in cooperation with HUD and endured nearly three decades of oversight by HUD. It is faithful to HUD guidelines in every relevant way and has never before been questioned or criticized by HUD in all of that time. Under this policy, HUD actually approved the initial management fee rates identified in the project proposal documents. Under this policy, OHCS has reviewed all management fee rates – initially and upon requested changes. Under this policy, OHCS has denied various requested changes. Under this policy, OHCS has imposed moratoriums on the payment of management fees for projects showing financial distress. All of this is evident from the project files. There is no legitimate basis for the OIG to displace this policy with a requirement that OHCS conform to the PUPM standards.

5. OHCS Management Fee Policy Has Been Efficient And Resulted In Superior Management Of Its Projects.

(a) OHCS Aggressively Complies With HUD Handbook 4590.1.

The OIG states that HUD Handbook 4590.1 requires that the HFA ensure that projects are maintained in good financial condition. In fact, OHCS goes to great lengths to monitor and analyze both the financial and physical condition of its projects. For financial monitoring, OHCS requires quarterly reports and annual audited financial statements, as well as annual budgets. OHCS also inspects records during periodic and other on-site inspections.

Quarterly reports are required from each project. Receipt of these reports is verified for timeliness, content and form. They then are reviewed in detail and compared with annual budgets (which are required to be submitted prior to the start of each fiscal year). Annual audited financial statements also are required, followed for, reviewed when received and analyzed. A minimum of four financial measurements are applied to each as "performance indicators" and standards are compared for each indicator. These measurements are Debt Service ratio, Total Expenses to Total Revenue, Physical Vacancy, and Payment Status.

Comment 26

Projects that fall below OHCS financial standards for any one of the four indicators are referred for "Special Review", where an in-depth analysis is performed using a system of 8 financial measurements including Net Cash Throw-off, Operating Cost Coverage Ratio, Cash Requirements to Total Revenue, Economic Vacancy Loss, Payroll Expense to Total Revenue, Annual Revenue Per Unit, Replacement Reserves Per Unit, and Surplus Cash Per Unit. Projects subject to Special Review are compared to industry standards and graded red, yellow or green for each measurement. Of the 22 projects named in this finding as having received excessive management fees, 18 generated surplus cash in each year of

the three-year scope of review of this audit. Of the 22, only 2 did not generate surplus cash in at least two out of the three years.

(b) The OIG Employs Selective Use of REAC Scores To Present A False Sense of the OHCS ACC Portfolio.

Comment 27

The selected REAC scores noted by the OIG in this finding did not result from excessive management fees – and the OIG presents no evidence that they did. As noted previously, OHCS conducts its own regular on-site reviews of projects in its ACC portfolio. These OHCS on-site reviews of project conditions and project management are much more thorough and detailed than HUD reviews done through the Real Estate Assessment Center (REAC). Indeed, OHCS reasonably believes that its inspections give a much better picture of the true health of a project than do REAC scores.

OHCS keeps very close scrutiny of the physical and financial health of its projects and regulates management thereof accordingly. With that perspective, it is instructive to bring out more information about the projects for which the OIG makes note of certain REAC scores. A small minority of the projects reviewed by OIG in this finding (only six) were said to have received scores of below 70 out of 100 in REAC inspections conducted by HUD. These projects were Country Club Manor, La Grande Plaza, Rose Apartments, Seneca Terrace, Stafford Square II, and Village East Apartments. The unsupported implication by the OIG is that OHCS allowed excessive management fees, which caused project funds to be diverted from project maintenance, thereby contributing to inferior maintenance of the projects. The implication is without basis in fact.

The real facts are that the composite average of the most recent REAC scores of which OHCS is aware for all of the twenty-two projects is 86.32 – a very respectable composite average. The composite average of the most recent REAC scores of which OHCS is aware for the sixteen projects not discussed by the OIG is 89.63. Finally, the composite average of the most recent REAC scores of which OHCS is aware for its Risk-Share Portfolio is 90.5. Beyond these more enlightening numbers is the further reality that many of the deficiencies that resulted in the lower REAC scores highlighted by the OIG turned on rather inconsequential factors, or mistakes by the REAC inspector. None were caused by putatively excessive management fees. Indeed, the questioned REAC scores may have been even lower, but for superior management. Where appropriate, REAC deficiencies were promptly corrected because of superior management. The OIG's failure to acknowledge the overall strength of the cited projects and the failure to acknowledge the prompt correction of cited deficiencies is very disturbing to OHCS.

The following is offered in partial explanation of the six projects cited for low REAC scores.

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1. Country Club Manor - 2003 REAC score 67c

The 2003 REAC Inspection deducted 8.1 points for air conditioners placed in the units' living room windows. The 1997 Uniform Building Code states in Section 310.4 that

> Basements in dwelling units and every sleeping room below the fourth story shall have at least one operable window or door approved for emergency escape or rescue that shall open directly into a public street, public alley, yard or exit court. The emergency door or window shall be operable from the inside to provide a full clear opening without the use of separate tools.

It is well known that the issue of blocked egress, and whether window air conditioners violate the above-quoted policy, has been an issue across the country. A national HUD policy clarifying this issue has yet to be released per the Portland HUD office. The Country Club Manor units are in compliance with the local fire code. The local fire code requires a living area to have two egress escapes.

Additionally 4.2 points were deducted due to non-functioning hardware on the hallway fire door (Level 3 finding). The management agent removed this hardware to enable use of the door by elderly tenants. It was determined by the management agent that the doors, with the hardware, were too difficult for the elderly tenants to operate (too heavy to open). Upon inquiry, the Fire Marshall informed the management agent that the hardware was not required. Accordingly, the management agent and owner chose to remove the hardware in order to accommodate the tenants.

An additional 12.3 points added to his 67c score would have given the project a score of 80. OHCS is unaware of any subsequent REAC score for Country Club Manor.

2. La Grande Plaza - 2003 REAC score 64

Twenty-two and seven-tenths (22.7) of the deducted points involved paving, concrete, and roofing issues. The Management Agent used a three-point approach to address these issues. That plan was in place before the inspection, but couldn't be implemented until later in the year. The three keys were: (1) accumulating cash from the 2003 operations by waiting until November, 2003 to perform the repairs; (2) communicating to the owners the rationale for holding back $10,000 from 2002's cash flow to address these needs; and (3) utilizing the replacement reserves for roofs for the buildings housing units 1, 2, 3, 4, 5, 8, 9, 10, 11, 14, and 15.

The roofs for the relevant buildings have been replaced. The parking lot entrance was rebuilt, the depression was filled and leveled, and the problematic areas of the

parking lot were resurfaced. Some new minor concrete issues have arisen, but those are being addressed just like they were last year. These were very costly items, but have been accomplished.

With the addition of the 22.7 deducted points the 2003 score would have been 86.7. In fact, the REAC Inspection score for 2004 is 94a.

3. Seneca Terrace - 2003 REAC score 62

Roofing and exterior paint were two of the major issues noted. The project exterior paint was completed and a new roof was installed in March of 2004. At the time of the 2004 OHCS Annual Inspection several of the unit issues, such as screens and hardware, also had been addressed. OHCS is unaware of a more recent REAC score.

4. Village East - 2003 REAC score 60c.

Fifteen and eight-tenths (15.8) points were deducted for issues that have been contested for valid reasons. Six and eight tenths (6.8) of those points were deducted due to roofing concerns. All roofs had been replaced with a 25-year composition shingle in 1995-1996. Before the shingles were replaced, necessary sheeting was removed and replaced, all barge rafters were rebuilt and the rakes had been replaced as necessary. Evergreen Roofing of Oregon inspected the roof and stated that “[t]he material on all buildings appears to be in good condition overall, showing only minor signs of wear and damage from the elements. ……No shingles are missing at this time and all areas appear watertight.”

Nine (9) points were deducted for meter seals on the vacant load side panels of the meter bases at the complex. The head engineer from the Springfield Utility Board spoke to the inspector and explained that its technician had made an error in installing the seals. The REAC Inspector still deducted the points.

If the 15.8 had not been deducted, the project score would have been 75.8. OHCS is unaware of a more recent REAC score.

5. Stafford Square – 2003 REAC score 56.

Eighteen and three-tenths (18.3) points were deducted for expired smoke detectors. The detectors had expired within the last two months and have (and continue to be) serviced. Nine and five-tenths (9.5) points were deducted for missing or damaged shingles and 1.4 points for damaged downspouts. New roofs/downspouts were installed in early 2004.

Rear fence damage resulted in the deduction of 3.1 points. This is an ongoing issue. Stafford Square I and II were sold to separate owners and a fence was built between them. The kids continuously break boards off the fence to go back and

forth. Another 4.3 points was deducted for necessary parking lot repair. The parking lot was repaired and resurfaced in 2003.

If you add these points back, the project would have received a score of 91. The 2004 REAC Inspection score is 87.

6. Rose Apartments - 2003 REAC score 51

Although the 2003 REAC Score was 51 points, the owner contested the score because 23.1 of the points were related to the commercial space and dealt with such things as the bar and pizza area. Another 17.4 points were subtracted due to the Fire Protection missing the decorative head of the sprinkler. The sprinkler was in good working condition.

If these points were added back the score would have been 74.1. The 2004 REAC Inspection score is 95.

(c) OHCS Management Administration Has Been Beneficial and Efficient.

The OIG has neither demonstrated that the management of OHCS ACC projects has been detrimental nor demonstrated that it has been inefficient. Certainly, it has failed to demonstrate that excessive management fees have been permitted inappropriately. In fact, the opposite is obvious. OHCS management policy has produced superior and efficient results for its projects.

Comment 28

Superior management produces superior results and OHCS policy has always been to ensure superior management of its projects. OHCS-funded project management fees have not been a detriment to project operations as compared to HUD's PUPM standards. In a profit-driven, market economy, OHCS has striven to ensure superior project management that provides better service to tenants and a more aggressive marketing technique, both of which produce better occupancy, which in turn reduces turn-around expense and produces a higher bottom line profit. Also, superior management produces better risk-management, more effective expense control, and superior project maintenance. All of these things create better cash flow, higher profits, and more residual receipts. OHCS policy, procedures and practices relative to management agent fee review and reasonableness have resulted in better management, higher profits, and more residual receipts than what would result if OIG's proposals were put into place.

The true reality is that the average management fee for OHCS State Agency Section 8 projects, when factored for occupancy, is as low or lower than the average management fee for the HUD Section 8 projects now administered by OHCS (where the PUPM standards do apply). As to quality, it was largely because of the high quality of the ACC portfolio that HUD engaged OHCS to manage its Section 8 portfolio. The OIG not only has mistakenly concluded that

OHCS has allowed inappropriate management fees, it has done a disservice to the hard-won reputation OHCS has earned for the quality and efficiency of its ACC administration.

Finding 2: Oregon Housing Inappropriately Allowed Projects To Pay $150,203 To Owners For Management Fee Splits.

Response: OHCS Appropriately Exercised Its Discretion In Allowing The Management Agent For Three Projects To Share Established Management Fees With Owners Performing Project Management Duties Delegated By The Management Agent.

Comment 29

As noted in the response to finding number 1, it does not appear that Chapter 3 of HUD Handbook 4381.5 was intended by HUD to displace OHCS ACC administration. Certainly, the PUPM management fee guidelines do not apply. Therefore, without conceding the broad application of this chapter asserted by the OIG, or even of Section 3.1, OHCS respectfully submits that its administration with respect to finding number 2 is entirely consistent with section 3.1. All ACC projects administered by OHCS, and in particular the three in question under this finding, have management agreements requiring that management agents be approved by OHCS before they may be engaged and paid – the apparent intent of Section 3.1. Furthermore, neither section 3.1 nor the management agreements applicable to the projects in question proscribe a management agent from paying for delegated duties. And, HUD's specific approval of the management agreements in question would indicate its agreement with OHCS' administration on this point.

It is curious that the OIG extrapolates from section 3.1 to reason that HUD has proscribed an approved management agent from paying another for the performance of delegated duties. It is equally curious that the OIG further extrapolates merely from the fact that an approved agent was authorized to share its fee to a conclusion that the three projects in question were charged an excessive fee rate. In truth, HUD did not proscribe (by section 3.1 or otherwise) such management fee sharing, or fee-splitting. Controlling case law speaks directly to that point. Furthermore (and without argument from the OIG), the aggregate management fee paid on each of these projects has always been an amount reviewed and approved by OHCS as an appropriate – and not excessive – management fee. OHCS never allowed an increased fee rate because of management fee sharing on any of the three projects in question. Quite the contrary, OHCS specifically declined any increase requested for such purpose.

Comment 30

As noted, relevant case law, known to OIG, and controlling with respect to HUD, includes the specific finding that HUD had no established policy against management fee-splitting in HUD Handbook 4381.5 or otherwise during times relevant to this finding. *Eugene Burger Mgmt. Corp. v. United States, HUD*,

2000 U.S. Dist. LEXIS 22089 (D.D.C. Sept 18, 2000), *citing United States v. Burger*, 2000 U.S. Dist. LEXIS 22066 (N.D. Cal. June 2, 2000). Accordingly, section 3.1 of that handbook does not preclude appropriate fee splitting. In *United States v. Burger, supra* at 22071, the court found as follows:

> *** HUD documents confirm that the practice [of fee-splitting] was not considered sufficiently improper [by HUD] to promulgate prohibitive policy directives. *** *HUD did not even view its 1994 Handbook modification as a policy directive prohibiting the practice [of fee-splitting].*

Emphasis added.

The same court found that:

> As late as June 20, 1996, HUD Inspector General Susan Gaffney issued a memorandum requesting that "the Office of Housing immediately issue a policy directive prohibiting all fee splitting practices. *** She noted, however, that HUD staff has suggested that HUD has no right to restrict a management agent's use of its earned fees, and cited to statements by Office of Housing staff that earned management fees are the "property of the agent to do with as they see fit" and that an agreement to split fees is "beyond the scope of HUD oversight." *** Accordingly, it appears that in 1996 even the agency itself did not believe that fee splitting was prohibited by the December 1994 HUD Handbook addition, which the Inspector General noted was itself "not strictly enforced."

United States v. Burger, supra at 22070, *citations omitted*.

Based on this finding, the cited courts respectively dismissed anti-kickback charges against Mr. Burger and disallowed a HUD ruling that barred his management company from retaining Section 8 housing contracts. Because HUD was a party to the actions that resulted in this finding, and because the finding was material to the issues therein, this finding should collaterally estop HUD, i.e., have an issue-preclusive effect, in any effort to assert that section 3.1 of the Handbook supports recovery against OHCS on this point. *See, e.g., Ins. Corp. of Ir., Ltd. v. Compagnie des Bauxites de Guinea,* 456 US 694, 702 n.9, 72 L Ed 2d 492, 102 S Ct 2099 (1982)(*collateral estoppel applied where party had opportunity to litigate issue previously and such issue had been basis for adverse judgment*); *Nelson v. Emerald People's Util. Dist.,* 318 Or 99, 103-04, 862 P2d 1293, 1297-98 (1993)(*issue preclusion arises in a subsequent proceeding when an issue of ultimate fact has been determined against a party in a prior final proceeding*).

Indeed, the OHCS position is much stronger than that of Mr. Burger or his management company on this matter. In the cited cases, the challenged fee-splitting was a condition of employment and no management services were performed by the owners. Arguably, therefore, the apparent policy rationale for the government's position in the cases (i.e., to prevent kickbacks and increased costs to projects) was, at least, plausible. In the OHCS circumstance, the alleged "fee-splitting" was not a condition of employment. Additionally, it was not accompanied by an increase in the fee management rate above that which OHCS already had determined was an appropriate fee for management services. Also, while the OHCS ACC portfolio is neither HUD financed nor HUD insured, Mr. Burger and his management company were involved with HUD-financed and HUD-insured projects where the provisions of Chapter 3 of Handbook 4381.5 surely would apply.

Comment 31

Finally, it bears reemphasizing that HUD has never given OHCS direction that fee splitting on the three projects in question is inappropriate. Should HUD provide such direction in the future, OHCS would respond appropriately.

Finding 3: Oregon Housing Allowed The Owner of Uptown Tower Apartments To Receive $405,005 In Excessive Distributions Because Of An Inappropriate Revaluation Of Commercial Space In The Project.

Response: There Were No Excessive Distributions To The Owner Of Uptown Tower Apartments Because OHCS Properly Revalued Project Commercial Space.

A correct understanding of the governing legal standards unequivocally establishes that OHCS did not allow excessive distributions with respect to Uptown Tower Apartments.

1. OHCS Did Not Allow Uptown Tower Apartments To Exceed Allowable Replacement Costs.

Comment 32

OIG claims in this finding that when OHCS undertook a revaluation of commercial space at Uptown Tower, the resulting reduction in commercial space value affected an increase to value attributable to dwelling space to exceed Replacement Cost per unit maximums as specified in 24 CFR 883.305 (c)(1). That is not true. At the time the Proposal for Uptown Tower was submitted to and approved by HUD, in May 1982, both OHCS and HUD were aware that Uptown Tower's replacement cost per dwelling unit, stated at $50,000 per dwelling unit in the Proposal, exceeded the limits established in 24 C.F.R. §883.305(c)(1). However, because the Proposal was in conformity with 24 C.F.R. § 883.305(d), it was correctly approved by HUD. Exhibit A, first page.

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The replacement cost limitations at 24 C.F.R. §883.305(c)(1) were not meant to be an exclusive restriction. A project can exceed replacement cost maximums stated in paragraph (c) as long as the excess is not taken into account or given credit for when determining or adjusting contract rents. This is in accordance with the next paragraph of the regulations, 24 C.F.R. §883.305 (d), which states:

> *Excess Costs.* The limitations of paragraph (c) of this section will not prohibit the total actual cost of a project from exceeding the limits referred to in that paragraph. However, in determining or adjusting contract rents, the HFA will not take into account or give credit for any cost which exceeds the applicable replacement cost limits.

Uptown Towers was a limited distribution account submitted under 24 C.F.R. §883 Subpart D -- Fast Track Procedures. Exhibit B. As such, submittal to HUD for approval was done as a formal Proposal under 24 C.F.R. §883.403 of that Subpart D. Proposals under that section were to include certifications including replacement cost. The Proposal for Uptown Tower was submitted on May 17, 1982 and received HUD approval on May 28, 1982. Exhibit A.

Item #7 in the Proposal shows the replacement cost schedule with per unit replacement cost of $50,000 (Exhibit A, eighth page). Item #5 under "CERTIFICATIONS" (Exhibit A, eleventh page) states that:

> The total cost of the project exceeds the limits referred to in 883.305 (c)(1)(ii). Pursuant to 883.305 (d), excess costs in determining and adjusting contract rents, the Division did not take into account or give credit for any cost which exceeded the applicable unit replacement cost limit of $42,625.

Exhibit C, worksheet calculation of replacement cost limit.

Comment 6

The OIG is mistaken in this finding where it states that the dwelling cost per unit Federal limitation was $50,075 and the revaluation caused Uptown Tower's dwelling cost per unit to exceed that limit. The Federal limitation actually was $42,625 per dwelling unit and Uptown Tower exceeded that amount (legally) in the Proposal.

The OIG finding addressed here is that OHCS inappropriately allowed a revaluation of commercial space at Uptown Tower, and that "OHCS was required to certify to HUD that estimated replacement costs of the portion of the project attributable to dwelling use did not exceed the Federal limitation on replacement cost". That finding is patently incorrect. OHCS actually was required to certify that any amount exceeding the replacement cost limits of (c) was not taken into account or given credit for when determining or adjusting contract rents.

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OHCS made the certification in the Proposal as required in paragraph (d) of the regulation. The limits of paragraph (c) were exceeded in the original Proposal of May 17, 1982, yet were approved by HUD pursuant to paragraph (d). The revaluation of Uptown Tower commercial space had no effect contrary to the approval already obtained in the Proposal, pursuant to paragraph (d)**.**

Again, the criteria of this finding, as described, was that OHCS was required to certify to HUD that estimated replacement costs of the portion of the project attributable to dwelling use did not exceed the Federal limitation on replacement cost at 24 C.F.R. §883.305 (c). The OIG could only reach this finding by ignoring the import of paragraph (d). OHCS correctly certified to HUD on May 17, 1982 that although replacement costs exceeded limits established in paragraph (c) the project was still within Federal regulations pursuant to paragraph (d). HUD understood, and properly approved, that certification on May 28, 1982.

2. OHCS Was Not Required To Justify Higher Equity Contributions Through Cost Certification Because They Were Approved By HUD In The Proposal.

Comment 33

The OIG is absolutely wrong in reaching its secondary conclusion in this finding, i.e, that "OHCS ignored requirements that a higher equity contribution must be justified through cost certification documentation." OHCS submitted all limited distribution account Proposals to HUD under *24 C.F.R. Subpart D -- Fast Track Procedures* for new construction or substantial rehabilitation projects as an HFA for which it provides permanent financing without Federal Mortgage Insurance. 24 C.F.R. §883.401(a).

Under the Fast Track Procedures, cost certification is not required for projects with rents that are equal to or less than comparable rent*s.* 24 C.F.R. §883.411(a). *That fact was certified in the Proposal.* Exhibit A, eleventh page - item #3. As the OIG noted in this finding, 24 C.F.R. §883.306 (c) states:

> For the purpose of determining the allowable distribution, an owner's equity investment in a project is deemed to be 10 percent of the replacement cost of the part of the project attributable to dwelling use accepted by the HFA at cost certification (See 883.411), *or as specified in the Proposal where cost certification is not required***,** unless the owner justifies a higher equity contribution through cost certification documentation accepted by the HFA.

Emphasis added.

Comment 34

OHCS limited distribution Proposals submitted under the Subpart D Fast Track Procedures contained certifications of Total Estimated Replacement Costs (Exhibit A, eighth page, item #8), certifications of Mortgage Amount (Exhibit A,

eighth page, item #4), schedules showing Equity Requirement (Exhibit D, sixth page, Schedule E, item #3), and comparable rents (as referenced above). The Proposal submitted and approved by HUD for Uptown Towers specifies an equity requirement of $800,056 or 20% of the development costs (as referenced above). OHCS followed the requirements of 24 C.F.R. §883.306 (c) in accordance with the Fast Track Procedures specifying the owner's equity requirement at 20% and received approval.

Due to statutory requirements, minimum equities for borrowers of projects financed under OHCS programs at the time were 20%. Statutorily, OHCS could not allow an equity investment of less than 20% for its limited distribution developers. When first considering Interim Rule 24 C.F.R §§883-884 in March 1980, OHCS raised this as an instance where state law conflicted with a provision in the interim rule. Gregg Smith, OHCS Administrator at the time, wrote the Rules Docket Clerk and suggested an "expansion of the equity concept" (see Exhibit E, letter from Gregg Smith dated 3-31-80). In his letter, Mr. Smith states that:

> …equity should be defined as the difference between the total cost of the development, including costs not attributable (to dwelling use), and the amount of the mortgage. Any return limitation should be based upon a percentage of the above defined equity.

Id., at 3.

Comment 35

A subsequent meeting was held to discuss that and other concerns OHCS had with the Interim Rule. Subsequent to that meeting, a letter dated July 1, 1980, was issued by Patrick LaCrosse, Area Manager for HUD, to Mr. Smith acknowledging OHCS "special procedures" and agreeing to afford OHCS "a greater degree of flexibility", and allowing that it "may submit proposals not in strict conformance" as long as "the proposals are in substantial conformance with the Area Office's funding strategy" and are "discussed with Area Office staff prior to their submission" (see letter marked Exhibit F). In a letter to Joe Hirsch, HUD Deputy Director of Housing Division, dated March 16, 1982, Larry M. Leach, OHCS Manager of Multi-Housing Finance, conveys HUD Central Office approval of the higher equity provision to explain why FAF escrows and cost certifications will not be needed. The escrow will not be required to reduce the otherwise allowable mortgage under the FAF because "the mortgage is being reduced in our commitment letter beforehand, with the sponsor responsible to put in at least 20% of the project value as equity" (see letter marked Exhibit G).

3. The Revaluation Of Commercial Space At Uptown Tower Apartments Was Undertaken In Compliance With 24 C.F.R. §883.305(c)(2).

The Proposal for Uptown Tower Apartments was processed under Subpart D, 24 C.F.R. §§883.401-883.412, "Fast Track Procedures". This subpart requires that:

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> Any proposal eligible for Fast Track Procedures submitted by an HFA must contain the certifications required by paragraph (d) of this section.

24 C.F.R. §883.403(a).

Regarding Replacement Cost per unit maximums, Subpart D, Fast Track Procedures at 24 C.F.R. §883.403(d)(3) excludes §883.305 (c)(1) and cites only §883.305 (c)(2) as a requirement. That paragraph states in part:

> Replacement costs of the project will consist of replacement costs attributable to dwelling use (which are subject to the limits in paragraph (c)(1) of this section) plus replacement costs not attributable to dwelling use. *The HFA must certify that replacement costs not attributable to dwelling use are reasonable.*

Emphasis added.

Comment 36

The revaluation by OHCS of the commercial space at Uptown Tower Apartments was entirely appropriate. Indeed, it was necessary to comply with 24 CFR 883.305(c)(2). As 24 C.F.R. §883.305(c)(2) requires the HFA to certify the reasonableness of the replacement cost of non-dwelling space, the revaluation of the commercial space was an adjustment to make a correction in keeping with that regulation. A correction, requested by the Sponsor, thought to be incumbent upon the HFA, and undertaken in an effort to comply with the regulation. Revaluing the commercial space in the project was in accordance with this requirement because it was determined that the original estimated valuation of the commercial space, done by simply taking 10% of the total proposed development costs, was not accurate or reasonable, however that value was imputed until better data became available. In the Proposal, the commercial space was only to comprise 3.4% of the total project square footage. At the time of completion of construction, all areas of the structure were used in residential operations, including the area that had been designated for commercial use, which was being used by the residential manager for storage related to residential use. A "Completion Fund Agreement" was executed at closing of permanent financing providing for a guarantee of completion of the commercial space as contemplated in the Proposal. After completion, the commercial space was certified at 8.8% of total project square footage, however the per-square-foot value of the commercial space was determined to be less than that of the dwelling space. As completion and certification of the commercial space was done well after the approval of the Proposal and the funding of the loan, a revaluation was required in keeping with the regulatory requirement to determine the reasonableness of replacement cost not attributable to dwelling use.

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Finding 4: Oregon Housing Allowed The Owner Of Uptown Tower Apartments To Receive $245,524 In Unreasonable Interest Payments From The Project.

Response: The Interest Payments Questioned By The OIG Not Only Were Reasonable And Justified, If Anything, They Were Conservative And Therefore Beneficial To The Residual Receipts Account.

1. Background Information – The Project Received The Value Of The Commercial Space Income For Eleven Years.

Comment 37

The Owners of Uptown Tower Apartments did not keep commercial space rents for the first 11 years of operation. Instead, that unlimited income was used for the benefit of the residential housing. When the owners realized that the commercial space income was not subject to the limited distribution restrictions they sought a rebalance of the accounts. The monies representing commercial rents that had been left in project operations were then treated by the owners as operating loans to the development (the only way they could recover those monies), to be repaid with interest.

HUD was contacted and asked for approval of this treatment of the commercial income that had been left in operations. Approval was granted by HUD in Nancy William's letter of March 24, 1992 (see Exhibit A). The "loaned money" had helped the Project deal with deficits in residential operations in the early years of operation.

2. The OIG Misconstrues The Standard For Determining An Appropriate Interest Rate On The Loan.

Comment 38

OIG references HUD Handbook 4350.1, Chapter 4 and cites subparagraph 30 E as authority to support the contention that unreasonable interest payments were allowed by OHCS. However, reliance by the OIG on this standard is not well-founded. Chapter 4 of HUD Handbook 4350.1 does not apply to Uptown Tower and other projects submitted under 24 C.F.R. Section 883 Subpart D. The applicability of Handbook 4350.1, Chapter 4 is stated as follows:

> 4.1 - Introduction and Applicability. A Reserve Fund for Replacements exists for most projects with HUD-insured, formerly coinsured, and HUD-held mortgages. This Chapter applies to these projects as well as to Section 202 and Section 162 Direct Loan Program projects and Section 801 and 811 Capital Advance Program projects.

Exhibit B.

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Uptown Tower is neither a HUD-insured nor a HUD-held mortgage project, nor is it a Section 202, 162, 801, or 811 project. Accordingly, the standard used by the OIG in making this finding does not apply to Uptown Tower Apartments.

Even if Chapter 4 of HUD Handbook 4350.1 applied to Uptown Tower, the standard quoted in that Chapter would not. Subparagraph 30 E restricts only interest paid from project funds. The operating loan subject to this finding was repaid, including interest, from surplus cash after all project operating expenses, reserves and distributions were funded. The context of subparagraph 4-30 makes it clear that the intent of the language is to safe-guard project operations from excessive interest expense when the loan is to the project and to be repaid with project funds. A distinction is made between "Owner Contributions in the form of equity" (subparagraph 4-30 D) and "Owner contributions in the form of unsecured debt" (subparagraph 4-30 E). Exhibit C. This refers to unsecured debt of the project, to be repaid by the project with project funds. Subparagraph 4-30 E then goes on to require pre-approval by the HUD Loan Management Branch Chief, with terms and conditions that are formally negotiated, and everything committed to in writing. Nancy Williams made no mention of any such requirements in her approval for HUD because of her caveat that interest be paid from surplus cash - which are not project funds.

To reemphasize this point, payment of interest subject to this finding was made from surplus cash. There is no HUD requirement restricting interest that is paid from surplus cash and not project funds. There is no concern that high rates of interest allowed on operating loans would be detrimental to project operations when the interest is paid from surplus cash.

3. The Interest Rate Was Not Inappropriate Even Applying The OIG Standard With Respect To Repayment Of Loan Interest.

Even if the standard cited by the OIG regulated surplus cash loan interest, the approach employed by OIG to find an "inappropriate" interest rate is incorrect. Indeed, the evidence is abundantly obvious that the interest rate was not only appropriate, but conservative.

Comment 39

The OIG has stated that 6-month CD rates were compared with the rate charged on the operating loan to derive the amount that OIG determined was paid in excess of a "reasonable amount". The note rate actually used for the operating loan from inception in August 1984 until January 1993 was Bank Prime Rate. The rate changed when Bank Prime Rate changed, but was not more than Bank Prime Rate during that time.

The OIG used 6-month CD rates as a maximum appropriate rate purportedly relying on HUD Handbook 4350.1, Chapter 4, subparagraph 30 E. The OIG finding (quoting sub-paragraph 30 E) states "[t]his sub-paragraph also indicates

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that these loans should be allowed to earn interest, but that interest should not exceed the rate that the owner could earn elsewhere in a reasonably safe security."

Again, this restriction referenced by OIG was directed to the repayment of unsecured debt of the project from project funds, which was not the case here. However, there is another problem with the OIG's use of this standard. The second problem is that the OIG only uses half of the standard. For clarification, this subparagraph actually states, in its entirety, as follows:

> E. Owner contributions in the form of unsecured debt (loans). These loans may, on a case-by-case basis, be allowed to carry a nominal interest rate that normally should not exceed the interest rate that the project owner or sponsor could earn elsewhere in a reasonably safe security, such as a Certificate of Deposit *of the same duration as the loan to the project.* The right to earn this interest must be pre-approved by the Loan Management Branch Chief and the terms and conditions of repayment should be formally negotiated and committed to writing.

Exhibit C (emphasis added).

Under the complete standard, a six-month CD rate clearly would not be an appropriate rate to use for this loan because it has a duration of almost twenty years. Again, as this paragraph applies only to loans being repaid from project funds, not surplus cash, it would not apply to the Uptown Tower operating loan, as discussed above. However, to demonstrate the unreasonableness of this finding, we point out that the rate the OIG uses is not even in conformity with the authority it partially cites for its finding.

Comment 40

Additionally, the OIG makes this statement immediately following the previously-quoted statement: "In our opinion, it is not likely that a partnership would earn the same rate of return as that charged by Banks." This shows a fundamental misunderstanding of what was actually being done. Banks always charge a margin above prime rate on loans to businesses the size of Uptown Tower. Uptown Tower could not, under normal circumstances, borrow at Bank Prime Rate. So, the rate being charged on the operating loan was below that charged by banks**.** Seemingly, the OIG does not understand this fundamental reality. So, what OIG is alleging that owners did not do (charge a rate lower than what banks charge) is exactly what they did do. The owners here were not trying to make a windfall. They were charging a rate that reasonably, even conservatively, reflected the level of risk and commercial standards.

The OIG says in this finding that "[w]e believe OHCS did not consider whether the amount of interest it allowed the owner to earn on the loan to the project was reasonable". In fact, OHCS staff considered Bank Prime Rate to be an obviously reasonable rate to allow.

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Finding 5: Oregon Housing Inappropriately Allowed Four Projects To Distribute $62,106 Of Residual Receipts When Surplus Cash Was Not Sufficient To Pay Owner Distributions.

Response: OHCS Acted Consistent With Applicable Legal Authority, Including Controlling Loan Documents, In Reasonably Exercising Its Discretionary Authority To Allow The Use Of Limited Receipts Reserves To Cover Shortfalls In Owner Distributions.

Comment 41

The OIG provides no explanation for its finding that OHCS acted inappropriately in allowing four limited-distribution projects to distribute $62,106 from residual receipts to owners when surplus cash was not sufficient to fully pay agreed distributions. It appears to imply, however, that such distributions are inconsistent with the limitation in 24 CFR 883.702 that "[w]ithdrawals from [the Residual Receipts Account] may be made only for project purposes and with the approval of the Agency."

OHCS submits that the distributions comport with applicable legal standards and that OHCS appropriately exercised its discretionary authority in approving the withdrawals from residual receipts. OHCS' position becomes obvious as the standards and controlling documents are examined in more detail.

1. Applicable Provisions.

24 C.F.R. §883.702 provides that"[w]ithdrawals from this account [Residual Receipts] may be made only for project purposes and with the approval of the Agency." In concert with this regulation, the relevant HAP Contract requires that "[w]ithdrawals from this account [Residual Receipts] will be made only with the approval of the HFA and for project purposes, including the reduction of housing assistance payments." Section 2.6 (c)(1). HUD Handbook 4350.1 allows withdrawals from Residual Receipts to "[m]ake mortgage payments when a mortgage default is actual or imminent." Section 25-9 B. And, finally, HUD Handbook 4350.1, at paragraph 25-2, defers the definition of Residual Receipts to the HFA by saying that "[w]hen a Residual Receipts Account is required, the project's Regulatory Agreement provides an exact definition of 'Residual Receipts'." Exhibit A.

After stating at "Section 3. Residual Receipts Account" that "withdrawals from this Account will be made only for project purposes and with the approval of the Division in accordance with guidelines from the Secretary" (see Exhibit B), the OHCS Regulatory Agreement, used for all limited distribution accounts, goes on to define Residual Receipts as funds that may be used for the "general benefit" of the Development (Exhibit B, second page). It states:

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> In the event there are neither Operating Expense deficiencies nor Loan delinquencies, the Division may, in its sole discretion, apply funds remaining in the Residual Receipts Account, if any, upon notice to and consultation with the Borrower, for the general benefit of the Development.

Then, in “Section 5. Distribution Of Income And Assets” the Regulatory Agreement allows that "[a]ny shortfall in return in one year may be made up from surplus cash flow in future years, or from funds existing in the Residual Receipts account." Exhibit C, paragraph d. The notable point here is that the distributions in question were made in a fashion consistent with the controlling Regulatory Agreement language.

2. The Distributions Comport With Applicable Standards.

There are four principal aspects to the standards controlling the distribution of residual receipts. Firstly, OHCS, as the HFA, must approve the distributions. Secondly, on a procedural level, the distributions must be accomplished consistently with the protocols of the Regulatory Agreement. Thirdly, on a substantive level, the distributions must be for “project purposes.” And, fourthly, the HFA must exercise the discretion given it under the ACC to determine whether or not individual requests qualify as “project purposes.”

It does not appear that the OIG is saying that OHCS failed to approve these distributions, or that it acted inconsistently with the Regulatory Agreement, or even that OHCS was incorrect in reserving distributions from residual receipts to project purposes. Rather, it appears that the OIG questions whether OHCS appropriately exercised its discretion in determining that distributions to make up Owner shortfalls were for program purposes.

Comment 42

Since the inception of the ACC, it has been the responsibility of the HFA (OHCS) to determine whether or not proposed uses of residual receipts would fulfill a "project purpose". The two examples given of project purposes in the CFR and HUD Handbook 4350.1 are: (1) for the reduction of housing assistance payments; and (2) to make mortgage payments in case of an actual or imminent default. These examples were never intended to be exhaustive. And, given that these examples do not directly address a physical aspect of a project, i.e., such as dealing with deferred maintenance, or repairing damaged siding, etc., it would seem that they were meant to expand the standard to financial aspects of a project. It is clear, therefore, that HUD did not, and does not, restrict an HFA’s interpretation of project purposes to the physical nature of a project. It is equally clear that HUD did, and does, allow an HFA to include relevant financial considerations within the ambit of the term “project purposes”.

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3. The OIG Cannot Demonstrate An Abuse By OHCS Of Its Administrative Discretion.

Comment 43

The overriding factor to consider in evaluating the criticism of these residual receipts distributions by the OIG is that final discretion to determine a project purpose and to approve distributions is given to OHCS, as the HFA, and not to the OIG or HUD. The OIG has failed to cite any controlling authority that precludes the determination on this point made by OHCS because there is none. In the absence of such countervailing authority, and given that OHCS acted consistently with the protocols of the ACC and relevant regulatory agreements in allowing the distributions, the OIG has no legitimate basis to find that OHCS abused its discretion. In fact, based on the examples given in the CFR and the HUD Handbook, OHCS had ample authoritative guidance to support the determination to allow distributions from residual receipts.

It is as inherently reasonable to conclude that paying owners their return on equity is in the best interests of the project, and should be considered a "project purpose", as it is to conclude that paying a delinquent loan payment should be considered a "project purpose". Both relate to the fiscal soundness of the venture, to maintaining continuity of ownership and management, and to preserving appropriate incentives for investment and participation. A promise to pay the return on equity from future project earnings alone, if and when they occur, is too tentative to provide such necessary assurances.

It was in this context that OHCS, more than 24 years ago, made a determination that paying owners their guaranteed return should be considered a "project purpose" and indicated so by the inclusion of language in the Regulatory Agreement (11/80) that memorialized that determination. This language was an important and necessary inducement for owner participation in the program. Later, language was added to the OHCS Standard Practices Manual that included paying shortfalls for other project purposes (see Exhibit 1). Neither the OIG nor HUD can second guess OHCS' determination that such distributions serve a project purpose without establishing that OHCS abused its discretion. The OIG has made no such showing and would be unable to do so.

(a) HUD Approved The Regulatory Agreement Language Allowing The Distributions Now In Question.

24 C.F.R. §883.307(b)(1) states as follows:

Comment 44

HUD approval. (1) A State Agency, prior to receiving HUD approval of its first New Construction or Substantial Rehabilitation Proposal using contract authority under this part, must submit copies of the documents relating to the method of financing Section 8 projects to HUD for review. These documents shall include bond resolutions or

> indentures, loan agreements, *regulatory agreements,* notes, mortgages or deeds of trust and other related documents, if any, but does not need to include the 'official statement' or copies of the prospectus for individual bond issues. HUD review will be limited to making certain that the documents are not inconsistent with or in violation of these regulations and the administrative procedures used to implement them. After review, HUD must notify the Agency that the documents are acceptable or, if unacceptable, will request clarification or changes. This review and approval will meet the requirements of 24 C.F.R. §811.107(a)."

Emphasis added.

Comment 43

On August 8, 1980 the first Proposal for New Construction Section 8 under 24 C.F.R. §883 was submitted to HUD for approval, which Proposal was approved by HUD on September 24, 1980 (see Exhibits E and F). Subsequently, 12 additional Proposals were submitted to and approved by HUD for projects done under 24 C.F.R. §883. Under the regulation as quoted above, the regulatory agreement used for each had to have been reviewed and approved by HUD prior to submission of the first Proposal. The OHCS Regulatory Agreement used on each of these, and subject to this OIG Finding, had to have been reviewed and approved by HUD (and was so approved) prior to submission of the first Proposal, as required in the CFR.

Additionally, OHCS personnel and owners interviewed in preparation for this response have related that each of these 13 loans was closed in escrow, with the closing attended by HUD personnel, OHCS personnel, owners, and attorneys representing all parties including Bond Counsel for OHCS. All parties, including HUD, reviewed all documents at the closing of each of the 13 loans. According to the described witnesses, and consistent with the fact that each closing was fully executed and completed, no issues were raised with any of the documentation, including the Regulatory Agreement.

The fact that a total of 13 Proposals were submitted and approved by HUD using the same Regulatory Agreement makes it indisputably manifest that the OHCS Regulatory Agreement was approved by HUD as used, and that HUD had considered as reasonable OHCS' exercise of its discretionary authority to provide that paying shortfalls of limited distributions from Residual Receipts would be considered a project purpose.

(b) HUD Reconfirmed OHCS Discretionary Authority To Determine Project Purposes in Allowing Distributions From Residual Receipts.

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Comment 45

Secondly, HUD has specifically stated that such distribution determinations were OHCS' to make. In a formal request to HUD for concurrence with an OHCS decision to allow a withdrawal from Residual Receipts for Stewart Terrace, HUD underscored that OHCS should make such determinations, stating in an email that "HUD does not approve or disapprove Residual Receipts requests for state insured projects. OHCS is the certifying authority for Stewart Terrace Residual Receipts account." In this email dated September 21, 2004, in response to this request, Richard Otis, HUD Project Manager, replied to Brandon Fink, OHCS Compliance Officer, and Lynn Blankenship, Management Agent, that "[i]f Brandon has no issue with the request, I suggest he approve the withdrawal." Exhibit D.

4. OHCS Exercise Of Its Administrative Discretion Has Been Reasonable.

Comment 42

OHCS treatment of Residual Receipts has been reasonable and consistent. After having been given the authority in the CFR to define "Residual Receipts", OHCS, in accordance with HUD guidelines, defined Residual Receipts as funds that may be applied to the general benefit of the Development. OHCS further considered that the usage of those funds for the payment of the limited return to the owner was to the general benefit of the Development. Given OHCS authority under the CFR to define "residual receipts" and given OHCS authority under the Handbook and the ACC to apply residual receipts for project purposes, it was entirely appropriate for OHCS to allow the withdrawals.

It is antithetical to the purposes of any limited-distribution project for an owner not to expect, and not to receive, its contractually promised return. There would be little inducement for prospective owners to invest in such projects (particularly, in OHCS' portfolio which required a 20% equity investment), and little assurance of ongoing financial viability. For example, many of the OHCS limited-distribution projects are small and owners rely on the annual distribution for their living expenses. Other ownerships rely on annual distributions for ongoing viability. Ensuring that an investor's return on investment is secure is an integral part of a partnership where investors have agreed to limit their profits. If investors cannot be confident of getting their return, especially as here where the investment return is limited, continued participation in the program is endangered. The payment of that return from the available and accumulated surplus earnings of the project is reasonable and necessary when current earnings are insufficient for that purpose. As such, the distributions fulfill a project purpose.

It is unconscionable for OIG to now say that OHCS should have used its discretionary authority differently than that permitted by HUD. OHCS is bound under ACC to HUD guidance, not to a different standard suggested by the OIG a quarter century after-the-fact. If HUD had believed OHCS' determinations of "project purpose" were outside of the Secretary's guidelines, then HUD could, and

presumably would have provided such contrary guidance. It did not - and the unambiguous understanding by OHCS from HUD's condoning of its Regulatory Agreement terms and project purposes determinations was that HUD was in agreement with OHCS practice in this area.

Finding 6: Oregon Housing Did Not Fulfill Its Contract Responsibilities.

Response: OHCS Has Faithfully Fulfilled Its Contractual Responsibilities.

The OIG has concluded that OHCS failed to fulfill its contract responsibilities because of the findings previously discussed. As should be apparent to any knowledgeable reader, the OIG findings are fundamentally flawed and at odds with the direction in 24 C.F.R. § 883.106 that OHCS, as an HFA, be given discretionary authority to administer its State Agency Section 8 program and to interpret its governing project documents. Not only has the OIG failed to honor the discretionary authority given OHCS, it has made egregious errors in seeking to apply largely irrelevant standards in its judgment of OHCS.

Comment 46

Not least among the OIG's mistakes, are its overreaching recommendations to sanction OHCS for its past administration and to recoup monies earned by OHCS. These recommendations fly in the face of the default procedures in 24 C.F.R. §883.607(b), as further set out in ACC Section 2.16(b)(1), which limit ACC default sanctions to prospective periods of noncompliance. They surely also contravene common equitable principles such as laches. The OIG's recommendations also fly in the face of OHCS' proven record of cooperation with HUD for nearly three decades and the factual reality that OHCS administration has produced a very attractive and efficient State Agency Section 8 project portfolio.

Conclusion

For the reasons given, and more, the findings by the OIG in its audit report are without merit. More than that, they are a series of conclusions reached by the application of improper standards and without supporting facts. They totally mischaracterize the role of OHCS as an HFA and denigrate the working relationship OHCS has had with HUD for the past three decades. Indeed, the OIG's findings, by implication, improperly take issue with HUD as much as they do with OHCS. The findings by the OIG should be disregarded in their entirety.

OIG Evaluation of Auditee Comments

Comment 1 The corrective action referred to may include repayment to projects or to HUD to correct the improper use of funds authorized by Oregon Housing. We are recommending that HUD consider making a determination of default only if the corrective actions per Recommendations 1A through 1J are not taken.

Comment 2 Oregon Housing claims that it never received notice from HUD of the existence of the violations found in our report. Nonetheless, by signing the Annual Contributions Contract with HUD, Oregon Housing was given notice that it must assume responsibility for ensuring compliance with Federal requirements and objectives. A close relationship with HUD does not relieve Oregon Housing from its contractual obligation.

Comment 3 We had discussed the issues with Oregon Housing staff throughout the audit and had provided written finding outlines, but the exit conference was the first time Oregon Housing asked us many of these questions; questions that required some research prior to responding. This applied to Oregon Housing's justification of its actions as well. Much of what Oregon Housing told us in the exit conference was never discussed with us prior to the meeting even though we had discussed the issues with Oregon Housing staff many times during the audit.

Comment 4 Oregon Housing is referring here to the Regulatory Agreement it executes with each of its projects. This document does allow withdrawal from the residual receipts account to pay owners for distributions when surplus cash is not sufficient. However, this document also states, "It is further agreed that in the event of a conflict between the terms and conditions of this Regulatory Agreement and the [Housing Assistance Payments] Contract, the terms of the [Housing Assistance Payments] Contract shall prevail and control."

The Housing Assistance Payments Contract and 24 Code of Federal Regulations 883.702(e) both state that withdrawals from the residual receipts account must be for project purposes. This is in conflict with the Regulatory Agreement. Additionally, even if HUD approved the Regulatory Agreement, it did not have the authority to waive the legal requirement stated in the Code of Federal Regulations that withdrawals from the residual receipts account must be for project purposes.

Comment 5 Oregon Housing appears to be correct in stating that 24 Code of Federal Regulations 883.305(d) allows total actual cost of a project to exceed the limits set in 24 Code of Federal Regulations 883.305(c) as long as the excess is not considered when determining or adjusting contract rents. Accordingly, we revised the report. However, as discussed in Comment 6, this correction does not substantially change our finding.

Comment 6 The response did not quote the requirement in its entirety, leaving out a key item. 24 Code of Federal Regulations 883.306 (c) states, "For the purpose of determining the allowable distribution, an owner's equity investment in a project is deemed to be 10 percent of the replacement cost of the part of the project attributable to dwelling use accepted by the HFA at cost certification (See §883.411), or as specified in the Proposal where cost certification is not required, unless the owner justifies a higher equity contribution through cost certification documentation accepted by the HFA."

We agree that the proposal estimated replacement cost per unit to be $50,000 (HUD approved the proposal May 28, 1982). However, to justify a subsequent higher equity contribution, the owner was required to submit cost certification documentation to the Housing Finance Agency per the section of the above regulation omitted in the Oregon Housing response. Oregon Housing failed to follow this requirement. . The costs were originally certified and accepted by Oregon Housing for this project in 1983. Twelve years later, in 1995, the owner asked, and Oregon Housing approved (without cost certification data) a decrease in commercial space value resulting in an increase in the per unit replacement cost to $54,583 (well over the HUD-approved amount of $50,000 per unit). This resulted in a higher owner equity contribution amount on the residential portion of the project, leading to an increase in the amount of the annual owner distribution.

Comment 7 We agree we should have used a rate more in line with the length of time of the investment. As a result, we revised our basis for computation of unreasonable costs. However, even though the time period from when the commercial portion of the property first generated income that was left in the project to the time the last payment of reimbursement to the owner was about 18 years, the first time the project was "loaned" commercial income was in August 1984 and the first reimbursement payment to the owner was in December 1994, just over ten years later. Therefore, we recalculated unreasonable costs using a 10-year Treasury Rate, not a 20-year rate suggested by Oregon Housing.

Comment 8 Oregon Housing's Annual Contributions Contract authorizes Oregon Housing to take necessary actions "...in accordance with the forms, conditions, regulations, and requirements prescribed or approved by HUD..." The Annual Contributions Contract also gives Oregon Housing the responsibility for development and supervision of the project as well as for the management and maintenance functions of the owner. All of this is subject to review and audit by HUD to "...ensure compliance with Federal requirements and objectives." Requirements of HUD include the following handbook references:

HUD Handbook 4381.5, Figure 1-2 lists the different types of HUD properties subject to the provisions of this Handbook and includes properties with project-based rental assistance under the Section 8 Multifamily programs.

Additionally, Paragraph 3.1 of Handbook 4381.5 discusses management agents and management fees for HUD-assisted as well as HUD-insured properties. Further, Figure 3-5 shows that an after-the-fact review of management fees must be performed for "Limited distribution and non-profit projects (regardless of how project rents are set)."

Comment 9 We agree with Oregon Housing's statement that owners determine the actual amount of the management fee. Nonetheless, Section 1.8 of its Annual Contributions Contract with HUD requires Oregon Housing to assume responsibility for the supervision over the management functions of project owners. Handbook 4381.5 Paragraph 3.10 a. (2) states, "Owners of projects subject to after-the-fact reviews may negotiate and implement revised fees with in-place agents without HUD approval, as long as the fee complies with the reasonableness standards described in Section 3. A new Management Certification must be submitted before the revised fee can be charged." Since Oregon Housing is required to assume responsibility for compliance with HUD requirements, it is responsible for determining the reasonableness of the management fees in accordance with Section 3 of the handbook.

Comment 10 The area of the Handbook to which Oregon Housing is referring (Paragraph 3.9 APPLICABLE MANAGEMENT FEE FOR RENT INCREASE REQUESTS) only applies to projects with budget-based rental increases. Since the rental increases for the projects we reviewed are not budget-based but are set through an annual adjustment factor, this area of the Handbook does not apply to these projects. Additionally, the management fees for many of the projects which we reviewed were associated with a request for an increase in the management fee percentage, not a rent increase.

Further, as noted in Comment 9, Paragraph 3.10 a. (2) states that when an owner requests an increase in the management fee percentage, an after-the-fact review must be performed. The new management fee must comply with the reasonableness standards in Section 3. Section 3, Paragraph 3.18 b. (1) states "[f]or projects subject to fee reviews, Loan/Asset Management staff use the applicable ranges to determine whether the owner-proposed fee percentages initially yield a PUPM dollar amount that is reasonable." Paragraph 3.18 b. (2) states "[i]f using the owner's proposed percentage results in a dollar yield that falls within the applicable range, the proposed percentage will be approved and remain in effect until the management agent requests an increase in the percentage amount." This shows that when an increase in the management fee percentage is requested, it must be reviewed on a per-unit-per-month basis for reasonableness.

Comment 11 We agree that profit-motivated projects are not required to have a management fee review if their rents are set with the use of the annual adjustment factor. We also agree that all the profit-motivated projects we reviewed have their rents set through the annual adjustment factor. Therefore, none of them required a management fee review. Consequently, we removed references to these five

projects from our report and adjusted the related questioned costs associated with these projects.

Comment 12 The report actually states, "Although Oregon Housing is not required to use HUD's computed management fee range, it must use some range. It must follow the same procedures HUD uses to determine the maximum fee range (i.e., the procedures in chapter 3 of HUD Handbook 4381.5). Since Oregon Housing did not compute its own residential management fee range, it should have used HUD's maximum residential management fee of $35 per-unit-per-month." Nothing in the report acknowledges, nor does the report imply, that per-unit-per-month residential management fee maximums do not apply to Oregon Housing.

Comment 13 HUD Handbook 4381.5 Paragraph 3.20 explains how reviews of residential management fees should be performed. Paragraph 3.20 c. states that the yield produced by the fee percentage must be assessed for reasonableness. Additionally, Paragraph 3.20 c. (3) states "[i]f the PUPM fee yield exceeds the acceptable range, the requested residential fee percentage may not be approved."

Further, our review of Oregon Housing files regarding the latest request for a change in the management fee percentage for 10 limited distribution projects found that all 10 of the files included Oregon Housing's approval of the management request for an increase in the fee and an official amendment. The files contained incomplete documentation supporting the fee increases and did not evidence that Oregon Housing performed an adequate management fee review prior to approving the fee increases. Of the 10 files reviewed,

- Three files did not include a management agent request for an increase in the management fee.
- Nine files did not include a management certification.
- Nine files did not contain documentation of a determination of reasonableness of the requested management fee adjustment. In addition, the one file that did include documentation did not include any information showing the size of the projects used as a comparison and did not show the location of the projects. Further, this documentation did not address HUD Section 8 rates as stated in Oregon Housing's' response.

We asked the Oregon Housing administrator and the attorney from the Oregon State Department of Justice for a copy of Oregon Housing's' written policy regarding the approval of increases in management fees. The administrator told us that she didn't think Oregon Housing had anything written unless maybe as part of the job description of some of the employees. She then told us she would get back to us to let us know for sure. She also said she thought there was probably an initial review performed for the management fees, but that was such a long time ago, she couldn't say for sure. In addition, a compliance officer told us that Oregon Housing does not have a formal process or a step-by-step procedure to approve management fee adjustments. Subsequently, the administrator

provided a two-page policy and admitted that this document was created in response to our request.

Oregon Housing staff told us the administrator and the manager could tell if the proposed management fee is unreasonable based on their knowledge and many years of experience in the field of property management. They also told us that they had made a rough market study to establish a reasonable management fee. However, this was never used for any specific property. It was created for the Research and Development department only. Further, they indicated that the approval of increases in management fees is very subjective.

Comment 14 We agree that HUD Handbook 4381.5 shows the steps that must be taken to perform a management review. One of these steps is to determine if the fees are reasonable in accordance with Section 3 of the chapter. As stated in Comment 13, if the fee yield produced by the proposed fee percentage falls outside the acceptable per-unit-per-month range, the proposed fee percentage may not be approved.

Comment 15 Oregon Housing is correct in stating that per-unit-per-month fees are mentioned in Chapter 3 of HUD Handbook 4381.5 in relation to add-on fees. According to Paragraph 3.7 a., the purpose of add-on fees is to address long-term project conditions that require additional management effort and are not considered in the initial calculation of the residential management fee range. Add-on fees may not be used to increase the fee range and in turn, increase the fee percentage.

However, Oregon Housing fails to note that per-unit-per-month fees are also applicable to the residential fee standards quoted in Paragraph 3.20 c. (3). Furthermore, Paragraph 3.19 shows how the calculation of the range of acceptable residential fee yields must be performed. Since the Annual Contributions Contract requires Oregon Housing to assume responsibility for project owner compliance with HUD requirements, it must follow these procedures.

Comment 16 We clarified in our report that this is the maximum residential fee range. In addition, the purpose of add-on fees to which Oregon Housing refers, as noted above in Comment 15, is to address long-term project conditions that require additional management effort and are not considered in the initial calculation of the residential management fee range. Add-on fees may not be used to increase the fee range and in turn, increase the fee percentage. Furthermore, in accordance with HUD Handbook 4381.5, Paragraph 3.7 a. (1), a schedule of project characteristics/conditions that warrant add-on fees and a flat fee amount for each must be established. Additionally, according to Paragraph 3.21 b. (3), "[i]f the owner/agent has requested an add-on fee for a project condition that does not have an established add-on fee, the add-on fee should be disallowed." This is to ensure that the condition was not already addressed in the computation of the residential fee range as shown in Paragraph 3.7 a. Consequently, Oregon Housing should have, but did not establish add-on fee amounts for the applicable conditions that

warrant add-on fees. Actually, the written policy Oregon Housing created in response to our inquiry (Comment 13) did not address add-on fees at all.

Comment 17 If add-on fees are not established for certain conditions of the projects, an add-on fee cannot be applied to the management fee for the projects.

Comment 18 The document at Exhibit F, to which Oregon Housing refers is an internal Oregon Housing document. Also, this document appears to refer to the maximum residential fee range computed by HUD. As noted in the report, Oregon Housing does not have to use HUD's calculated range, but must use some range.

The letter from Bonnie Billedeaux (signed by Nancy Williams for Ms. Billedeaux) was dated August 28, 1986 and refers to an old version of Handbook, 4381.5 REV 1. This handbook was replaced by Handbook 4381.5 REV 2, CHG 2 on June 27, 1997. Paragraph 2.1 of the current handbook states, "This chapter discusses the approval procedures for the selection of management agents." It does not mention management fees. Further, Paragraph 2.2 b. of the current handbook states, "State/local housing agency Approval Authority. State/local agencies have approval authority for all non-HUD insured projects where the agency financed the project or serves as the subsidy contract administrator. As part of the approval process, the state/local agency must submit to HUD a Previous Participation Certification (Form HUD-2530) for the proposed management agent as described in Paragraph 2-9a. With respect to all other procedures discussed in this chapter, state and local agencies may develop their own criteria or elect to use the procedures established in this Chapter. See Section 3 of this chapter for additional guidance." Chapter 3 of this handbook deals with management fees.

Further, Federal regulations at 24 Code of Federal Regulations 883.101 do not refer to any discretion of the Housing Finance Agency. Also, as stated in Comment 9, Since the Annual Contributions Contract requires Oregon Housing to assume responsibility for project owner compliance with HUD requirements, it must follow the handbook procedures regarding determining the reasonableness of management fees.

Comment 19 The transmission of the change to HUD Handbook 4381.5 issued December 29, 1994 was addressed to contract administrators as well as others and stated that it applied to HUD-assisted properties.

Comment 20 The letter cited in Oregon Housing's' Exhibit H does not indicate what HUD was to look at in this review. The letter states that it would be a review of the operation of Oregon Housing "...as it performs the Management Function of the Section 8 New Construction and Substantial Rehabilitation Housing Assistance Programs." This letter also does not identify what the outcome of the review was. It only stated that HUD was planning to do a review (in April 1981).

Comment 21 Although Oregon Housing is correct in saying that the Handbook states that fees derived from project income must be quoted and calculated as a percentage of the amount of income collected by the agent, the Handbook also states, in Paragraph 3.19 b. that the "[r]esidential fee yield used for establishing the range(s) must be computed by applying the residential fee percentage to the monthly rent potential for all revenue-producing units (adjusted to reflect a 95 percent collection rate)." In Paragraph 3.19 b. (2), it states that "[y]ields must be computed on a per-unit per-month basis." In Paragraph 3.20 c. it states that if the yield is not reasonable (in comparison to what was calculated above) the fee percentage may not be approved. Further, the section for add-on fees (Paragraph 3.7) states that the add-on fee may not be used to increase the percentage fee and Paragraph 3.7 a. states that add-on fees are a flat dollar per unit fee.

Comment 22 This was not in an Oregon Housing written policy, but in a letter to a project owner. Oregon Housing did not provide a written policy to support this statement.

Comment 23 The written policy does not address how this is to be determined. Furthermore, in our review of Oregon Housing files, we did not find that Oregon Housing was consistent in this practice (see Comment 13).

Comment 24 The written policies in the Exhibit provided do not address extenuating circumstances that may demand higher rates. Further, HUD Handbook 4381.5 Paragraph 3.7 a. states that "[t]he owner may request any dollar amount for a specific add-on so long as the amount does not exceed the dollar limit established for that add-on fee by the appropriated [sic] Area Office." Oregon Housing does not maintain an established list for add-on fees.

Comment 25 Oregon Housing states that HUD approved the initial management fee rates identified in the project proposal documents. However, Oregon Housing did not provide copies of these documents nor the approvals. Additionally, the one property for which Oregon Housing did provide the proposal (Finding #3, Exhibit A) does not include any reference to management fees. Also included in this exhibit is a list of items that received HUD approval. Management fees are not listed. Further, many of the projects for which we are questioning excessive management fees had a change in management fee percentage due to either a request for an increase in the percentage or due to a change in the management agreement.

Comment 26 Even though 18 projects generated surplus cash in each year of the three-year scope of the audit, the residual receipts accounts are underfunded as a result of excessive management fees. This means this money is not available in the future, if necessary, to use for project purposes. Further, any funds left in this account at the termination of the Contract revert to HUD.

Comment 27 The Scope and Methodology section of the report mentions Real Estate Assessment Scores solely to explain our basis for selecting those projects for review. The findings do not contain any references to the Real Estate Assessment Center scores.

Comment 28 Oregon Housing believes its approval of excessive "...management fees have not been a detriment to project operations as compared to HUD's PUPM standards." It also believes these fees resulted in more residual receipts than what would result if it was only approving allowable management fees. However, if more funds are being paid out prior to the calculation of surplus cash, that equates to less residual receipts.

Oregon Housing's' comparison of the "...average management fee for OHCS State Agency Section 8 projects [Annual Contributions Contract projects], when factored for occupancy..." and the "...average management fee for the HUD Section 8 projects now administered by OHCS [Performance Based Contract Administrator projects] (where the PUPM standards do apply)" shows that the average management fee percentage for the Annual Contributions Contract projects is 7.6 percent and the average management fee percentage for the Performance Based Contract Administrator projects is 7.2 percent. While this difference is not very large, the average percentage for the Annual Contributions Contract properties is higher than the average percentage for the Performance Based Contract Administrator properties. Additionally, when we compared the average per-unit-per-month management fee for these properties, we found that the Annual Contributions Contract properties averaged $46 per-unit-per-month ($11 more than the maximum residential management fee per-unit-per-month for Oregon as computed by HUD). We also found that the Performance Based Contract Administrator properties averaged only $30 ($5 less than the maximum residential management fee per-unit-per-month for Oregon as computed by HUD). Therefore, Oregon Housing's' statement is not correct.

Comment 29 Section 3.1 of Handbook 4381.5 specifically states that management fees may only be paid to the person or entity approved to manage the project. This indicates the owner may not receive management fees unless the owner is the approved management agent. In addition, even if Oregon Housing was correct in stating that nothing in the Handbook prohibits the management agent from paying for delegated duties, these duties were never identified except as asset management services.

Paragraph 6.41 b. of Handbook 4381.5 states "[a]sset management costs must not be billed to a project's operating account. These costs may only be paid from funds available for distribution to owners in accordance with the terms of the Regulatory Agreement...On limited distribution projects, any asset management fees paid from project funds must be included in the distributions-paid entry on Line 2C of Form HUD-93486. Computation of Surplus Cash, Distributions and Residual Receipts."

Further, even if HUD did approve the initial management agreement, the management agreement for Uptown Tower Apartments did not provide for a fee-split arrangement between the owner and management agent. This was accomplished in amendments to the management agreement. These amendments were not approved by HUD. The documents we obtained clearly show that Oregon Housing approved this situation, not HUD. We are confident that if HUD had been consulted on these fee split situations, they would have been denied. Also, Oregon Housing's' financial review specialist told us that even though Oregon Housing did not specifically approve this situation with regards to the other two projects, it also did not find the projects in non-compliance. Oregon Housing never provided documentation showing HUD approved this situation.

Comment 30 *United States v. Burger, supra* at 22071is a criminal case, from another district, that applies an equitable principle to dismiss a criminal indictment essentially on the grounds that the law that the defendant allegedly violated was not fairly established at the time of the violation. The mere fact that Burger was indicted on behalf of HUD gave notice that fee-splitting was not proper from HUD's perspective.

Comment 31 Oregon Housing did not provide any documentation showing that HUD was aware of the management fee splitting. The fact that HUD was unaware of the fee splitting does not mean that HUD approved this practice. Oregon Housing must follow the guidance found in HUD Handbook 4381.5. As discussed in Comment 29, HUD Handbook 4381.5 provides that management fees only be paid to the person or entity approved to manage the project. The Handbook further prohibits using project funds to pay for asset management costs.

Comment 32 OIG does not deny that HUD approved the per unit replacement cost for Uptown Tower Apartments at $50,000 in the proposal. However, the approval letter to which Oregon Housing refers states, "This approval is based upon your proposal as submitted, including the financing certifications required by 24 CFR Section 883.308. If, at any time, you make changes, including [but not limited to] changes to your financing methods which would affect the correctness of any element of the financing certifications, you must submit such changes to this office for review and approval." The revaluation of the commercial space changed both the residential and commercial space value and as a result changed the unit replacement cost. Therefore, according to the approval, Oregon Housing should have submitted any changes to HUD for approval.

Comment 33 OIG does not dispute that HUD approved the proposal. Nor does OIG dispute that cost certification documentation was not required by HUD for initial approval of this project (although it was required by Oregon Housing). However Oregon Housing should refer to the last part of the quote at 24 Code of Federal Regulations 883.306(c), which states that if the owner wants to justify a higher

equity contribution, it must be through cost certification documentation accepted by the Housing Finance Agency.

Comment 34 Regardless of what Mr. Smith wrote in his letter to the Rules Docket Clerk regarding an "...expansion of the equity concept...", 24 Code of Federal Regulations 883.306(c) states that the equity investment is determined to be either "...10 percent of the replacement cost of the part of the project attributable to dwelling use accepted by the HFA at cost certification (See § 883.411), or as specified in the Proposal where cost certification is not required, unless the owner justifies a higher equity contribution through cost certification documentation accepted by the HFA."

The original calculation of owner's equity and owner's distribution was in accordance with the above requirement. Therefore, according to the last part of the sentence in 883.306(c), if the owner wished to justify a higher equity contribution, it must be through cost certification documentation.

Comment 35 OIG does not dispute that it is proper to use the 20 percent equity contribution as submitted in the proposal (see (c) below) (as total owner's equity) or that the owner had a right to justify a higher equity contribution using costs in the proposal. However, when the equity contribution was recalculated, the owner used a different value for the commercial space. This was a value not included in the proposal. Therefore, this cost should have been supported by cost certification documentation. When Oregon Housing recalculated the owner's equity, it should have calculated it as in column A below, but it calculated the new equity contribution as in column B below.

	A	B
a	$4,000,000	$4,000,000
b	(3,200,000)	(3,200,000)
c	$ 800,000	$ 800,000
d	(400,000)	(70,000)
e	$ 400,000	$ 730,000
f	0.06	0.06
g	$ 24,000	$ 43,800

a. The proposed replacement cost of the property (rounded down from $4,000,056).
b. Less: The amount of the loan.
c. Total owner's equity.
d. Less: the value of the commercial space (A. $400,000 as shown in the proposal. B. $70,000 amount owner attempted to justify without using cost certification documentation).
e. Owner's equity attributable to dwelling use.
f. Times 6% - 24 Code of Federal Regulations 883.306(b)(1).

g. Owner's distribution allowed each year from available surplus cash.

Comment 36 The value of the commercial space included in the owner's proposal, sent by Oregon Housing to HUD for approval, was determined to be reasonable at $400,000. In addition, the value of the residential space included in the proposal was determined to be reasonable at $3,600,000. HUD approved the proposal with this initial valuation. Further, the architect (a partner in the ownership partnership) certified (less than one month after cost certification for the project) that the commercial space was 8.88% of the total property. This valuation remained in place for the first 12 years of the project's operation.

Although Oregon Housing states, "As completion and certification of the commercial space was done well after the approval of the Proposal and the funding of the loan, a revaluation was required in keeping with the regulatory requirement to determine the reasonableness of replacement cost not attributable to dwelling use..." The time between approval of the proposal (May 28, 1982) and the cost certification (July 19, 1983) was only about 14 months. However, the revaluation was not requested until nearly 12 years later (April 21, 1995) because as the owner explained, "It is timely because it is only now, 11 years into operations, that project operations provide enough surplus cash to make the payments on **'**equity.**'**" This indicates that it was only when the project finally became a viable investment, the owners wanted to find ways to obtain a higher distribution of funds from the project. In late 1990, Oregon Housing asked HUD if an adjustment in owner's equity in accordance with 24 Code of Federal Regulations 883.306(b)(1) could be made. HUD informed Oregon Housing that this increase is initiated by HUD, not the owners, and "[a]ny such adjustments will be made in accordance with a Notice in the Federal Register." A handwritten note at the bottom of HUD's response, dated March 12, 1992, indicates that Oregon Housing relayed this information to the owner of Uptown Tower Apartments. Thus, it appears that the owner first tried to have the owner equity increased through the regulations at 24 Code of Federal Regulations 883.306(b)(1). When that approach was denied, it appears the owner and Oregon Housing circumvented this regulation by changing the value of the commercial space to increase the owner distribution.

Further, in a letter to HUD on March 13, 1992, Oregon Housing again confirms that the commercial space was certified at 8.88 percent of the building space and with a value of $400,000.

Comment 37 Approval was not granted by Nancy Williams in her letter to Oregon Housing. What Ms. Williams said was that if Oregon Housing decided to allow retroactive payments for the commercial space income, the payments, including interest, could only be paid from surplus commercial space rental income and not from reserves accumulated from excess residential space rental income. We determined during our audit that loans made to a project by an owner should generate interest (be allowable), but that interest should not exceed the rate which

the owner could earn elsewhere in a reasonably safe security. In other words, interest generated should be reasonable. In this case, we found that the interest generated was not reasonable.

Comment 38 OIG concedes that HUD Handbook 4350.1, Chapter 4 does not apply to this project. We were using this citation only to determine what might be a reasonable interest rate to charge because Section 9 of the regulatory agreement states that the borrower covenants and agrees, "...(h) That payment for services, supplies or materials for the Development shall not exceed the amount ordinarily paid for such services, supplies or materials in the area where the services are rendered or the supplies or materials are furnished."

Consequently, we removed the reference to this citation from the report.

Comment 39 As a result of the comments provided by the auditee, we revised our finding to use the 10-year Treasury Rate instead of the 6-month CD Rate in calculating the unreasonable costs. The first and last commercial rent payments were "loaned" to the project on September 1, 1984, and December 1, 1991, respectively. The first and last reimbursement payments were made to the owner on December 15, 1994, and March 31, 2002, respectively. As such, use of a 10-year rate is appropriate.

Comment 40 The loans carried very little risk to the owner since the project's income flow was virtually guaranteed by its Section 8 subsidy. We do not believe the owner of this project would receive this rate on any other low risk investment in which he was not a related party. Additionally, Oregon Housing indicates that the project was charged only the prime rate until January 1994. However, we noted that the financial statements for this project indicate that the rate charged was anywhere from being "...the average annual rate the partners were charged on the partners' third-party loans..." to being "prime plus 2 1/2 percent". Additionally, Oregon Housing agreed with the owner of the project to this amount (prime plus 2.5 percent). Further, the amount charged to the project was more than $95,000 in excess of prime for the time in question. However, we have determined that the 10-year Treasury rate would be more appropriate to use.

Comment 41 OIG did not "imply" that "...distributions are inconsistent with the limitation in 24 Code of Federal Regulations 883.702..." OIG specifically stated that this was the case. Oregon Housing approved distribution of funds from residual receipts in order to pay limited distributions to owners when surplus cash was not sufficient. OIG also specifically stated in the draft report that payment of these limited distributions from the residual receipts accounts is not a project purpose.

Comment 42 HUD Handbook 4381.5 Paragraph 6.49 a. (2) and (3) also support the assertion that distributions from the residual receipts account are not appropriate to pay the owner's limited distribution when surplus cash is not sufficient. Paragraph (2) states, "(2) Limited dividend owners may pay both the annual distribution earned...plus distributions unpaid from previous years, but only up to the amount

of surplus cash available." Paragraph (3) further restricts distributions stating, "(3) [d]istributions may not be paid in excess of the surplus cash available as of the end of the prior fiscal year."

OIG does not disagree that residual receipts could be used, if necessary, for financial aspects of the project. However, payment of owner distributions, when the project does not generate enough surplus cash does not constitute a project purpose. It benefits the owner, not the project, to pay owner distributions. These distributions from residual receipts can be a detriment to the project since they decrease the amount of funds available for true project purposes such as emergency repairs.

Comment 43 The "...controlling authority..." that OIG cited in the report still stands. The regulatory agreement to which Oregon Housing refers states that if there is a conflict between the regulatory agreement and the Housing Assistance Payments Contract, the Housing Assistance Payments Contract will prevail. Therefore, although the regulatory agreement states that residual receipts may be used to pay owner distributions when there is a shortfall in surplus cash, the Housing Assistance Payments Contract states that residual receipts may be used only for project purposes. Further, as noted in Comment 42 above, HUD Handbook 4381.5 Paragraph 6.49 a. (3) specifically states that distributions may not be made in excess of available surplus cash.

The owners of limited distribution projects sign a Housing Assistance Payments Contract that explains the return on equity that they can expect throughout the term of the Contract and this explanation does not state that owner distributions may be paid from residual receipts when surplus cash is not sufficient.

Comment 44 Again, as stated in Comment 43, the regulatory agreement to which Oregon Housing refers states that if there is a conflict between the regulatory agreement and the Housing Assistance Payments Contract, the Housing Assistance Payments Contract will prevail. Although the regulatory agreement states that residual receipts may be used to pay owner distributions when there is a shortfall in surplus cash, the Housing Assistance Payments Contract states that residual receipts may be used only for project purposes.

Comment 45 We agree that HUD does not approve or disapprove residual receipts requests. However, approvals must still comply with Federal requirements that the use of residual receipts be for project purposes. Further, the approval to which Oregon Housing is referring in its response deals with a withdrawal from the residual receipts account for the replacement of the roof at the project in question. This is an obvious project purpose as it benefits the project. Distributions to the owners are not project purposes and are not allowable according to HUD Handbook 4381.5 Paragraph 6.49 as stated above.

Comment 46 We agree that HUD must give Oregon Housing an opportunity to take corrective action prior to determining that it is in substantial default. Therefore, we re-worded the report to take this into consideration.