

AUDIT RELATED MEMORANDUM
96-CH-222-1814

September 27, 1996

MEMORANDUM FOR: Frank Slezak, Chief, Contract Operations Branch,
Illinois State Office

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

SUBJECT: ERA Arbor III Realty Co., Inc.
Single-family Property Disposition Program
Noblesville, Indiana

We completed an audit of ERA Arbor Realty III Co., Inc. as you requested in your memorandum, dated January 10, 1996. On April 23, 1991, HUD entered into a contract with ERA Arbor III Realty Co., Inc. to manage and sell HUD properties assigned to it. Arbor Realty was the exclusive listing agent for a two-county area in Indiana. The contract was effective from May 1, 1991 through April 30, 1992.

On July 19, 1991, HUD terminated the contract for the convenience of the Government. A formal settlement agreement was not executed. However, HUD continued to pay Arbor Realty commissions on the sale of assigned properties based on verbal agreements. On February 20, 1996, after HUD stopped the payments, Arbor filed a complaint with the Board of Contract Appeals claiming that HUD owed it \$229,746 plus interest and damages.

Our objectives were to determine whether HUD underpaid or overpaid commissions and bonuses to Arbor and whether the expenses claimed by Arbor were reasonable and supported.

To accomplish our objectives, we reviewed the contract, applicable HUD regulations, settlement statements, purchase agreements, invoices, correspondence between Arbor Realty and HUD, and notes on their meetings. We also interviewed the President of Arbor and HUD staff in the Indiana State Office and in the Illinois State Office who were involved with the Exclusive Listing Agent program. We reviewed every property in the Indiana State Office inventory to determine whether HUD had assigned the property to Arbor and whether it underpaid or overpaid Arbor for the sale of the property. Appendix A shows each property we reviewed and the

results of our review. We also reviewed expenses claimed by Arbor to determine whether they were reasonable and supported.

During the term of the contract, the Indiana State Office's inventory of single family properties totaled 412. HUD selectively assigned 94 properties to Arbor Realty during the course of the contract.

We concluded that HUD overpaid Arbor Realty for commissions and bonuses. We calculated the commissions at 9 percent, 7 percent, and 3 percent because of conflicting rates in the contract. Arbor Realty received \$390,264 in commissions and bonuses for the sale of 209 properties. Based on a 9 percent commission rate, Arbor Realty received overpayments totalling \$156,296. Based on a 7 percent commission rate, Arbor Realty received overpayments totalling \$200,940. Based on a 3 percent commission rate, Arbor received overpayments totalling \$290,227.

Further, Arbor Realty could not adequately support its claimed expenses. Arbor could not provide originals of cancelled checks and invoices for \$113,093 in claimed expenses.

Our audit period was May 1, 1991 through April 30, 1992. The coverage was adjusted as necessary. We performed our site work between March and August 1996 at the Indiana State Office. We conducted our audit in accordance with generally accepted government auditing standards.

We kept Arbor Realty informed about our audit results throughout the audit. We provided interim data on the underpayments and overpayments and a draft of this audit-related memorandum. In response, Arbor provided written comments. Arbor's comments to the draft of this audit-related memorandum are included in their entirety in Appendix E. We held an exit conference on September 13, 1996.

We provided a copy of this audit-related memorandum to the President of ERA Arbor Realty III Co., Inc. and HUD's Office of Counsel.

If you have any questions, please contact me at (312) 353-7832.

Results of Audit

HUD overpaid Arbor Realty between \$156,296 and \$290,227 for commissions and bonuses under the Exclusive Listing Agent contract. The excess payments were for properties sold by other realtors before and after the contract period, properties sold directly by HUD, and properties never assigned to Arbor or never sold. HUD authorized the payments. The Chief, Single Family Disposition Branch, said the contracting officer verbally agreed to pay Arbor a commission on the sales of all properties that had been assigned to it. The commissions were to be paid on closing of the sales. The Indiana State Office paid a commission on assigned but unsold leased properties because they had been held off the market for an extended period.

Contract Terms

The HUD-Arbor contract provided that from May 1, 1991 through April 30, 1992, Arbor would be the exclusive listing and management service agent for HUD-owned properties in a two-county area in Indiana. HUD would, at its discretion, assign the properties to be included in the contract. The contract as amended was confusing as to whether Arbor should receive 9 percent, 7 percent, or 3 percent of sales prices.

At sales closing, Arbor was to receive commissions and bonuses for sales of properties assigned to him and listed by him and reimbursements for services such as securing, repairing, and winterizing the properties. The amount Arbor received in bonuses for each property depended on the number of days elapsed between the date HUD assigned the property to Arbor and the sales closing date.

The contract was modified three times. Modification 1, effective April 24, 1991, was issued to set the sales commission rate at 7 percent. The modification was issued as a compromise to settle the confusion as to whether Arbor should have been paid at 3 percent or 9 percent of sales.

HUD unilaterally issued modifications 2 and 3. Modification 2, effective June 17, 1991, was issued as a clarification. The modification excluded from the contract properties with sales pending at the beginning of the contract and properties sold by HUD. The validity of this unilateral modification is in dispute.

Modification 3, effective July 19, 1991, terminated the contract for the convenience of the Government. There was no formal settlement agreement identifying the

amounts to be paid to Arbor after termination. HUD , however, continued to pay Arbor Realty a commission for properties as they were sold, including properties sold without any Arbor participation. These included properties sold before and after the contract period.

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How We Determined the Allowability of Commissions

We determined the allowability commissions and bonuses on assigned and unassigned properties for which a purchase agreement was signed during the contract period, including properties sold directly by HUD. We used the date the purchase agreement was signed as the best determinant that Arbor was the listing agent. We also allowed commissions on properties Arbor sold as the selling agent after the contract period.

We did not allow Arbor Realty a commission on sales with purchase agreements executed by another agent before or after the contract period, regardless of when the sale was closed.

Commissions on Sales Involving Arbor

As listing agent, Arbor Realty was entitled to a commission and bonus on the sale of an assigned property sold during the contract period. After the contract terminated, Arbor was entitled to a 6 percent commission on any property it sold.

Based on our review, Arbor was entitled to sales commission on 88 sales. Arbor participated in the sales of each of the properties. Eighty-three of the sales occurred during the contract period. Therefore, Arbor was entitled to a commission of 9, 7, or 3 percent (depending on how the contract is interpreted) on these 83 sales. The remaining five sales were after the contract period. Consequently , Arbor was entitled to a commission of 6 percent on these five sales.

Arbor Realty received \$128,053 for participating in the 88 sales. At a commission of 9 percent Arbor was underpaid \$105,746 at 7 percent Arbor was underpaid \$61,103; and at 3 percent, Arbor Realty was overpaid \$28,185. Our computations are summarized below.

Payments at 9 Percent Commission				
Description	No.	Received	Earned	Over/ (Under)
Assigned and sold during contract	83	\$113,290	\$221,793	\$(108,503)
Sales after termination 6%	5	14,763	12,006	2,757
TOTALS	88	\$128,053	\$233,799	\$(105,746)

Payments at 7 Percent Commission				
Description	No.	Received	Earned	Over/ (Under)
Assigned and sold during contract	83	\$113,290	\$177,150	\$(63,860)
Sales after termination 6%	5	14,763	12,006	2,757
TOTALS	88	\$128,053	\$189,156	\$(61,103)

Payments at 3 Percent Commission				
Description	No.	Received	Earned	Over/ (Under)
Assigned and sold during the contract	83	\$113,290	\$ 87,862	\$ 25,428
Sales after termination 6%	5	14,763	12,006	2,757
TOTALS	88	\$128,053	\$ 99,868	\$ 28,185

Appendix B shows the details for each property included in the above tables.

Commissions on Sales Not Involving Arbor

Arbor received commissions and bonuses totaling \$262,211 for the sales of 132 properties in which it did not participate. We did not allow the payments.

Arbor received \$237,835 for properties sold outside the contract period: \$22,215 for 13 properties sold before the contract period and \$215,620 for 107 properties sold after the contract period. Of these properties, 59 had not been assigned to Arbor.

Claimed Expenses Not Supported

Arbor Realty also received commissions totaling \$16,897 for leased properties and properties sold directly by HUD. Arbor did not provide listing agent services for these properties; therefore, we did not allow Arbor listing agent commissions for these properties.

In addition, Arbor Realty received \$7,479 in bonuses for sales in which it was not involved. HUD made the payment after receiving an invoice from Arbor. The invoice showed a lump sum due for bonuses.

Appendix C lists the properties for which Arbor received commissions and bonuses for sale of properties in which it was not involved.

At the request of the Office of Counsel, we prepared Appendix D which shows the properties not assigned.

Arbor Realty did not provide adequate support for its revised claim for expenses totaling \$113,093. HUD has not paid this claim. The expenses were in addition to commissions and bonuses claimed. Adequate support includes cancelled checks, invoices, and bank statements to evidence the purpose of the expense and that it was actually paid. Because of the lack of documentation, we cannot express an opinion on the allowability of these expenses.

Arbor Realty did provide some piecemeal documentation, but it was not sufficient. Arbor Realty did not provide original checks and invoices for any of the expenses. It provided some check register copies of checks totaling \$21,037 which had cleared the bank. It did not provide any documentation for the remaining expenses totaling \$92,056.

The Office of Counsel and the Office of Inspector General repeatedly requested that Arbor Realty provide original documentation supporting its claim. In a letter dated April 15, 1996, the Office of General Counsel directed Arbor Realty to produce all records pertaining to the contract and its complaint. We reiterated the request in several discussions and in a letter dated May 23, 1996. The letter itemized the claim and specified the documentation needed to support each amount claimed.

The largest expenses comprising \$101,629 of the \$113,093 were: commissions to Arbor Realty agents (\$44,605); compensation for the president and employees' salaries and

commissions (\$39,240); yard signs, office space rental, and computer software (\$13,844); ERA regional fees (\$2,940); and attorney retainer fees (\$1,000).

Some of the expenses may be reasonable. Regardless, some expenses are clearly ineligible because they were covered under the commissions. For instance, commissions and other compensation should be covered by commissions. In the absence of adequate supporting documentation, we do not express an opinion on the allowability of these expenses.

Auditee Comments

This is in response letter to your Final Draft of the audit report you have prepared. In your first paragraph you state that Arbor entered into a contract with HUD, "to manage and sell HUD properties assigned to it." This is an incorrect reading of the contract terms: terms that have taken on special emphasis in your report. The actual words of the contract are "SERVICES Part 1-B and SCOPE Part 1-C. "Management and disposition services for assigned HUD-owned single family properties..." Your interpretation would indicate that Arbor was contractually obligated to "sell" HUD properties, while Arbor's duties in Sec. C included only advertising, listing in the multiple listing service, placing "For Sale" signs, and co-operating with other interested selling brokers. At no location in the contract is Arbor required to sell or close any property on which it has performed the required services, in order to be entitled to a commission. Arbor is only required to perform the services under Section C, and at sales closing, it was to be paid the amount of 7%, (as amended). There is no requirement for the property to sell or close during the term of the contract, and the auditor should not have attempted to re-write the contract or insert their interpretations in making determinations as to the propriety of payments.

OIG Evaluation of Auditee Comments

Part I, Section C.4.c of the contract is entitled Listing/Sales Service Requirements. Arbor's comments accurately describe some of its responsibilities. However, the contract also states that the contractor shall put forth every effort to produce an acceptable purchase offer on each available property.

Arbor's proposal also stated that the sole purpose of the contract was to sell HUD property. At the close-out

conference, Arbor's president agreed that "disposition" was synonymous with "sale".

When the contract was terminated, Arbor was no longer the listing agent for unsold properties. Thus, HUD was no longer obligated to pay commissions to Arbor as the listing agent for any of the properties that sold after the contract was terminated.

Auditee Comments

You also draw a legal conclusion that "the contract was not modified to include a formal termination agreement". Sufficient evidence has been presented to you to indicate that a modification was, in fact, made in the form of an agreement between Arbor and the HUD Contracting Officer. Whether that agreement was formalized through the actions of Arbor and HUD is a matter of judicial review, and exceeds the scope and purpose of an audit.

You state that "HUD continued to pay Arbor Realty commissions after the contract was terminated", as though a formal agreement was required to make such payments, though the Federal Acquisition Regulation 49-103 allows settlement to occur by (a) negotiated settlement, (b) determination by the Termination Contracting Officer, or (c) costing out under vouchers. In addition, the Termination Contracting Officer may exercise a Partial Settlement, as allowed in Federal Acquisition Regulation 49.109.5. Your audit failed to investigate or report if any other of these options were utilized by the Termination Contracting Officer in authorizing payments, before concluding that the payments were not proper.

OIG Evaluation of Auditee Comments

Our statement that no formal settlement agreement was executed is accurate. The evidence Arbor presented consisted of letters from HUD's Indiana State Office describing the properties sold for which Arbor should submit an invoice. We agree that HUD directed Arbor to submit invoices to receive the commissions. We found no documentation explaining the contracting officer's basis for authorizing payments.

Auditee Comments

You stated that HUD delivered 230 properties to Arbor on the date the contract was effective, yet only 59 properties bear the delivery date of 5-1-91 on the attached charts.

OIG Evaluation of
Auditee Comments

We discussed with HUD's Chief of Contract Operations and HUD's Attorney in the Illinois State Office whether the list of properties attached to the contract was meant to be a property delivery order. They both agreed that the attachment was not a delivery order. Therefore, we changed our memorandum and appendices to show that the 230 properties were not delivered.

Auditee Comments

Your report does not demonstrate how you determined that 70 properties claimed by the contractor were listed as "Not Delivered", when more than adequate HUD-generated documentation was presented to you by the contractor to prove that those properties were considered by HUD as being in our assigned inventory. Even the Indiana Office's payment for these properties indicate that they knew that these properties had been assigned to us.

Further, your report simply concludes that if a property did not receive an accepted bid or close during the contract period, that Arbor was not entitled to a commission, while as stated above, these requirements are not contained in the contract.

OIG Evaluation of
Auditee Comments

During the term of the contract HUD assigned to Arbor 94 of the 412 properties in its inventory. The properties assigned were identified in three separate delivery orders. We concluded that the 318 properties were undelivered properties. HUD reserved the right to selectively assign properties; therefore, HUD was not obligated to assign all properties in HUD's inventory during the contract period. When the contract was terminated for the convenience of the Government, Arbor no longer participated in the sales as the listing agent. Therefore, Arbor would only be entitled to commission for properties that sold (had a signed purchase agreement) during the contract period regardless of the date the sale closed.

Auditee Comments

As part of the "Results of Audit-Contract Terms" you mention that modification #2 was issued on June 17, 1991. This attempted modification was illegally drawn and not accepted by the contractor and designed to deprive the contractor of large sums of commissions already having been earned for a period of over a month and a half. This was a substantial material change of the terms of the contract and not simply a "clarification". In an inter-office

memorandum from Carol Smith to J. Nicholas Shelley, and dated June 24, 1991; and made a part of the Appeal File under 49.4, the Contracting Officer states that she was using authority granted under the clause "Changes with Alternate I". This Clause states "The Contracting Officer may at any time, by written order, without notice to the sureties if any, make changes within the general scope of this contract in any one or more of the following: (1) Description of services to be performed, (2) time of performance, or (3) place of performance. This amendment did not deal with any of these allowable changes and was not permissible under this clause, or any other part of the contract. The audit should have examined this amendment and the surrounding issues before accepting it as a legal amendment and using it as a basis for determining commissions due to Arbor.

OIG Evaluation of Auditee Comments

Modification 2 did not affect our calculation of the commissions earned by Arbor. We did not exclude properties because they were covered in modification 2 from our calculation of commissions Arbor earned. For example, we allowed Arbor commission for direct HUD sales during the contract period. We only excluded properties if they were sold before or after the contract period.

Auditee Comments

The draft audit-related memorandum states that, "We determined the allowability of the commission paid to Arbor based on whether Arbor Realty participated in the sale of a property." Participation in the sale of a property is not mentioned in the contract as a requirement for the payment of commission to Arbor, and is not a permissible basis for the auditors to make a determination as to allowability. Assignment of a property to Arbor III and the performance of duties required in Section C. of the Contract are all that is required of the Contractor, and should have been all that the audit utilized in determining whether a commission was earned.

The audit used the date on which a purchase agreement was signed as a determinant that Arbor was the listing agent. If you mean the date on which the purchase agreement was signed and accepted by HUD, rather than signed by a potential buyer, then Arbor has no argument, that the acceptance date could be used to determine when HUD's liability to pay commission upon closing began to attach.

OIG Evaluation of Auditee Comments

We modified our memorandum and appendices to allow Arbor commissions on all properties sold during the contract period. The properties include those sold directly by HUD and in which Arbor did not participate in the sale of the properties. We also allowed commissions on properties sold after the contract period for which Arbor was the selling agent. We used the purchase agreement dates to determine whether the properties were sold during the contract period. This was to Arbor's advantage since we allowed a commission even if HUD's acceptances and the sales' closing occurred after termination.

Auditee Comments

The balance of the Audit report becomes irrelevant and unusable when the contract and clauses are applied as listed above. The number of errors and misinterpretations contained in the charts (appendices) are too numerous to list in the response, due to the misapplication of the auditors' unresearched opinion and conclusions as to applicable law, regulations, and terms of the contract.

While the auditors were personable and polite in our discussion, I can only find that the audit was one-sided and designed to verify conclusions already improperly drawn by the Chicago office prior to ordering this audit. I restate my earlier position that the audit should have thoroughly investigated the Indianapolis office and the actions of the Chief Property Officer and the Contracting Officer in the improper and incompetent handling of the contract, the attempts to defraud the contractor of earned commissions, the true reason for the termination of this contract, the settlement agreement reached between the office and the contractor, and payments received by the contractor as a result of that agreement.

OIG Evaluation of Auditee Comments

We have evaluated Arbor's comments to our draft and revised our memorandum and appendices accordingly. We do not agree that we have misapplied the law, regulations, and contract terms.

Our review was independent and not designed to verify conclusions of the Illinois State (Chicago) Office. We acknowledge that the Indiana State Office made errors in administering the contract and its termination. However, we believe that the errors unjustifiably benefitted Arbor. Arbor offered no documentation supporting the charge that the Indiana State Office staff attempted to defraud Arbor.

Auditee Comments

Distribution

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