U.S. Department of Housing and Urban Development
Office of Inspector General
Pacific/Hawaii District
450 Golden Gate Avenue, Box 36003
San Francisco, California 94102-3448

Audit Memorandum 99-SF-212-1801

October 23, 1998

TO: Janet Browder, Director, Multifamily Housing, 9AHM

FROM: Glenn S. Warner, District Inspector General for Audit, 9AGA

SUBJECT: Unfavorable Laundry Lease Agreements at HUD-Insured Multifamily Projects Davis/Sacramento, CA

At the request of HUD attorney Shirley Hochhausen, we recently conducted a review of laundry lease agreements at selected HUD-insured multifamily projects in the Davis, CA area. During the review we found instances in which projects are being deprived of revenue due to unfavorable leases with the project owner general partners. The purpose of this memorandum is to alert your office so that appropriate action may be taken.

SUMMARY

We reviewed the laundry lease agreements at 16 projects in the Davis/Sacramento area and found 4 projects with unfavorable laundry room lease arrangements with project owner general partners. As a result, the projects received income that was substantially less than the average laundry income earned at projects which either owned the laundry equipment or had lease arrangements with non-identity-of-interest vendors. We estimate that the annual income lost to these projects ranged individually from $1,850 to $7,050. Further, these identity-of-interest arrangements were not disclosed in the projects' financial statements as required.

PURPOSE AND METHODOLOGY

In 1995 we conducted an audit of the Walnut Ranch Apartments located in Dixon, CA. The audit found that the loss of revenue, due to an unfavorable laundry lease arrangement with the project's general partner Karen Fox, contributed to the owner's fiscal default of the project's HUD-insured loan. (Audit report number 86-SF-212-0001 issued December 19, 1995.) The lease provided for the project to furnish the space and utilities in exchange for $750 per year. This arrangement was disclosed in the project's June 30, 1995 audited financial statements but was not disclosed in the January 1, 1990 management certification signed by the general partner. We estimated that the unfavorable lease deprived the project of $7,726 a year in revenues, contributing to the project's fiscal default. As a result of the audit, in April 1998 HUD attorney Shirley Hochhausen requested that we review laundry leases at other HUD-insured projects owned by Fox.

Thus, the objectives of this limited review were: (1) to identify HUD-insured properties owned by Karen Fox or her ex-husband Louis Fox and determine if these properties had laundry lease arrangements similar to the one at Walnut Ranch, and (2) to compare these arrangements with the terms of typical arm's-length laundry lease agreements at other projects in the same geographical area. To accomplish these objectives we:

- Obtained HUD's listing of insured multifamily projects located in the Davis/Sacramento, CA area and selected a sample of 16 projects containing 40 to 120 units. The 16 projects included two Fox projects plus 14 projects owned by others. (We identified Fox-owned properties through query of HUD Sacramento staff and review of the list.) We contacted the management agents for the selected projects to determine: if the projects have a self-service laundry facility on site; who is the owner of the washing machines and dryers; and how the laundry equipment owner compensates the project for use of the laundry space and utilities.

- Compared the terms of the laundry leases reviewed above to the laundry lease arrangements for the projects owned by Karen or Louis Fox and to any other projects identified as having an identity of interest between the project owner and laundry equipment vendor.

- Compared the latest available per unit amount of laundry revenue realized by the selected projects to the per unit amount of laundry revenue realized by the Fox-owned projects and to other projects identified as having an identity of interest between the project owner and vendor.

- Reviewed audited financial statements and management certifications to determine if any identity of interest between owners and vendors was disclosed.

REVIEW RESULTS

The review identified four HUD-insured projects located in Davis, CA that had unfair laundry room lease agreements with their respective general partners. These included two Fox-owned projects, as well as two projects where John Whitcombe has an ownership interest. These agreements were not disclosed in the projects' audited financial statements. As a result, HUD was unaware that an identity of interest (IOI) existed between project owners and vendors, and the projects were deprived of income that would have been realized if the laundry space leases had been with independent vendors.

Paragraph 3-4 G.17 of HUD Handbook 4370.2 REV-1, *Financial Operations and Accounting Procedures for Insured Multifamily Projects*, requires project owners to list IOI companies in the project's audited financial statements. *The Management Agent Handbook* 4381.5 REV-2, paragraph 2.9 c. requires the owner and agent to submit a management certification. In section 11. of the management certifications, the agent and owner must either identify any existing IOI entities or certify that an identity of interest does not exist among the agent, owner and any individuals or companies that regularly do business with the project. The certifications further state that the agent agrees to exert reasonable effort to maximize project income.

Our review of 16 HUD-insured projects in the Davis/Sacramento area found 4 projects in which the project's general partner also owned the entity which leased laundry space at the project for the installation and operation of coin-operated washers and dryers. The average project income from these IOI arrangements was 83¢ per unit per month (pupm). The remaining 12 projects either owned the laundry machines or entered into lease agreements with non-related vendors from which they receive a percentage of the laundry income collected. The average project's share of laundry income for these 12 projects was $5.37 pupm. The typical lease agreement, where there was no identify of interest, provided for the project to receive 50 percent of gross proceeds from the laundry machines as well as a so-called "decorating allowance" of several thousand dollars. In contrast, the IOI leases provided for fixed payments to the projects or no compensation at all.

Fox Properties

Our 1995 audit of the Walnut Ranch Apartments found that the general partner, Karen Fox, executed a lease between herself and the project for the use and operation of the project's laundry facilities. Our subject review found two additional Fox-owned properties with similar laundry leases.

Pepperwood Apartments (project number 136-35628) is a 41-unit project located in Davis, CA. Karen Fox and Leona Kline are the general partners of Pepperwood Apartments Investors, the project owner. On November 10, 1981, Pepperwood Apartments Investors entered into an agreement in which general partner Leona Kline (Fox's mother) pays the project $60 per month to install and operate coin-operated washers and dryers at the project. The IOI relationship between the owner and laundry vendor was not disclosed in the project's April 30, 1997 audited financial statements certified by Karen Fox and Leona Kline, nor was it disclosed in the December 29, 1987 management certification signed by Karen Fox. In 1997 the project reported $793 ($1.61 pupm) of laundry income. Based on the average $5.37 pupm for non-IOI laundry leases, we estimate the project would have earned an additional $1,850 in 1997 using a non-IOI vendor. Nevertheless, we note that the project appears to be financially sound. For the year ending April 30,1997, the project had a $37,052 surplus cash balance and a net income of $76,028 before depreciation expense.

Le Tournesol Apartments (project number 136-35629) is a 45-unit project located in Davis, CA. Lou Fox (ex-husband of Karen Fox) is the general partner of Le Tournesol Apartments Investors, the project owners. The project's management agent, Jon Berkley Management Inc., told us that Lou Fox owns and collects money from the laundry equipment at the project, but does not pay the project for use of the laundry space and utilities. The agent was unable to locate the project's laundry lease agreement, but stated that he remembered seeing one. The IOI between the owner and laundry vendor was not disclosed in the project's April 30, 1997 audited financial statements certified by Lou Fox, nor was it disclosed in the June 20, 1994 management certification signed by Lou Fox. In 1997 the project reported $59 (11¢ pupm) of laundry income. Based on the average $5.37 pupm for non-IOI laundry leases, we estimate the project should have earned an additional $2,840 in 1997. The project's financial status was marginal: for the year ending April 30,1997, the project had a $4,910 surplus cash deficiency while the net income was $39,825 before depreciation expense.

Whitcombe Properties

The review also identified two additional projects with unfavorable leases.

Anderson Place I Apartments (project number 136-44052) is a 128-unit project located in Davis, CA. John Whitcombe and Paul Makey are the general partners of project owner Anderson Place Associates I Limited Partnership. John Whitcombe Properties leases laundry equipment to the Anderson Place I Apartments. The lease provides that the project receive $100 per month from the laundry machine collections. The IOI between the owner and laundry vendor was not disclosed in the project's December 31, 1996 audited financial statements certified by John Whitcombe and Paul Makey. (The search of HUD's files for Anderson Place I as well as Anderson Place II, discussed below, revealed no management certifications.) In 1996 the project reported $1,200 (78¢ pupm) of laundry income. Based on the average $5.37 pupm for non-IOI laundry leases, we estimate the project would have earned an additional $7,050 in 1996 using a non-IOI laundry vendor. Regardless, the financial status of the project appeared strong. For the year ending December 31, 1996 the project had a $109,522 surplus cash balance and earned $406,285 before depreciation expense.

Anderson Place II Apartments (project number 136-44101) is a 112-unit project located in Davis, CA. John Whitcombe and Paul Makey are the general partners of project owner Anderson Place Associates II Limited Partnership. The project has the same laundry lease arrangement with John Whitcombe Properties as Anderson Place I. The IOI between the owner and laundry vendor was not disclosed in the project's December 31, 1996 audited financial statements certified by John Whitcombe and Paul Makey. In 1996 the project reported $1,200 (89¢ pupm) of laundry income. Based on the average $5.37 pupm for non-IOI laundry leases, we estimate the project should have earned an additional $6,021 in 1996. Regardless, the project's financial position was strong. For the year ending December 31, 1996 the project had a $89,891 surplus cash balance and earned $333,571 before depreciation expense.

Recommendations

Except for LeTournesol whose financial condition was marginal, the projects do not appear to have suffered negative effects from the unfavorable leases. Nevertheless, we believe HUD needs to take action to assure that the owners of these and other projects with unfair leases comply with HUD requirements since lost income could become significant under different circumstances.

We discussed the results of our review with Tom Azumbrado of your staff. Based on this discussion, we recommend that you:

A. Instruct HUD Multifamily Housing Management staff to review projects' financial statements for indications, such as unusually low laundry income, of unfavorable IOI laundry lease arrangements. Where instances are found, appropriate action should be taken to assure that fair compensation is provided to the project and that necessary disclosures are made to HUD.

B. Require the owners of Pepperwood, Le Tournesol, and Anderson Place I & II to (1) disclose the IOI laundry leases in their annual audited financial statements and management certifications and (2) obtain leases that provide for reasonable compensation to the projects.

C. Advise Office of Housing in headquarters as to the existence of these IOI laundry arrangements so that headquarters can instruct other field offices to monitor for similar arrangements at other insured projects in their jurisdictions.

We have not communicated the results of this review to either the project owners or management agents.

Within 60 days, please furnish us a status report on the corrective action taken, the proposed corrective action and date to be completed, or why action is not considered necessary, for each recommendation. Also, please furnish us with copies of any correspondence issued because of this review.

If you or your staff have any questions, please contact assistant district inspector general Mark Pierce at 436-8104.

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