Issue Date
December 11, 1995
AUDIT RELATED MEMORANDUM
96-CH-212-1804

MEMORANDUM FOR: Beverly E. Bishop, Director, Office of Housing,
Illinois State Office
Edward Hinsberger, Director of Multifamily
Housing, Illinois State Office

FROM: Dale L. Chouteau, District Inspector General for Audit,
Midwest

SUBJECT: Barbara Jean Wright Courts
Chicago, Illinois

INTRODUCTION/BACKGROUND

We completed a review of Barbara Jean Wright Courts located in Chicago, Illinois. We conducted the review to assess and determine the reasons for the Project's poor physical condition. Our review covered the period of January 1993 through April 30, 1995.

Barbara Jean Wright Courts is a 272 unit residential apartment complex. HUD insured the Project's mortgage under Section 236 of the National Housing Act in August 1972. The Project is owned by Wright Court, Ltd., an Illinois limited partnership. The Project is managed by Central City Management Corporation.

Barbara Jean Wright Courts defaulted on its mortgage in 1981 and the mortgage was assigned to HUD. The original amount of the mortgage was $6,103,000 and the remaining principal balance at April 30, 1995 was $5,923,237.

In 1984, HUD gave preliminary approval to a workout arrangement to give the Project an opportunity to bring the mortgage current. The completion of the workout arrangement was contingent upon HUD's final approval of a change in ownership. HUD did not approve the change in ownership because one of the principals involved had been suspended from participation in HUD programs.

The workout arrangement provided that the owners would make capital contributions to the Project totaling $900,000 in three equal annual installments. These contributions were to commence after HUD's approval of the change in ownership. However, the owners have contributed almost $700,000 in advance of receiving HUD's final approval. The preliminary workout arrangement also provided that payments to the reserve for replacement fund would be waived until completion of the workout agreement.

Rents for 108 units, or forty percent of the Project's units, are Federally subsidized through HUD's Section 8 Program. HUD provides additional rent subsidies through mortgage interest reduction payments. Between January 1, 1993 and April 30, 1995, HUD provided the Project with $1,128,938 of Section 8 subsidies and $713,713 of interest reduction subsidies, for a total of $1,842,651.

Under the mortgage interest reduction arrangement, some tenants pay a HUD-approved basic rental amount in lieu of the market rent. The Project's rental information follows:

Bedroom Size	Basic Rent	Market Rent
2	$501	$580
3	$558	$645
4	$616	$712

The Project does not have any one bedroom units.

HUD's Fair Market Rent limits for the Chicago area as of September 1995 were: $716 for two bedroom units; $895 for three bedroom units; and $1,003 for four bedroom units.

PROBLEMS

The Project currently needs approximately $5.3 million of funds for project rehabilitation. However, because the Project has no reserve for replacement or excess operating funds available, it will become increasingly difficult for the Project's owners to properly rehabilitate this Project.

Specific causes for the Project's lack of funds to properly operate the Project are:

- The Project has received only one rental increase in the past 6 1/2 years, due at least in part to a poor working relationship between the former HUD Asset Manager and the management agent. Also, as a result of a computer input error, HUD used incorrect information in considering the management agent's requests for rent increases. HUD believed the Project had 100 more four bedroom units than it actually had.

  HUD recently approved a modest (approximately $30 per unit) rental increase that became effective on September 1, 1995. However, this increase merely provided the Project's management agent with additional funds needed to cover operating costs. The increase did not provide any additional funds for rehabilitation work.

- HUD's Multifamily Housing staff said the Project's annual insurance premiums of approximately $107,000 appear excessive. The Project's owner arranged for the insurance coverage through an affiliated company.

- The Project had two units destroyed by fire in 1992 and 1993. The two units are still not rehabilitated and income producing because of inadequate insurance settlements. These inadequate settlements resulted from a high deductible of $10,000, and settlement amounts that were substantially lower than bids received for the cost of the repairs. The management agent said the Project had no additional funds available to pay the balance of the repair costs.

- The Project has been unsuccessful in dedicating its streets to the City of Chicago, due mainly to its lack of follow-up and communication with the City. Therefore, the Project has incurred costs for the upkeep of the streets and for snow removal. The Project eventually will also be responsible for major repairs of the streets and underground utility lines, all of which are twenty-three years old.

- The management agent's annual fee of $114,000 is excessive. All expenses such as bookkeeping, on-site project management, and clerical staff are charged to and paid directly by the Project. The management fee essentially compensates the President of the management company for his part-time involvement in the management of the Project. The management company incurs virtually no overhead costs over and above the costs paid directly by the Project.

- Until recently, major appliances and equipment (i.e. refrigerators, stoves, electrical boxes, furnaces, boilers, etc.) have not been replaced since the Project's inception. The Project's management began to replace these items in 1995 using the Project's scarce operating funds.

- There has recently been an increase in vacancies (17 as of August 5, 1995), and a resulting decrease in rental revenues because:

  1) A newly constructed project opened up in February 1995, about a block from the Project. The new project has comparable unit types and rents as Barbara Jean Wright Courts.

  2) The former Project Engineer failed to ensure that vacated units were made ready for occupancy in a timely manner. He also did not advise the Project's management office when the units were available for occupancy.

  3) The Project's waiting list (excluding Section 8 prospective tenants) included many names that had not been purged for over three years. Therefore, filling a vacancy takes longer then it should because some of the prospective residents are no longer interested, no longer need an apartment, cannot be located, are not ready to move, or do not have funds available for the security deposit.

     The management agent's on-site Project Manager reviewed the waiting list for two bedroom units in August 1995. Based on her review, it appeared that only 30 of the 91 names listed were still viable potential residents. The Project Manager has not reviewed the waiting lists for the three and four bedroom units.

SURROUNDING AREA/PHYSICAL CONDITION

The Project is located in an area that is rapidly changing for the better. For example, the University of Illinois at Chicago recently acquired some land directly across the street from the

Project, and is in the process of developing it. Young urban professionals are buying up and rehabilitating nearby areas. Additionally, the Project is easily accessible to downtown Chicago.

The Project appears to be adequately maintained. However, because of the age of the Project, and its lack of substantive rehabilitation over the years, both HUD's construction analyst and an independent construction analyst concurred that the Project currently needs approximately $5.3 million in rehabilitation work. More than sixty percent of this required rehabilitation was classified by the construction analysts as "high urgency" and pertained to items such as:

- Exterior walls and foundations
- Roofs
- Walks and guardrails
- Doors and windows
- Electrical, plumbing, and heating systems

CORRECTIVE OPTIONS AVAILABLE

Barbara Jean Wright Courts presents a unique situation that is in need of a unique and immediate solution. Consequently, we believe an untraditional solution will be needed to deal with this Project. During our review, we considered different options to address the situation. The options described below should not be considered all inclusive, or mutually exclusive. Indeed, a combination of options described, or other options not yet considered may be better. The options considered were:

1) HUD could maintain the status quo, not approve any change of ownership or significant rental increase, and not foreclose on the Project. However, this option does nothing to assist the Project with its financial problems. Therefore, OIG does not consider this option viable.

2) HUD could approve one of the two recent changes of ownership proposed by the Project's owners. However, both proposals would cost taxpayers approximately $13 million through HUD's previous payoff of the Project's mortgage and future tax credits provided to the owners. Because of the cost to taxpayers, and the lack of assurance that the current

situation would not recur, OIG does not consider this option viable.

3) HUD could approve a significant rental increase in order to help alleviate the Project's financial problems. However, many current residents who pay either basic or market rents would probably move, thus possibly creating a net loss of total rental revenue. Conversely, assuming that all basic and market rate residents remained at the Project, even a significant rental increase would not provide the funds necessary for the needed rehabilitation. Therefore, OIG does not consider this option viable.

4) HUD could foreclose on the Project; scatter Section 8 residents via vouchers; and sell the Project as-is to an outside developer. The President of the Project's management agent and HUD's Chief of Multifamily Housing for the Illinois State Office did not disagree with our opinion that HUD could sell the Project for greater than the outstanding mortgage amount.

The surrounding area is improving dramatically. The University of Illinois is developing the area immediately across the street, and young urban professionals are buying up and rehabilitating nearby areas.

5) HUD could foreclose on the Project; scatter Section 8 residents via vouchers; perform the required rehabilitation work; and sell individual units as condominiums to low and moderate income families for between $45,000 and $55,000 per unit.

Priority for purchasing the units could be given to the 160 current non-subsidized families who are paying market or basic rents. These owners' monthly mortgage payments (including estimated insurance, property taxes, and assessment fees) would be relatively comparable to their current rents, and these payments would remain relatively constant. Moreover, the mortgage payments would be affordable to both low and moderate income families. A comparison of the estimated monthly mortgage payments (including insurance, taxes, and assessment fees) and the Project's current basic rents is as follows:

BEDROOM EST. EST. MONTHLY HUD APPROVED

SIZE	MTG. AMT.	MTG. PAY	BASIC RENTS	DIFFERENCE
2	$45,000	$ 659	$ 501	$158
3	$50,000	$ 705	$ 558	$147
4	$55,000	$ 751	$ 616	$135

The estimated monthly mortgage payment is based upon a fixed interest rate of 8.375% for 30 years. We obtained the interest rate from a local bank. We estimated annual real estate taxes of $1,400 for a two bedroom unit, $1,500 for a three bedroom unit, and $1,600 for a four bedroom unit; and an estimated monthly management fee of $200 per unit.

As of December 1994, HUD established the "low-income" level for a family of four in the Chicago area to be $40,200. Based on our estimated monthly mortgage payments, the following minimum yearly incomes would be required to accommodate a 30 percent housing payment:

2 Bedrooms - $26,348
3 Bedrooms - $28,202
4 Bedrooms - $30,055

Therefore all units would be available to low and moderate income families in the Chicago area.

6) HUD could foreclose on the Project; perform the required rehabilitation work; and sell the Project as a cooperative to a mutual housing association consisting of low and moderate income families. Priority for membership in the cooperative could be given to the current residents - both market/basic and Section 8. The new owners' monthly housing payments should be relatively comparable to their current rents, and the payments would virtually remain constant.

7) HUD could foreclose on the Project; scatter Section 8 residents via vouchers; perform the required rehabilitation work; and then sell the units as condominiums to young urban professionals and other individuals - some of whom may be of low or moderate incomes - at market rates. Based on our casual observation of surrounding properties, we estimate that the units could sell for between $80,000 and $100,000 per unit, with total sales proceeds of approximately $25,000,000.

The advantages of options 4, 5, and 7 are that they would make HUD whole and help to achieve the Secretary's goal to increase the number of homeowners in this country.

Option numbers 4, 5, and 7 discussed above include the scattering of Section 8 tenants via housing vouchers. This is consistent with HUD's Reinvention Summary. The Reinvention Summary states that as contracts expire on existing Project-based Section 8 programs, the Housing Certificate Fund will become the vehicle for providing portable subsidies for low-income Americans.

24 CFR Part 290 addresses the management and disposition of HUD-owned multifamily projects and certain multifamily projects subject to HUD-held mortgages. 24 CFR Part 290.5(a) states that the purpose of the regulations is to manage and dispose of HUD-owned multifamily projects in a manner that will, in the least costly fashion among the other reasonable alternatives available, further the goals of:

1) Preserving projects so that they are available to and affordable by low and moderate income persons;
2) Preserving and revitalizing residential neighborhoods;
3) Maintaining the existing housing stock in a decent, safe, and sanitary condition;
4) Minimizing the involuntary displacement of tenants;
5) Minimizing the need to demolish multifamily projects;
6) Maintaining the rental housing project for the purpose of providing rental or cooperative housing.

Option number 6, selling the Project to a cooperative, appears to accomplish all of the above listed goals. However, since this option would most likely involve a new HUD-insured mortgage, HUD would again be at risk of financial loss in the event of loan default.

While option numbers 4, 5, and 7 do not accomplish all of the above listed goals, they do accomplish most of them. That is:

Option number 4 (selling the Project as is to an outside developer), accommodates goals 2, 3, 5, and 6, but does not accommodate goals 1 and 4.

Option number 5 (selling the Project as condominiums to low and moderate income persons), accommodates goals 1, 2, 3, 5, and 6, but does not fully accommodate goal 4.

Option number 7 (selling the Project as condominiums at market rates), accommodates goals 2, 3, 5, and 6, but does not accommodate goals 1 and 4.

24 CFR Part 290.5(b) states that in determining the manner by which a project shall be managed and disposed of, HUD may balance competing goals relating to individual projects in a manner that will further the achievement of the overall purpose of the regulations. 24 CFR Part 290.11 states that upon completion of a determination and finding of good cause, the Assistant Secretary for Housing may waive any provision of the regulations in any particular case subject only to statutory limitations.

Moreover, options 4, 5, and 7 each accomplish an increase in homeownership, which is one of the seven principles in The Legislative Plan to Reinvent HUD. Specifically: more families must be able to buy their own homes because homeownership is critical to creating and nurturing the fabric of a community, the conditions for healthy family life, and the long-term economic well-being of the Nation.

RECOMMENDATIONS

We recommend that the Director of Housing for the HUD Illinois State Office:

A) Develops and implements a strategy and plan for addressing the financial and physical condition of Barbara Jean Wright Courts, or divesting HUD of this Project.

If HUD does not divest itself of Barbara Jean Wright Courts, we recommend that the Director of Housing for the HUD Illinois State Office assures that the Project Owner:

B) Procures the Project's property insurance coverage on a competitive basis.

C) Provides a cost-benefit analysis to justify the $10,000 deductible amount on the Project's property insurance policy. If the analysis does not justify the deductible amount, the deductible on the property insurance policy should be reduced.

D) Continues efforts to dedicate the Project's streets to the

City of Chicago;

E) Provides justification to show that the management fee is reasonable in relation to the time and effort required and actual costs incurred by the management agent. If the fee is not adequately supported, the management fee should be reduced accordingly.

The above recommendations will be controlled in the Department's Automated Audit Management System. Within 60 days, please give us, for each recommendation made in this memorandum, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Also, please furnish us copies of any correspondence or directives issued because of this audit.

Should you or your staff have any questions, please have them contact me at (312) 353-7832.

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