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AUDIT MEMORANDUM  
00-CH-119-0801

September 28, 2000

MEMORANDUM FOR: William C. Apgar, Assistant Secretary for Housing-Federal Housing  
Commissioner, H

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

SUBJECT: HUD's Settlement Agreement  
Associated Estates Realty Corporation  
Office Of Multifamily Housing

INTRODUCTION

We completed a review of HUD's Settlement Agreement with Associated Estates Realty Corporation. The Settlement Agreement affected four Projects: Rainbow Terrace Apartments; Longwood Apartments; Park Village Apartments; and Vanguard Apartments. The objectives of our review were to determine: (1) why HUD entered into the Settlement Agreement; (2) whether the Agreement was appropriate according to Federal laws and HUD's requirements; and (3) if HUD enforced the terms of the Settlement Agreement.

In order to achieve our objectives, we reviewed HUD's files maintained by the Headquarters Office of Asset Management (formerly the Office of Portfolio Management), the Headquarters Departmental Enforcement Center, and the Cleveland Multifamily Program Center. HUD's files contained physical inspection reports, management review reports, and audited financial statements for the four Projects. We interviewed HUD's current and former staff which included: the Director of Multifamily Housing Assistance Restructuring (formerly the General Deputy Assistant Secretary for Housing); the former Director, the Acting Director (formerly the Deputy Director), Chief Counsel, a Senior Attorney, Attorneys, a Team Leader, and an employee (formerly the Director of Operations) of the Departmental Enforcement Center; the Director, Deputy Director, and the Field Director (formerly a Senior Realty Specialist) of Asset Management; the Director of the Columbus Multifamily Hub; the Director, Senior Project Managers, and a Project Manager for the Cleveland Multifamily Program Center; the Director of the Fort Worth Multifamily Property Disposition Center; a Senior Realty Specialist for the Atlanta

Multifamily Property Disposition Center (formerly a Team Leader for the Departmental Enforcement Center and formerly a member of the Special Workout Assistant Team); the Assistant General Counsel for the Midwest; the Director of Physical Inspections for the Real Estate Assessment Center; the Senior Community Builder/Coordinator and the Legal Counsel for the Cleveland Area Office; an Economist for the Ohio State Office; an Analyst for the Office of Policy Development and Research; the former Counselor to the Secretary; the former General Deputy Assistant Secretary for Housing-Assistant Federal Housing Commissioner; and the former Deputy Assistant Secretary for Multifamily Housing. We also interviewed: Assistant United States Attorneys for the District of Columbia and the Northern District of Ohio; and the City of Cleveland's Chief Assistant Director of Law and the former City Director of Community Development.

The Settlement Agreement was entered into because of HUD's desire to settle a rent increase lawsuit filed by Associated Estates. HUD also wanted to remove Associated Estates from the four Projects to protect the tenants from unhealthy and unsafe living conditions. The Settlement Agreement required: HUD to pay Associated Estates \$1.78 million for requested rent increases; Associated Estates to find new owners for Rainbow Terrace and Park Village Apartments, or transfer the Projects to HUD; and HUD agreed not to take administrative actions against Associated Estates and released Associated from any and all claims except tax or criminal fraud.

Because of apparently extreme poor communication between the various HUD Offices affected by the Settlement Agreement, HUD's staff who negotiated the Agreement were not aware that the United States Attorney's Office for the Northern District of Ohio had previously accepted a civil false claims and equity skimming case against Associated Estates. They also were not aware of a previous cost savings agreement that required Associated Estates to share with HUD the savings from refinancing Rainbow Terrace Apartments' mortgage. The negotiators also violated Federal laws and HUD's own requirements by settling the civil suit and waiving civil action without the Department of Justice's approval. HUD lacked documentation to justify \$1.67 million of the \$1.78 million paid directly to Associated Estates under the Settlement Agreement and did not pursue funds owed by Associated under the previously negotiated cost savings agreement.

While HUD enforced the terms of the Settlement Agreement, it did not take possession of Rainbow Terrace and Park Village Apartments as permitted, but not mandated by the Agreement. HUD's Director of Asset Management said HUD did not want to take possession of the Projects because of the cost associated with repairing them. By not taking possession of Rainbow Terrace and Park Village Apartments, HUD contradicted one of its stated reasons for negotiating the Settlement Agreement and failed to protect the Projects' tenants from unhealthy and unsafe living conditions. We also find it incongruous that HUD could find \$1.78 million to pay a large real estate management company but was unwilling to find the funds needed to protect the tenants from unsafe and unsanitary living conditions.

We presented our draft audit memorandum to the Assistant Secretary for Housing-Federal Housing Commissioner. We held an exit conference with HUD's Director of Asset Management, the Acting Director and Chief Counsel for the Departmental Enforcement Center, and the Deputy

General Counsel for Programs and Regulations on September 21, 2000. HUD disagreed with our conclusions and recommendations.

We included excerpts of HUD's comments in the audit memorandum. The complete text of the comments are in Appendix A. A copy of this memorandum was provided to the Assistant Secretary for Housing-Federal Housing Commissioner.

Within 60 days, please provide 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 provide us copies of any correspondence or directives issued because of the review.

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

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#### Auditee Comments

Excerpts paraphrased from HUD's comments on our draft audit memorandum follow. Appendix A, pages 52 to 60, contains the complete text of the comments.

HUD and the Assistant United States Attorney for the District of Columbia viewed HUD's chances of prevailing in the rent increase lawsuit as poor. The settlement negotiations could provide HUD an uncontested exit by the Projects' owners. This would give an opportunity for new ownership or HUD to move to protect the residents and work with the community to improve the overall conditions of the Projects. The Settlement Agreement was entered into because HUD wanted to resolve long-standing problems at the Projects by transferring the Projects from Associated Estates to a new owner. If a new owner could not be found, the Projects' owners would transfer the Projects to HUD.

#### OIG Evaluation Of Auditee Comments

We agree that HUD's staff (the former Deputy Assistant Secretary for Multifamily Housing and the Chief Counsel for the Departmental Enforcement Center) and the Assistant United States Attorney for the District of Columbus, who was assigned to defend HUD in the rent increase lawsuit filed by Associated Estates, believed HUD was probably liable for failing to process the rent increase for Rainbow Terrace Apartments. However, this does not eliminate the fact that HUD did not provide the Settlement Agreement to the United States Attorney's Office for the District of Columbia for approval as required by Federal laws (Section 516, Title 28 and Section 901 note, Title 5 of the United

States Code) and HUD's Handbook (1530.01 REV-4 CHG-2).

Title 28, United States Code, Section 516, says the conduct of litigation in which the United States, an agency, or an officer is a party, or is interested, and securing evidence therefore, is reserved to officers of the Department of Justice.

Executive Order 6166, dated June 10, 1933, incorporated into Title 5, United States Code, Section 901 note, states defending claims and demands against the Federal Government, now exercised by any agency or officer, are transferred to the Department of Justice. As to any case referred to Justice for defense in the courts, the function of decision whether and in what manner to defend, or to compromise, or to appeal, or to abandon defense, now exercised by any agency or officer, is transferred to the Department of Justice.

HUD Handbook 1530.01 REV-4 CHG-2, Section 1-2b, paragraph 3, requires HUD to provide recommendations to the Department of Justice concerning: (a) initiation of litigation; (b) intervention in ongoing litigation; (c) defense of litigation; (d) proposals for settlement; and (e) appeals from adverse judgments. Paragraph 3 also requires HUD attorneys to coordinate closely with their counterparts at the Department of Justice.

The United States Attorney's Office for the District of Columbia represented HUD in the rent increase lawsuit. Federal laws and HUD's Handbook required HUD to get the Department of Justice's approval since Justice represented HUD in the lawsuit. However, this was not done.

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**Auditee Comments**

Apparently horrendous poor communication is inappropriate regarding HUD's Program Offices. The facts cited in the audit memorandum are in error. Correct information was either given to the Office of Inspector General or was readily available in HUD's files.

OIG Evaluation Of  
Auditee Comments

We changed the phrase “apparently horrendous poor communication” to apparently extreme poor communication based upon HUD’s comments. This captures the apparent total break down in communication between the various HUD Offices. HUD’s former Director of the Departmental Enforcement Center, the Director of the Cleveland Multifamily Program Center, the Director of the Columbus Multifamily Hub, a Senior Realty Specialist for the Atlanta Multifamily Property Disposition Center, and the Legal Counsel for the Cleveland Area Office were aware of or attended presentations of the multifamily equity skimming and civil false claims case to the United States Attorney’s Office for the Northern District of Ohio. However, HUD’s staff (the former General Deputy Assistant Secretary for Housing, the Director and Deputy Director of Asset Management, the former Deputy Assistant Secretary for Multifamily Housing, and a Senior Attorney for the Departmental Enforcement Center) who negotiated the Settlement Agreement said they did not know a civil case was accepted by the United States Attorney’s Office. We found no written evidence to support they were aware of the civil false claims and equity skimming case. They said they did not inquire to determine if the various HUD Offices were aware of any legal action underway against Associated Estates.

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Auditee Comments

HUD’s Director of Asset Management cited costs as one of several reasons, but not the only reason in allowing the owners time to attempt to sell the Projects to a private party. The owners exited Longwood Apartments and HUD took ownership of Vanguard Apartments. HUD also took ownership of Rainbow Terrace and Park Village Apartments after Associated Estates was unable find a new owner. Therefore, the Office of Inspector General’s statement of incongruity is gratuitous.

OIG Evaluation Of  
Auditee Comments

The Settlement Agreement was HUD’s attempt to settle the management problems with the Projects. However, HUD did not take possession of Rainbow Terrace and Park Village Apartments as permitted by the Settlement Agreement until eight months after the Agreement was signed. HUD’s Director of Asset Management said HUD executed the Settlement Agreement to remove Associated Estates from the Projects and to protect the Projects’ tenants. Associated Estates was allowed to continue managing the

Projects for over eight months after the Settlement Agreement was executed. During this time, the Projects' tenants continued to be subjected to conditions that were not decent, safe, and sanitary. Therefore, HUD contradicted one of its stated reasons for negotiating the Settlement Agreement and failed to protect the Projects' tenants from unhealthy and unsafe living conditions.

Contrary to the Assistant Secretary for Housing-Federal Housing Commissioner's comments, the audit memorandum does not report that HUD's Director of Asset Management cited cost as the only reason for negotiating the Settlement Agreement. In fact, this memorandum reports additional reasons that HUD executed the Agreement. HUD's former Deputy Assistant Secretary for Multifamily Housing said City of Cleveland officials were strongly opposed to HUD terminating the Section 8 assistance to the Projects and relocating the tenants. Also, HUD claimed it wanted to remove Associated Estates from Rainbow Terrace, Longwood, and Park Village Apartments in order to protect the residents. However, as previously mentioned, Associated Estates was allowed to continue managing the Projects for over eight months after the Settlement Agreement was executed.

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#### ASSOCIATED ESTATES REALTY CORPORATION

Associated Estates Realty Corporation is located at 5025 Swetland Court, Richmond Heights, Ohio. It is a self-administered and self-managed equity real estate investment trust. The company was formed in July 1993 to continue the business of Associated Estates Group that was established to acquire, develop, and operate multifamily housing units. Associated Estates Realty Corporation became a publicly traded company through an initial public offering of its common shares in November 1993 and is currently traded on the New York Stock Exchange.

Associated Estates is a fully integrated multifamily investment company engaged in property acquisition, advisory and development, management, disposition, operation, and ownership activities. It owns substantially all of the economic interest in four corporations that provide management and other services for the company and third parties. Associated Estates currently owns and/or operates 146 housing projects in 13 States. Of the 146 projects, 44 are affiliated with HUD and the remaining 102 are non-HUD market rate projects.

Excluding the four Projects included in the Settlement Agreement, HUD's Director of the Cleveland Multifamily Program Center said the remaining HUD projects owned or managed by Associated Estates were in good physical condition. However, HUD's Director of the Cleveland Multifamily Program Center does not consider Associated Estates to be a good

owner/management agent because HUD management reviews performed between May 1997 and May 2000 showed Associated Estates misused project funds to pay non-project expenses from the four Projects included in the Settlement Agreement plus three other projects.

PROJECTS IN THE SETTLEMENT AGREEMENT

The Settlement Agreement between HUD and Associated Estates included Rainbow Terrace Apartments, Longwood Apartments, Park Village Apartments, and Vanguard Apartments. Associated Estates managed the four Projects and had an ownership interest in Rainbow Terrace, Longwood, and Park Village.

Rainbow Terrace  
Apartments

Rainbow Terrace Apartments was insured in 1983 under Section 221(d)(4) of the National Housing Act. The Project was owned by Rainbow Terrace Incorporated, for which Associated Estates was the only shareholder. Associated Estates assumed ownership of the Project in 1993 through a transfer of physical assets. However, final approval was not granted by HUD because Associated Estates failed to maintain the Project in good repair and condition.

Rainbow Terrace Apartments consists of 484 garden style units. All of the units were subsidized with Section 8 housing assistance. At December 31, 1998, the Project had surplus cash of \$261,201 and a vacancy rate of 3.8 percent. The Project generated large amounts of surplus cash because Associated Estates prepaid 78.4 percent or \$7,039,303 of the mortgage with the transfer of physical assets in 1993.

The physical condition of Rainbow Terrace Apartments was unsatisfactory. In September 1996, the City of Cleveland cited 4,507 housing code violations. On April 17, 1998, all of the violations remained outstanding. A City of Cleveland Housing Court Judge found Associated Estates guilty of failing to maintain the Project according to the City's Housing Code. The Judge required Associated Estates to pay a \$25,000 fine to the City and \$20,000 to two tenant advocacy groups. Inspections by a HUD contractor in 1997 showed the Project was unsatisfactory with all units failing to meet HUD's Housing Quality Standards.

Longwood Apartments

Longwood Apartments was purchased in 1987 for cash through a HUD foreclosure sale. The Project was owned by Longwood Apartments Limited Partnership; Associated

Estates was the Partnership's General Partner. The foreclosure sales contract stipulated that Longwood Apartments Limited Partnership was to rehabilitate the Project's units according to State and local laws, codes, ordinances and regulations; demolish eight units; provide relocation if necessary during rehabilitation; and submit to HUD a proposed management plan and management agreement. HUD's Director of the Cleveland Multifamily Program Center said the Project's owner complied with the terms of the sales contract.

Longwood Apartments was insured through the Coinsurance Program in 1987 after the purchase by Longwood Apartments Limited Partnership. When the co-insured loan was closed, the Project's owner received approximately \$2.5 million in excess loan proceeds as an equity take out. The Project became fully insured by HUD in 1991 under Section 221(d)(4) of the National Housing Act by virtue of default by the co-insured lender.

Longwood Apartments consists of 820 garden style units. All of the units received Section 8 housing assistance. At December 31, 1998, the Project had a \$460,531 non-surplus cash position and an 8.1 percent vacancy rate.

The physical condition of Longwood Apartments was unsatisfactory. In July 1996, the City of Cleveland cited 4,392 housing code violations. On April 17, 1998, all of the violations remained outstanding. Inspection reports issued by a HUD contractor in 1997 showed the Project was unsatisfactory with all units failing to meet HUD's Housing Quality Standards.

#### Park Village Apartments

Park Village Apartments was insured in 1991 under Section 223(f) of the National Housing Act. The Project was owned by Park Village Apartments Limited Partnership; Associated Estates was the Partnership's General Partner. The Project was previously insured by HUD and was acquired by Park Village Apartments Limited Partnership through a HUD foreclosure sale in 1985. The Project was insured through the Coinsurance Program in 1987 and was converted to full insurance in 1991 by virtue of default by the co-insured lender. With the co-insured loan in 1987, the Project's owner received excess loan proceeds of approximately \$1 million as an equity take out.



Park Village Apartments consists of 94 garden style units. All but two units were subsidized with Section 8 housing assistance. At December 31, 1998, the Project had a \$788,121 non-surplus cash position and a 5.66 percent vacancy rate.

The physical condition of Park Village Apartments was unsatisfactory. In November 1997, the City of Cleveland cited 443 housing code violations. On April 17, 1998, all the violations remained outstanding. A June 20, 1997 inspection report issued by a HUD contractor showed the Project was unsatisfactory with all units failing to meet HUD's Housing Quality Standards.

#### Vanguard Apartments

Vanguard Apartments was insured in 1975 under Section 236 of the National Housing Act. The Project was owned by Vanguard Phase I Company which assumed ownership in 1977. The Black Economic Union of Ohio was the Project's General Partner and Associated Estates was the management agent. The Project consisted of 313 units ranging from efficiencies to six bedroom units. Of the 313 units, all but six units were subsidized with Section 8 housing assistance.

Vanguard Apartments' financial condition was weak because it had a \$718,392 non-surplus cash balance at December 31, 1996. The Project had a five percent vacancy rate in June 1997.

The physical condition of Vanguard Apartments was unsatisfactory. The City of Cleveland cited 2,952 housing code violations during its April 24, 1997 inspection. A June 20, 1997 inspection report issued by a HUD contractor showed the Project was unsatisfactory with all units failing to meet HUD's Housing Quality Standards. HUD abated the Section 8 housing assistance and terminated the Housing Assistance Payment Contract set to expire on September 30, 1997. After the abatement, the Project could not continue to meet its expenses and HUD foreclosed on the Project. American Management Incorporated, HUD's contracted management agent, assumed possession of the Project on December 1, 1997. The tenants were relocated from the Project in 1998.

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Auditee Comments

Excerpts paraphrased from HUD's comments on our draft audit memorandum follow. Appendix A, pages 52 to 60, contains the complete text of the comments.

The sections of the audit memorandum entitled Associated Estates Realty Corporation and Projects In The Settlement Agreement appear to be factual.

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EVENTS LEADING UP TO THE SETTLEMENT AGREEMENT

Associated Estates Realty Corporation was originally Associated Estates Group. When Associated Estates Group decided to form Associate Estates Realty Corporation, it requested HUD's approval for a transfer of physical assets to the new company. Before granting approval of the transfer, HUD's Cleveland Multifamily Program Center inspected Rainbow Terrace Apartments.

HUD's And Associated Estates' Repair Estimates For Rainbow Terrace Apartments Differed

An October 1993 inspection of Rainbow Terrace Apartments by HUD's Cleveland Office of Multifamily Housing (now the Cleveland Multifamily Program Center) showed \$705,242 in needed repairs. However, the Cleveland Multifamily Program Center did not take any action concerning the inspection until almost two years later. A Senior Project Manager for the Program Center said it was an oversight that action regarding the Rainbow Terrace inspection was not taken in a timely manner.

In 1995, HUD's Cleveland Multifamily Program Center informed Associated Estates that final approval of the transfer of physical assets would not be granted until Associated Estates submitted a Management Improvement Operating Plan to address the repair needs cited in the October 1993 inspection report. Associated Estates replied in a letter dated August 17, 1995 that the physical inspection report showing over \$700,000 in needed repairs was wrong and that only \$231,194 of repairs were needed. Again, because of the Cleveland Multifamily Program Center's apparent oversight, HUD did not take any additional action until 1996 other than to deny granting final approval of Rainbow Terrace Apartments' transfer of physical assets.

On December 28, 1995, Associated Estates submitted a rent increase request for Rainbow Terrace Apartments to HUD's

Cleveland Multifamily Program Center. The request cited \$1,934,000 of repairs needed to the Project over a three-year period. On April 5, 1996, the Cleveland Multifamily Program Center responded to the request by asking Associated Estates to explain how the Project deteriorated so quickly that repairs went from only \$231,194 in August 1995 to over \$1.9 million in December 1995. HUD's Cleveland Multifamily Program Center advised Associated Estates that its rent increase request would be held in abeyance until a HUD contractor completed a physical inspection of the Project.

Because of delays in scheduling a contractor to inspect Rainbow Terrace Apartments, HUD's Cleveland Multifamily Program Center did not receive a report on the Project's physical condition until August 1996. HUD's contractor determined the Project was in poor physical condition and required repairs in excess of \$614,000. The contractor's report showed that Associated Estates did not correct all of the items cited in the Cleveland Multifamily Program Center's October 1993 physical inspection. The contractor's estimated repairs contradicted the amount of repairs that Associated Estates claimed was needed. Associated Estates and HUD's Cleveland Multifamily Program Center never reconciled their differences about the amount of repairs needed to Rainbow Terrace Apartments. Instead, the Cleveland Multifamily Program Center assigned the Project to HUD's Special Workout Assistance Team in February 1997.

Associated Estates Did Not Maintain The Projects In A Decent, Safe, And Sanitary Manner

In August 1996, the City of Cleveland cited Associated Estates for 4,507 housing code violations at Rainbow Terrace Apartments. The City also inspected Longwood Apartments in July 1996 and cited Associated Estates for 4,392 housing code violations. Based on the contractor's August 1996 inspection of Rainbow Terrace and the City's inspections of Rainbow Terrace and Longwood, HUD's Cleveland Multifamily Program Center concluded that Associated Estates failed to maintain Rainbow Terrace and Longwood Apartments in a decent, safe, and sanitary manner.

HUD's Cleveland Multifamily Program Center was also concerned about the physical condition of Park Village and Vanguard Apartments since Associated Estates managed

these two Projects. The Cleveland Multifamily Program Center referred the four Projects to HUD's Special Workout Assistance Team in February 1997.

HUD's Workout Assistance Team was established to work with owners of troubled projects in order to remove them from HUD's troubled list within 90 days. The Special Workout Assistance Team contracted for inspections of the four Projects in April and May 1997. The contractor's inspections showed that none of the units at Rainbow Terrace, Longwood, Park Village, and Vanguard Apartments met HUD's Housing Quality Standards.

The HUD contractor's inspection reports for Rainbow Terrace, Longwood, and Park Village Apartments showed the units failed HUD's Housing Quality Standards because of life-threatening health and safety violations. The following table shows the number of units inspected and the number of life-threatening health and safety violations for Rainbow Terrace, Longwood, and Park Village Apartments. The Cleveland Multifamily Program Center's files did not show the number of life-threatening health and safety violations for Vanguard Apartments. The Center's files only contained a summary of the contractor's inspection of Vanguard Apartments that showed none of the units met HUD's Standards.

<i>Project</i>	<i>Units Inspected</i>	<i>Health And Safety Violations</i>
<b>Rainbow Terrace</b>	484	3,068
<b>Longwood</b>	820	3,993
<b>Park Village</b>	94	532

In May 1997, HUD's contractor re-inspected Rainbow Terrace, Longwood, Park Village, and Vanguard Apartments. The re-inspections were to determine whether Associated Estates corrected the previously cited Housing Quality Standards violations. The re-inspection reports showed Associated Estates did not correct the previously cited violations and none of the units at Rainbow Terrace, Longwood, and Vanguard Apartments met HUD's Standards for decent, safe, and sanitary housing. The HUD contractor also determined that 84 of the 94 units at Park Village Apartments were still not decent, safe, and sanitary. As a result of the contractor's inspections, HUD's

Cleveland Multifamily Program Center issued notices of violation of the Housing Assistance Payment Contracts and Regulatory Agreements to the Projects' owners in June 1997.

During the time of the HUD contractor's inspections, the City of Cleveland also inspected Park Village and Vanguard Apartments. The City of Cleveland visited Park Village Apartments in November 1997 and Vanguard Apartments in April 1997. The City cited 443 and 2,952 housing code violations, respectively.

In July and August 1997, HUD's contractor again performed follow-up inspections of Rainbow Terrace, Longwood, Park Village, and Vanguard Apartments. The inspections were to determine whether the Projects met HUD's Housing Quality Standards. The contractor determined that none of the units at Rainbow Terrace, Longwood, and Vanguard Apartments, and only six units at Park Village Apartments complied with HUD's Standards.

Based on these follow-up inspections, HUD abated the Section 8 housing assistance for Vanguard Apartments in September 1997. HUD delayed abating the housing assistance for Rainbow Terrace, Longwood, and Park Village Apartments to allow Associated Estates time to make the needed repairs; however, Associated Estates failed to do this. In February 1998, HUD issued declarations of default under the Regulatory Agreements and Housing Assistance Payment Contracts for Rainbow Terrace, Longwood, and Park Village Apartments. The declarations advised Associated Estates that HUD intended to take action to abate the Section 8 housing assistance and obtain possession of the three Projects if Associated Estates did not take action to make the needed repairs.

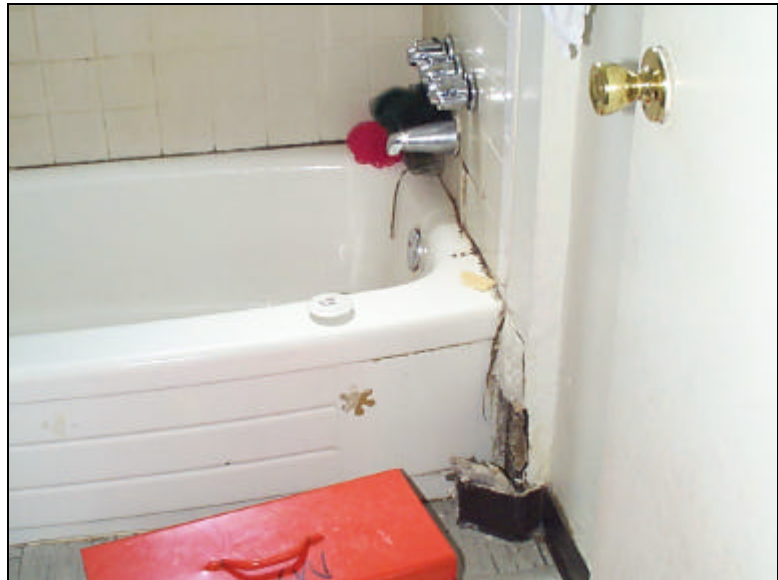
In response to HUD's declarations of default, Associated Estates submitted proposals in February 1998 to restructure Rainbow Terrace and Longwood Apartments' mortgages. Associated Estates requested HUD to provide funds to make the needed repairs and extend the mortgages with the additional funds due at the end of the loans as balloon payments. Associated Estates did not submit a proposal for Park Village Apartments. HUD denied Associated Estates' proposals in March 1998.

HUD's Director of the Cleveland Multifamily Program Center and a Departmental Enforcement Center Team Leader (formerly a Special Workout Assistance Team member) performed site visits of Rainbow Terrace, Longwood, and Park Village Apartments in May 1998. The visits were to determine the physical condition of the Projects. HUD's staff determined that all three Projects were still not decent, safe, and sanitary. The following pictures show examples of the conditions cited by HUD.

The apartment at 6924 Carson Avenue for Rainbow Terrace had damaged drywall, the bathtub needed to be re-glazed, and the tub's faucet was leaking.



The apartment at 2521 East 33<sup>rd</sup> Street for Longwood had damaged drywall and the bathtub caulking needed to be replaced.



The apartment at 9110 Hough Avenue for Park Village had missing ceramic tile and drywall. The resident taped plastic over the hole to avoid further damage.



Associated Estates  
Inappropriately Used  
Project Funds To Pay  
Non-Project Expenses

In addition to trying to deal with the physical conditions of the Projects, HUD's Cleveland Multifamily Program Center and the Special Workout Assistance Team conducted management reviews of the Projects in May 1997. The reviews included four months of 1997 expenditures from Rainbow Terrace, Longwood, Park Village, and Vanguard Apartments. The reviews determined that the Projects' owners and/or management agent misused \$101,778 for expenses that were not reasonable and necessary.

HUD's Cleveland Multifamily Program Center and the Special Workout Assistance Team also determined that the owner of Rainbow Terrace Apartments received \$1,941,913 in distributions between January 1994 and December 1996 in violation of the Regulatory Agreement. The owner distributions were made after HUD inspected Rainbow Terrace Apartments in October 1993 and determined that the Project needed over \$700,000 in repairs.

HUD Presented The Civil  
False Claims And Equity  
Skimming Case To OIG  
And The Department Of  
Justice

HUD's Director of the Cleveland Multifamily Program Center and a Departmental Enforcement Center Team Leader (formerly a Special Workout Assistance Team member) presented the results of the contractor's and the City's physical inspections to the Office of Inspector General and the United States Attorney's Office for the Northern District of Ohio on June 2, 1998. The inspection results showed Associated Estates received Section 8 housing assistance for units that were not decent, safe, and sanitary. The Director of the Cleveland Multifamily

Program Center and the Departmental Enforcement Center Team Leader also presented the results of the HUD management reviews that showed Associated Estates misused project funds to pay non-project expenses. The presentation occurred before the start of negotiations for the settlement with Associated Estates.

HUD's Director of the Cleveland Multifamily Program Center and a Departmental Enforcement Center Team Leader requested the United States Attorney's Office to pursue a civil false claims and equity skimming case against the Projects' owners and Associated Estates. The United States Attorney's Office was enthusiastic and accepted the civil case from HUD. Based upon Federal laws, the civil false claims and equity skimming case potentially exceeded \$71 million in recoveries for HUD.

HUD Abates The Housing Assistance And Associated Estates Files Suit

Based upon the HUD contractor's and the City's physical inspections of Rainbow Terrace, Longwood, and Park Village Apartments, HUD's Director of the Columbus Multifamily Hub issued letters on June 20, 1998 to abate the Section 8 housing assistance for the three Projects (the assistance for Vanguard Apartments was previously abated in September 1997). HUD's Director of Asset Management (formerly Director of Portfolio Management) also issued letters in June 1998 to accelerate the mortgages for the Projects.

Associated Estates filed a lawsuit against HUD in May 1998 for holding the 1995 rent increase request for Rainbow Terrace Apartments in abeyance. An amended lawsuit was filed in June 1998. The amended lawsuit was not only for the failure to process the rent increase, but was also a claim against HUD for arbitrary and capricious action regarding the declaration of default and abatement of Rainbow Terrace's Housing Assistance Payment Contract.

HUD Reviewed The Lawsuit Filed By Associated Estates

In July 1998, HUD's former Deputy Assistant Secretary for Multifamily Housing and the Chief Counsel for the Departmental Enforcement Center reviewed the rent increase lawsuit. They concluded that HUD was probably liable for failing to process Associated Estates' rent increase request for Rainbow Terrace Apartments. Additionally, an Assistant United States Attorney for the United States Attorney's Office for the District of Columbia assigned to



defend HUD in the lawsuit informed HUD that it was probably liable for failing to process the rent increase.

HUD's former Deputy Assistant Secretary for Multifamily Housing and the Chief Counsel for the Departmental Enforcement Center said HUD may have also been liable for abating the Section 8 housing assistance to the Projects. They believed HUD's actions against Associated Estates were weak because 1996 mortgagee inspection reports for Rainbow Terrace, Longwood, and Park Village, and a 1997 mortgagee inspection report for Vanguard Apartments showed the Projects were in satisfactory condition when the physical problems appeared to have existed for several years.

HUD's former Deputy Assistant Secretary for Multifamily Housing and the Chief Counsel for the Departmental Enforcement Center said it would be hard to defend an argument that HUD was not aware of the physical problems at the Projects prior to the HUD contractor's 1997 inspections. Based upon the concerns of the former Deputy Assistant Secretary for Multifamily Housing and the Chief Counsel for the Departmental Enforcement Center, the June 1998 letters to abate the Section 8 housing assistance and accelerate the mortgages were rescinded in July 1998. Therefore, HUD continued to pay Section 8 housing assistance to Associated Estates even though HUD was aware that the Projects' tenants lived in units that were not decent, safe, and sanitary.

HUD Started Negotiating  
A Settlement With  
Associated Estates

HUD's Director and Deputy Director of Asset Management (formerly the Office of Portfolio Management), the former Deputy Assistant Secretary for Multifamily Housing, and a Senior Attorney for the Departmental Enforcement Center entered into negotiations with Associated Estates to settle the rent increase lawsuit in July 1998. HUD's former General Deputy Assistant Secretary for Housing joined the settlement negotiations in November 1998. The primary objectives of the negotiations were to settle the lawsuit and remove Associated Estates from the Projects to protect the tenants from unhealthy and unsafe living conditions. The negotiations continued for over eight months until the Settlement Agreement was signed in March 1999.

Additional Reasons For  
Negotiating The  
Settlement Agreement

In addition to the concerns by HUD’s Headquarters Office of Multifamily Housing and the Departmental Enforcement Center that HUD may lose the rent increase lawsuit filed by Associated Estates and that HUD may also be liable for abating the Projects’ Section 8 housing assistance, the former Deputy Assistant Secretary for Multifamily Housing said the City of Cleveland was a factor behind the Settlement Agreement. He said the City’s Mayor and City Council members were strongly opposed to HUD terminating the Section 8 housing assistance to Rainbow Terrace, Longwood, and Park Village Apartments. The City’s former Director of Community Development said City officials were also opposed to relocating the tenants from the Projects.

In addition, HUD’s Director of Asset Management claimed that there was not sufficient housing in Cleveland to relocate the tenants of Rainbow Terrace, Longwood, and Park Village Apartments. However, HUD’s Director and Deputy Director of Asset Management, the former General Deputy Assistant Secretary for Housing, the former Deputy Assistant Secretary for Multifamily Housing, and the Departmental Enforcement Center’s Senior Attorney who negotiated the Settlement Agreement did not have evidence to support this claim. Instead, they relied upon statements made by the City of Cleveland.

The City’s former Director of Community Development said the City did not have any current studies regarding the lack of affordable housing. The only information the City provided was based on 1990 census data that did not report the lack of affordable housing units. An Economist at HUD’s Ohio State Office said HUD had not performed any recent studies of available housing in Cleveland. Consequently, HUD lacked documentation on the availability of affordable housing in Cleveland.

HUD’s Staff Negotiating  
The Settlement Agreement  
Were Not Aware That A  
Civil Case Was Accepted

HUD’s staff who negotiated the Settlement Agreement (the former General Deputy Assistant Secretary for Housing, the Director and Deputy Director of Asset Management, the former Deputy Assistant Secretary for Multifamily Housing, and a Senior Attorney for the Departmental Enforcement Center) said they did not know a civil case was accepted by the United States Attorney’s Office for the Northern District of Ohio. We found no written evidence to support

they were aware of the civil false claims and equity skimming case. They did not inquire if any legal action was underway against Associated Estates.

Given the eight months negotiation time frame, there was sufficient time for HUD's former General Deputy Assistant Secretary for Housing, the Director and Deputy Director of Asset Management, the former Deputy Assistant Secretary for Multifamily Housing, and the Departmental Enforcement Center's Senior Attorney to determine what actions were pending against Associated Estates.

The former General Deputy Assistant Secretary for Housing, the Director and Deputy Director of Asset Management, the former Deputy Assistant Secretary for Multifamily Housing, and a Senior Attorney for the Departmental Enforcement Center said they would not have known to ask about any legal action against Associated Estates since they were not aware that the United States Attorney's Office accepted the civil false claims and equity skimming case. They said they would have expected any HUD staff aware of the civil case to inform them. The former General Deputy Assistant Secretary for Housing also said he relied on the Departmental Enforcement Center's attorneys to determine what legal action was outstanding against Associated Estates before the Settlement Agreement was executed.

HUD's former Director of the Departmental Enforcement Center was aware that a civil case was accepted. He said he only told the former Deputy Assistant Secretary for Multifamily Housing of the case. However, HUD's former Deputy Assistant Secretary for Multifamily Housing denied that he knew the civil false claims and equity skimming case was accepted. The former Director of the Departmental Enforcement Center said the former General Deputy Assistant Secretary for Housing was not interested in discussing any actions against Associated Estates, other than the Settlement Agreement.

HUD's Directors of the Columbus Multifamily Hub and the Cleveland Multifamily Program Center said they thought the former General Deputy Assistant Secretary for Housing (now Director of Multifamily Housing Assistance Restructuring), the former Deputy Assistant Secretary for

Multifamily Housing, and the Director and Deputy Director of Asset Management were aware that a civil case was accepted by the United States Attorney's Office. They said they never informed the former General Deputy Assistant Secretary for Housing that a civil case was accepted. HUD's Director of the Cleveland Multifamily Program Center said the former General Deputy Assistant Secretary for Housing was not receptive to any discussions other than the Settlement Agreement and did not inquire whether any legal action was initiated against Associated Estates. HUD's current General Deputy Assistant Secretary for Housing said it was absolutely ridiculous that he was not receptive to discussing the actions against Associated Estates.

HUD's Director of the Cleveland Multifamily Program Center said there were two problems with communication within the Office of Multifamily Housing regarding the actions against Associated Estates. The first problem was in July 1998 when the letters to abate the Section 8 housing assistance and accelerate the mortgages were rescinded for Rainbow Terrace, Longwood, and Park Village Apartments. HUD's Director of the Cleveland Multifamily Program Center said he did not know whether the Office of Multifamily Housing or the Departmental Enforcement Center was handling the case against Associated Estates. He said he requested the Director of the Columbus Multifamily Hub to find out who was handling the case.

HUD's Director of the Cleveland Multifamily Program Center said when he was advised by the Director of the Columbus Multifamily Hub in August 1998 that the Office of Multifamily Housing was handling the case, staff from HUD's Office of Multifamily Housing and the Departmental Enforcement Center had already started negotiating a settlement with Associated Estates in July 1998. He said once the decision was made to negotiate a settlement, the only information he was able to provide was the information requested to finalize the Settlement Agreement.

HUD's Director of the Cleveland Multifamily Program Center said the second problem with communication was the former General Deputy Assistant Secretary for Housing never gave him the opportunity to discuss the acceptance of the civil false claims and equity skimming case. The former

General Deputy Assistant Secretary for Housing said he was never informed about the acceptance of the civil case. He said he was advised by HUD's Senior Attorney for the Departmental Enforcement Center, who drafted the Settlement Agreement, that HUD would lose the rent increase lawsuit and it was in HUD's best interest to settle. Therefore, the former General Deputy Assistant Secretary for Housing signed the Settlement Agreement.

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**Auditee Comments**

Excerpts paraphrased from HUD's comments on our draft audit memorandum follow. Appendix A, pages 52 to 60, contains the complete text of the comments.

The audit memorandum shows that HUD's Special Workout Assistance Team conducted management reviews in May 1997. The reviews disclosed that Associated Estates improperly received \$1.9 million in owner distributions from Rainbow Terrace Apartments between January 1994 and December 1996. While the Office of Housing agrees with the approach of the Special Workout Assistance Team, there are two problems with relying on the review in a court of law. First, HUD's Cleveland Multifamily Program Center did not promptly identify or pursue the improper distributions. Second, the basis that the distributions were improper depends entirely on establishing that the Project was not in satisfactory condition when distributions were made. The audit memorandum does not report all of the physical inspections, including the mortgagee inspections that undermine HUD's case regarding the improper owner distributions.

**OIG Evaluation Of  
Auditee Comments**

While HUD's Cleveland Multifamily Program Center may not have identified and pursued Associated Estates regarding the improper owner distributions, this does not negate the fact that Associated improperly received owner distributions between January 1994 and December 1996 in violation of the Regulatory Agreement. The owner distributions were made after HUD inspected Rainbow Terrace Apartments in October 1993 and determined that the Project needed over \$700,000 in repairs. In addition, a letter dated August 17, 1995 from Associated Estates reported that Rainbow Terrace Apartments was not in good condition and required over \$200,000 in needed repairs. Thus, there was documentation that established the Project

was not in good repair and Associated Estates was not permitted to receive any owner distributions as required by the Regulatory Agreement.

This memorandum reports that 1996 mortgagee inspection reports for Rainbow Terrace, Longwood, and Park Village Apartments, and a 1997 mortgagee inspection report for Vanguard Apartments showed the Projects were in satisfactory condition. However, physical inspections conducted in 1993, 1996, and 1997 by HUD and/or the City of Cleveland showed the Projects were in very poor condition and the physical problems appeared to have existed for several years. In addition, the United States Attorney's Office for the Northern District of Ohio believed that HUD's staff presented a strong equity skimming case and had accepted the case regardless of the mortgagee inspections.

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#### Auditee Comments

No referral was made to the United States Attorney's Office for the Northern District of Ohio to pursue a multifamily equity skimming and civil false claims case. Thus, there was nothing for that Office to accept. HUD's Director of the Cleveland Multifamily Program Center and the former Departmental Enforcement Center Team Leader were not authorized to make a referral to the United States Attorney's Office. Neither person attempted to assert that authority. That authority was delegated to the General Counsel or her designee. While there were discussions between HUD's staff and the United States Attorney's Office concerning Associated Estates, no formal referral was made for the Office to take civil action.

As late as September 1998, the Assistant United States Attorney for the Northern District of Ohio involved in this matter acknowledged this point in a letter to the Director of the Cleveland Multifamily Program Center by inquiring if HUD still wanted his Office to review the matter against Associated Estates for potential civil prosecution. An authorized, affirmative answer to the Assistant United States Attorney was required from the General Counsel or her designee to initiate litigation on HUD's behalf. However, no request was made.

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**OIG Evaluation Of  
Auditee Comments**

The assertion that there was no referral to the United States Attorney's Office for the Northern District of Ohio to pursue a multifamily equity skimming and civil false claims case is further evidence of the deplorable communication within HUD. Although we agree that we found no written referral to the United States Attorney's Office, several of HUD's staff attended meetings with the Assistant United States Attorney for the Northern District of Ohio and requested him to pursue a civil case against Associated Estates. The staff included the Director of the Cleveland Multifamily Program Center, the Director of the Columbus Multifamily Hub, a former Departmental Enforcement Center Team leader, and the Legal Counsel for the Cleveland Area Office. These individuals acknowledged to us that they requested the United States Attorney's Office to take action against Associated Estates. As a result of the meetings, the United States Attorney's Office opened a case (Case # USAO97-01948) and assigned two attorneys to it-- one to handle defense matters related to a potential suit by Associated Estates and one to handle the affirmative civil litigation. The United States Attorney's Office assigns a case number to matters that they accept for legal action.

The September 1998 letter from the Assistant United States Attorney for the Northern District of Ohio, who accepted the equity skimming and civil false claims case presented by HUD, is not evidence that the Assistant United States Attorney had not accepted the case. To the contrary, it is evidence of the Assistant United States Attorney's interest in pursuing the case in a timely manner. HUD did not have the courtesy of sending a reply.

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**Auditee Comments**

The audit memorandum omits two factors. First, the Projects' residents were opposed to HUD terminating the Section 8 housing assistance. Second, a competent housing authority with the capacity to administer the issuance of 1,800 Section 8 vouchers and counsel the residents was problematic. The memorandum implies that more analysis was needed regarding the availability of affordable housing in Cleveland. It is true that the City of Cleveland did not conduct a separate study to support the lack of affordable housing. Cleveland housing officials have many sources of general information on vacancy rates and voucher success rates that do not depend on specific studies. It is difficult to

OIG Evaluation Of  
Auditee Comments

believe that the Office of Inspector General is arguing that HUD should have concluded that sufficient housing existed to relocate nearly 1,800 low-income families in addition to the 313 families relocated from Vanguard Apartments in 1998.

We agree that HUD's staff indicated that the Project's residents were opposed to the termination of the Section 8 assistance. HUD's staff also informed us that they did not believe the Cuyahoga Metropolitan Housing Authority had the capacity to administer the issuance of 1,800 Section 8 vouchers and counsel the residents. However, this does not alter the fact that the Projects were not decent, safe and sanitary. In addition, HUD's point of view is selective because the residents of Vanguard Apartments were relocated even though they opposed relocation. In regards to HUD's claim that the Cuyahoga Metropolitan Housing lacked the capacity to administer the additional vouchers, this point is not fully supported. In 1999, the Housing Authority issued 2,213 Section 8 vouchers and 1,776 were used for affordable housing within 120 days of issuance.

HUD did not provide evidence to support its claim that there was not available housing to relocate the tenants of Rainbow Terrace, Longwood, and Park Village Apartments. An Economist at HUD's Ohio State Office said HUD had not performed any recent studies of available housing in Cleveland.

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Auditee Comments

Based on the erroneous reporting of HUD's referral and the acceptance by the United States Attorney's Office for the Northern District of Ohio, the audit memorandum then suggests that HUD's staff negotiating the settlement should have known that a civil case against Associated Estates was accepted by the United States Attorney's Office. Since no case was referred; therefore, no case was accepted by the United States Attorney's Office. The Office of Inspector General is suggesting that HUD staff should know something that did not and does not exist.

The Inspector General's Office also asserts that HUD's staff who negotiated the Settlement Agreement should have inquired if legal action was underway against Associated Estates. The system of controls over referrals for litigation



allows counsel to be cognizant of referrals and pending litigation, so no inquiry was warranted regarding the litigation. What the Office of Inspector General does not report is that HUD's staff did inquire if the Inspector General's Office knew of any reason HUD should not execute a settlement with Associated Estates. An electronic message from the Inspector General's Office was provided to the audit staff during the review. The response was that there were no impediments to the settlement. Given that the Inspector General's Office staff was present at discussions with the United States Attorney's Office, the inquiry and written response is material and its omission is symptomatic of the problems with the draft audit memorandum.

After discussing who did not know about or were not told about the referral to the United States Attorney's Office which did not happen, the draft audit memorandum tries to make the case that there was a significant pattern of miscommunication because the Cleveland Multifamily Program Center had to inquire who was handling the Associated Estates matter. In fact, the Departmental Enforcement Center and the Office of Housing both worked on the case. The Cleveland Multifamily Program Center was in frequent communication with the Headquarters Office of Housing. The second point made by the Office of Inspector to buttress this issue is that the Cleveland Multifamily Program Center allegedly was not given an opportunity to discuss the non-existent acceptance of a civil false claims and equity skimming case.

#### OIG Evaluation Of Auditee Comments

As previously mentioned, the assertion that there was no referral to the United States Attorney's Office for the Northern District of Ohio to pursue a multifamily equity skimming and civil false claims case is incorrect and is evidence of the poor communication between the various HUD Offices. In addition, HUD's staff who negotiated the Settlement Agreement (the former General Deputy Assistant Secretary for Housing, the Director and Deputy Director of Asset Management, the former Deputy Assistant Secretary for Multifamily Housing, and a Senior Attorney for the Departmental Enforcement Center) said they did not know a civil case was accepted by the United States Attorney's Office for the Northern District of Ohio. We found no written evidence to support they were aware of the civil false claims and equity skimming case. However,

they said they did not inquire if any legal action was underway against Associated Estates.

Given the length of time the negotiations occurred, there was sufficient time for HUD's former General Deputy Assistant Secretary for Housing, the Director and Deputy Director of Asset Management, the former Deputy Assistant Secretary for Multifamily Housing, and the Departmental Enforcement Center's Senior Attorney to determine what actions were pending against Associated Estates.

We agree that HUD made an inquiry with the Office of Inspector General. The inquiry was in the form of an electronic message and simply stated "anything from your folks in Cleveland on" Associated Estates or its President. The inquiry was made to a Senior Auditor on November 4, 1998 by HUD's Director of Asset Management (formerly the Director of Portfolio Management). The inquiry did not mention a possible Settlement Agreement with Associated Estates even though negotiations started approximately four months prior to the inquiry. Since the Office of Inspector General did not have any on-going audit work, the Senior Auditor informed the Director that "we have nothing going on" regarding Associated Estates' President or the Projects. At no time did anyone at HUD provide the Office of Inspector General a copy of the proposed Settlement Agreement for comment.

HUD's Director of the Cleveland Multifamily Program Center said there were two problems with communication within the Office of Multifamily Housing regarding the actions against Associated Estates. The first problem was that he did not know whether the Office of Multifamily Housing or the Departmental Enforcement Center was handling the case against Associated Estates. The second problem with communication was the former General Deputy Assistant Secretary for Housing never gave him the opportunity to discuss the acceptance of the civil false claims and equity skimming case. The Director of the Cleveland Multifamily Program Center's statement is also supported by HUD's former Director of the Departmental Enforcement Center that the former General Deputy Assistant Secretary for Housing was not interested in discussing any actions against Associated Estates, other than the Settlement Agreement.

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### THE SETTLEMENT AGREEMENT

HUD agreed to pay Associated Estates a total of \$1,784,457 (\$1,679,457 for Rainbow Terrace's 1995 rent increase and \$105,000 for its 1994 rent increase). The payment was to settle the lawsuit filed by Associated Estates. The payment for the rent increases was subject to Associated Estates' compliance with the other terms in the Settlement Agreement. The \$1.78 million was paid directly to Associated Estates in November 1999, not the Project. If HUD would have made the payment to Rainbow Terrace Apartments, Associated Estates would have been prohibited from withdrawing the funds since the Project was in very poor physical condition. A Senior Attorney for HUD's Departmental Enforcement Center said Associated Estates would only agree to the Settlement Agreement if the rent payment was made directly to Associated.

The Settlement Agreement was executed on March 12, 1999. The Agreement required Associated Estates to facilitate the transfer of Rainbow Terrace and Park Village Apartments to a purchaser acceptable to HUD or to transfer the two Projects to HUD by deeds-in-lieu of foreclosure. This was to be done by April 11, 1999 or within an extension of time agreed to by HUD. An extension of time would be based upon HUD's determination that Associated Estates was proceeding in good faith.

The Agreement required any prospective purchaser(s) of Rainbow Terrace and Park Village Apartments to demonstrate the financial ability to implement a redevelopment plan and make the needed repairs identified by HUD and the City of Cleveland. The purchaser(s) were to submit a transfer of physical assets application to HUD by April 11, 1999 or within a time period permitted by HUD. In the application, the purchaser was to indicate its willingness to assume possession of the Project(s), make the needed repairs, and start developing a redevelopment plan with the assistance of the City.

At the time of transfer, the owners of Rainbow Terrace and Park Village Apartments were to provide a certification that neither they nor their principals or affiliates would receive any benefit from the sale of the Projects, other than releases of liability and any reserved rights. They were not to have any relationship with the purchasing entity, its principals, partners, or shareholders. They were not to participate in the provision of goods or services for the Projects after the transfer.

In the event that the owners of Rainbow Terrace and Park Village Apartments failed to identify an acceptable purchaser or that HUD did not approve the transfer of physical assets application, the owners agreed to provide HUD with deeds-in-lieu of foreclosure within 30 days of HUD's request or within such additional time period approved by HUD. The deeds-in-lieu were to contain for each Project: mortgagee's title insurance policy; certification that there were no liens, encumbrances or restrictions other than the HUD mortgage, real estate taxes, and assessments; easements, restrictions, reservations and covenants of record; and other HUD-approved liens or encumbrances. Also, certified audited financial statements for the year ending December 31, 1998 were required for submission.

Associated Estates and the Longwood Apartments Limited Partnership were to provide HUD with a certification that they did not receive any monetary compensation from Longwood Apartments or any future owners. For withdrawing as General Partner, Associated Estates received a release of liability from HUD and the right to pursue insurance claims owed to it.

The owners, management agents, and affiliates of Rainbow Terrace and Park Village Apartments were not obligated to advance funds to the Projects. HUD agreed not to take any enforcement action or to deny them participation in HUD's programs. The owners agreed to bring Rainbow Terrace and Park Village Apartments' mortgages current upon execution of the Settlement Agreement. Prior to executing the Agreement, the owners of Park Village Apartments brought the mortgage current on March 4, 1999. Rainbow Terrace Apartments' mortgage was not delinquent when the Settlement Agreement was executed. Thus, Associated Estates was not required to pay any funds to bring Rainbow Terrace's mortgage current.

Associated Estates agreed to continue managing Rainbow Terrace and Park Village Apartments. However, Associated Estates was not required to manage the Projects after September 1999. During the period Associated Estates continued to manage the Projects, the owners agreed to: submit monthly accounting reports to HUD; supply HUD with a list of identity-of-interest contracts; seek HUD approval for all new contractual liabilities or expenditures of \$50,000 or more; and cooperate with all reasonable requests by HUD.

The Settlement Agreement stated that when Rainbow Terrace and Park Village Apartments were transferred to new owners and Associated Estates acted in good faith to comply with the terms of the Agreement, the owners of Rainbow Terrace, Longwood, Park Village, and Vanguard Apartments and Associated Estates would not be denied participation in HUD's programs. HUD agreed not to take administrative action against the Projects' owners and Associated Estates. The administrative action included: limited denials of participation; debarments; suspensions; program civil remedies; and civil money penalties.

The Settlement Agreement released the Projects' owners, Associated Estates, and their affiliates from any and all claims other than tax and criminal fraud. The claims included HUD's ability to pursue action under Section 1715z-4a of Title 12 of the United States Code (Double Damages Remedy for Unauthorized Use of Multifamily Housing Project Assets and Income), the Projects' Regulatory Agreement, Mortgage, Mortgage Note, and Housing Assistance Payments Contracts, or any other document relating to the ownership and operation of the Projects. After the transfer of Rainbow Terrace and Park Village Apartments, the owners were to release HUD from any and all claims they had against HUD relating to the management or ownership of the four Projects. This included the rent increase lawsuit filed by Associated Estates.

HUD Lacked  
Documentation To Justify  
The Rent Increase  
Amount Paid To  
Associated Estates

HUD lacked documentation to justify \$1.67 million of the \$1.78 million paid to Associated Estates under the Settlement Agreement. During the negotiations of the Agreement, HUD's Headquarters Office of Asset Management (formerly the Office of Portfolio Management) requested the Cleveland Multifamily Program Center in

August 1998 to process Associated Estates' 1995 rent increase request as if the request was processed at the time of receipt. Based upon the request, the Program Center determined in August 1998 that it would not approve the request given Rainbow Terrace Apartments' poor physical condition and the misuse of Project funds to pay non-Project expenses by Associated Estates.

HUD's Office of Asset Management did not accept the Cleveland Multifamily Program Center's decision and, in September 1998, requested it to process Associated Estates' request again based upon the physical needs of the Project.

HUD's Cleveland Multifamily Program Center performed another review of the rent increase request. The Program Center's review concentrated on the \$667,105 requested annually by Associated Estates to fund Rainbow Terrace's Reserve for Replacement account. Of the \$667,105 requested for the Replacement account, the Program Center determined that a number of repair items were funded in a previous rent increase request. The Program Center also determined that Associated Estates' request included several items that were long-term improvements and did not warrant the amount requested for the Reserve for Replacement account. As a result, the Program Center concluded it would only approve Associated Estates to receive \$130,158 for the 1995 rent increase request.

HUD's Headquarters Office of Asset Management again disagreed with the Cleveland Multifamily Program Center's analysis and requested it to perform still another review in October 1998. The Office of Asset Management requested the Program Center to prepare four scenarios based upon documentation submitted by Associated Estates.

The first scenario showed Associated Estates' initial request totaling \$1,718,764. The second scenario showed Associated Estates' claim that it was owed \$2,636,549 based upon costs it incurred. The Program Center's third scenario showed Associated Estates was entitled to only \$842,051 since the request included several items that were long-term improvements and did not warrant the \$667,105 requested annually for the Reserve for Replacement account. The Program Center's fourth scenario totaled

\$1,745,535; however, the Program Center's Director said this scenario included costs claimed by Associated Estates that were not sufficiently supported.

A Senior Project Manager for HUD's Cleveland Multifamily Program Center submitted the four scenarios to the Deputy Director of Asset Management in October 1998. The Senior Project Manager informed the Deputy Director that the Cleveland Multifamily Program Center could only justify a rent increase under the third scenario of \$842,051. He said Associated Estates would need to provide additional supporting documentation to support any higher amount.

HUD's Headquarters Office of Asset Management selected the last scenario of \$1,745,535 and requested Associated Estates to provide the supporting documentation. Associated Estates provided documentation in November 1998. HUD's Headquarters Office of Asset Management sent the documentation to the Cleveland Multifamily Program Center for review. The Program Center reviewed the documentation in December 1998 and advised the Office of Asset Management that the documentation was not sufficient to support a rent increase in excess of the \$842,051 as previously determined by the Program Center.

Nonetheless, HUD's Director of Asset Management approved most of the costs claimed by Associated Estates. The Director approved Associated Estates to receive \$1,679,457 in December 1998 for the 1995 rent increase request.

HUD's Director of Asset Management said the Cleveland Multifamily Program Center was being unreasonable by not allowing some of the repair costs claimed by Associated Estates. He said he thought the Program Center approved the documentation submitted by Associated Estates; however, he did not have anything to support this. HUD's Cleveland Multifamily Program Center did not approve the documentation submitted by Associated Estates. The Program Center also did not approve the requested rent increase because it included temporary labor costs and Associated Estates did not provide documentation to show that the cost of the repairs completed by identity-of-interest companies was reasonable.

The amount of the settlement may have been determined independently of the processing by the Cleveland Multifamily Program Center. An electronic message sent by the Departmental Enforcement Center's former Director of Operations to a former Enforcement Center Team Leader showed that HUD would settle with Associated Estates for an amount between \$1.5 and \$3 million. The message was sent in September 1998 prior to: (1) the four scenarios submitted by the Cleveland Multifamily Program Center in October 1998; (2) the documentation submitted by Associated Estates in November 1998; and (3) the Director of Portfolio Management's approval of the \$1,679,457 rent increase payment in December 1998. HUD's former Director of Operations for the Departmental Enforcement Center could not provide an explanation for her September 1998 electronic message.

Rainbow Terrace  
Apartments Did Not  
Benefit From The  
Settlement Payment

As required by the Settlement Agreement, HUD paid \$1.78 million to settle the rent increase lawsuit filed by Associated Estates. The settlement payment was paid directly to Associated Estates in November 1999, not to Rainbow Terrace Apartments. Thus, the Project and its tenants did not benefit from the payment.

Had HUD approved the requested rent increases in 1994 and 1995, the benefits of the rent increase would have accrued to the Project. The owners would have been able to receive a distribution only after the Project's operating expenses were paid and if the Project was in good condition. HUD's direct payment of the \$1.78 million to Associated Estates overrode these controls. The payment was, in effect, an authorized distribution even though the Project was not in good condition.

HUD Did Not Provide  
The Settlement Agreement  
To Justice For Approval

HUD did not provide the Settlement Agreement to the Department of Justice for approval as required by Federal laws (Section 516, Title 28 and Section 901 note, Title 5 of the United States Code) and HUD's Handbook (1530.01 REV-4 CHG-2).

Title 28, United States Code, Section 516, says the conduct of litigation in which the United States, an agency, or an officer is a party, or is interested, and securing evidence therefor, is reserved to officers of the Department of Justice.

Executive Order 6166, dated June 10, 1933, incorporated into Title 5, United States Code, Section 901 note, states defending claims and demands against the Federal Government, now exercised by any agency or officer, are transferred to the Department of Justice. As to any case referred to Justice for defense in the courts, the function of decision whether and in what manner to defend, or to compromise, or to appeal, or to abandon defense, now exercised by any agency or officer, is transferred to the Department of Justice.

HUD Handbook 1530.01 REV-4 CHG-2, Section 1-2b, paragraph 3, requires HUD to provide recommendations to the Department of Justice concerning: (a) initiation of litigation; (b) intervention in ongoing litigation; (c) defense of litigation; (d) proposals for settlement; and (e) appeals from adverse judgments. Paragraph 3 also requires HUD attorneys to coordinate closely with their counterparts at the Department of Justice.

The United States Attorney's Office for the District of Columbia represented HUD in the rent increase lawsuit brought by Associated Estates. Federal laws and HUD's Handbook required HUD to get the Department of Justice's approval since Justice represented HUD in the lawsuit. However, this was not done.

HUD's Chief Counsel for the Departmental Enforcement Center said it was an unfortunate oversight that the Department of Justice was not provided the Settlement Agreement prior to execution. Since HUD was Justice's client, he said Justice usually agrees with its client's requests and would have probably approved the Agreement. However, the Assistant United States Attorney assigned to defend HUD in the rent increase lawsuit and the Chief of the Civil Division for the United States Attorney's Office for the District of Columbia said HUD never requested their approval before executing the Settlement Agreement. They learned of the Agreement after it was signed and they definitely never approved it.



HUD Inappropriately  
Released Associated  
Estates From Any And All  
Claims

HUD released Associated Estates from any and all claims, except tax or criminal fraud contrary to the requirements of Titles 5 and 31 of the United States Code which prohibit Federal agencies from compromising the collection action on a claim that appears to be false.

Executive Order 6166, dated June 10, 1933, incorporated into Title 5, United States Code, Section 901 note, states the function of prosecuting in the courts of the United States for claims and demands by, and offenses against the Government, now exercised by any agency or officer, are transferred to the Department of Justice. As to any case referred to Justice for prosecution in the courts, the function of decision whether and in what manner to prosecute, or to compromise, or to appeal, or to abandon prosecution, now exercised by any agency or officer, is transferred to the Department of Justice.

Title 31, United States Code, Section 3711, requires the Secretary of HUD to attempt to collect a claim of money or property arising out of the Department's activities. The Secretary may not compromise, suspend, or end collection action on a claim that appears to be fraudulent, false, or misrepresented by a party with interest in the claim.

The United States Attorney's Office for the Northern District of Ohio accepted the civil false claims and equity skimming case in June 1998. But, the Settlement Agreement excluded HUD from pursuing action against Associated Estates under the Federal law regarding equity skimming. While the Settlement Agreement does not specifically address civil false claims, the Agreement released Associated Estates from any and all claims by HUD, except tax or criminal fraud. An Assistant United States Attorney for the United States Attorney's Office for the Northern District of Ohio said he accepted the civil false claims and equity skimming case because HUD's Cleveland Multifamily Program Center and the Departmental Enforcement Center presented a strong case. However, he said HUD's release of any and all claims against Associated Estates in the Agreement ended the case. HUD did not request the Assistant United States Attorney to approve the Settlement Agreement.

HUD's former Deputy Assistant Secretary for Multifamily Housing questioned whether HUD would have won the false claims case because 1996 mortgagee inspections showed Rainbow Terrace, Longwood, and Park Village Apartments were in satisfactory condition. HUD's Director of the Cleveland Multifamily Program Center said his Office did not take any action regarding the mortgagee inspections. He said his Office relied on their own inspections to determine the physical conditions of the Projects, not the mortgagee inspections.

A Senior Attorney for HUD's Departmental Enforcement Center said HUD lost two civil false claims cases in Mississippi because HUD never stopped paying the Section 8 housing assistance. She said since HUD continued to pay housing assistance to Associated Estates for units that were not decent, safe, and sanitary, she believed that HUD would have lost the false claims case against Associated Estates. However, HUD's former Deputy Assistant Secretary for Multifamily Housing and the Senior Attorney for the Departmental Enforcement Center were not aware that a civil false claims case was accepted by the United States Attorney's Office for the Northern District of Ohio prior to executing the Agreement. The United States Attorney's Office believed it was a strong case and had already accepted the case regardless of the mortgagee inspections.

The Settlement Agreement  
Did Not Address Funds  
Owed To HUD

The Settlement Agreement released Associated Estates from any and all claims by HUD, including an agreement entered into in 1987 with Associated Estates. In April 1987, HUD entered into an agreement with Associated Estates to share the cost savings from a refinancing of Rainbow Terrace Apartments. The cost savings were to be shared equally between HUD and Associated Estates. However, the Settlement Agreement did not account for over \$400,000 owed to HUD from the previous cost savings agreement.

The April 1987 agreement required Associated Estates to comply with any policy change made by HUD's Assistant Secretary for Housing that would modify the cost savings to be collected. HUD's former Assistant Secretary for Housing issued a memorandum dated September 30, 1987 that outlined HUD's share of the cost savings from refinanced mortgages would be 90 percent. The

memorandum called for the remaining 10 percent in savings to stay with owners as an incentive to refinance high interest mortgages. However, HUD never pursued Associated Estates to recover the savings nor did it use this as an offset against the funds paid under the Settlement Agreement. HUD never pursued the money because the Cleveland Multifamily Program Center Project Manager, who calculated the savings, never told the Cleveland Multifamily Program Center's Director or the HUD staff involved in the settlement negotiations about the potential recovery.

The Project Manager said he did not calculate the savings until March 1999, at which time HUD had almost executed the Settlement Agreement. He did not raise the issue because HUD's General Deputy Assistant Secretary for Housing had already stated HUD was going to settle and the terms of the Settlement Agreement were completed. The Project Manager for HUD's Cleveland Multifamily Program Center calculated that Associated Estates owed HUD \$402,240 due to the change in the cost savings between March 1990 and December 1993.

HUD's Project Manager did not calculate the cost savings due to HUD between April 1987 and February 1990. The Project Manager had no idea how much Associated Estates owed HUD in total. We were unable to determine the actual amount due from Associated Estates because HUD's files did not contain the necessary documentation to calculate the total cost savings. HUD was owed a significant amount of money that should have been used to offset the funds paid under the Settlement Agreement. Since Associated Estates was released from any and all claims, HUD cannot recover the cost savings from the refinancing of Rainbow Terrace Apartments based upon the terms of the Settlement Agreement.

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**Auditee Comments**

Excerpts paraphrased from HUD's comments on our draft audit memorandum follow. Appendix A, pages 52 to 60, contains the complete text of the comments.

Associated Estates' expenses were consistent with the audited financial statements provided to HUD. Associated supplied additional documentation to support actual expenses. Items were deleted from the rent increase

OIG Evaluation Of  
Auditee Comments

because of Associated Estates' failure to supply the necessary documentation. HUD's Cleveland Multifamily Program Center and the Office of Asset Management (formerly the Office of Portfolio Management) agreed that the documentation submitted by Associated Estates related to the operation and management Rainbow Terrace Apartments.

HUD lacked documentation to justify \$1.67 million of the \$1.78 million paid to Associated Estates under the Settlement Agreement. During the negotiations of the Agreement, HUD's Headquarters Office of Asset Management requested the Cleveland Multifamily Program Center to process Associated Estates' rent increase request as if the request was processed at the time of receipt.

A Senior Project Manager for HUD's Cleveland Multifamily Program Center submitted the rent increase request to the Deputy Director of Asset Management. The Senior Project Manager informed the Deputy Director that the Cleveland Multifamily Program Center could only justify a rent increase of \$842,051. He said Associated Estates would need to provide additional supporting documentation to support any higher amount.

HUD's Headquarters Office of Asset Management requested Associated Estates to provide the supporting documentation. Associated Estates provided documentation to HUD. HUD's Headquarters Office of Asset Management sent the documentation to the Cleveland Multifamily Program Center for review. The Program Center reviewed the documentation and advised the Office of Asset Management in writing that the documentation was not sufficient to support a rent increase in excess of the \$842,051 as previously determined by the Program Center.

HUD's Director of Asset Management said he thought the Program Center approved the documentation submitted by Associated Estates; however, he did not have anything to support this. HUD's Cleveland Multifamily Program Center did not approve the documentation submitted by Associated Estates.

Auditee Comments

The settlement payment was not made until Associated Estates complied with the terms of the Settlement Agreement that in part required them to find an acceptable owner or deed Rainbow Terrace Apartments to HUD. Since an acceptable owner was not located, Associated Estates deeded the Project to HUD. HUD's possession of the Project benefited the residents and control of the asset was a positive development for HUD. There was no basis for a settlement where Associated Estates would give the property to HUD and HUD would receive the rent increase proceeds. Rainbow Terrace Apartments benefited from the settlement since HUD was able to monitor more closely the performance of Associated Estates and subsequently remove it from ownership and management of the Project.

OIG Evaluation Of  
Auditee Comments

HUD made the settlement payment directly to Associated Estates, not to Rainbow Terrace Apartments. Therefore, the Project and its tenants did not benefit from the payment. Had HUD approved the requested rent increases, the benefits of the rent increase would have accrued to the Project. Associated Estates would have been able to receive a distribution only after the Project's operating expenses were paid and if the Project was in good condition. Since HUD's and the City of Cleveland's inspections showed the Project was in very poor condition, Associated Estates was prohibited from receiving any owner distributions. HUD's direct payment to Associated Estates overrode these controls.

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Auditee Comments

The Assistant United States Attorney for the District of Columbia, who was representing HUD in the rent increase lawsuit filed by Associated Estates, believed HUD was probably liable for failing to process Rainbow Terrace Apartments' rent increase request. Attorneys from HUD's Departmental Enforcement Center agreed. The Assistant United States Attorney and attorneys from the Enforcement Center recommended that HUD should process the rent increase requests and provide any increases that were warranted. This would resolve the lawsuit subject to dismissal.

The Enforcement Center also advised the Assistant United States Attorney for the District of Columbia that there were other issues involving Longwood, Park Village, and

Vanguard Apartments that HUD desired to resolve. In several court filings, the Assistant United States Attorney represented that settlement negotiations were occurring between HUD and Associated Estates. At no time during the negotiations did the Assistant United States Attorney request to see the Settlement Agreement. Instead, the Enforcement Center believed the Assistant United States Attorney was satisfied that HUD was reaching a settlement

OIG Evaluation Of  
Auditee Comments

We agree that the Assistant United States Attorney for the District of Columbia believed that HUD was probably liable for failing to process Associated Estates' rent increase request. However, this does not change that fact that HUD did not provide the Settlement Agreement to the Assistant United States Attorney for approval as required by Federal laws and HUD's Handbook.

The United States Attorney's Office for the District of Columbia represented HUD in the rent increase lawsuit brought by Associated Estates. Federal laws and HUD's Handbook required HUD to get the Department of Justice's approval since Justice represented HUD in the lawsuit. However, this was not done. The Assistant United States Attorney and the Chief of the Civil Division for the United States Attorney's Office for the District of Columbia said HUD never requested their approval before executing the Settlement Agreement. They learned of the Agreement after it was signed and they definitely never approved it.

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Auditee Comments

The Office of Inspector General cites 28 United States Code Section 516, Executive Order 6166, 31 United States Code Section 3711, and HUD Handbook 1530.1 REV-4 CHG-2. None of these citations supports the Inspector General's allegation that the Settlement Agreement violated Federal laws or HUD's requirements.

As previously mentioned, there was no referral to the Department of Justice requesting that affirmative litigation be filed in connection with Rainbow Terrace, Longwood, Park Village, or Vanguard Apartments. The absence of any referral renders Executive Order 6166 inapplicable since the Order contains another provision omitted in the Inspector General's audit memorandum. The provision says that nothing shall be construed to affect the function of any

agency or officer with respect to cases at any stage prior to referral to the Department of Justice. There was never any referral to Justice for affirmative litigation. The only referral to the Department of Justice that existed was for the defense of the rent increase lawsuit filed by Associated Estates regarding Rainbow Terrace Apartments.

The Inspector General's citation of 31 United States Code Section 3711 is also flawed. This provision is not even applicable to the settlement at issue. The statute defines a claim as any amount of funds or property determined by an agency to be owed to the Government. No determination that any specified amount of funds were owed to the United States was ever made let alone that the claim appeared to be fraudulent, false, or misrepresented.

In regards to the assertion that the Settlement Agreement precluded the Department of Justice from bringing a false claims case, the Agreement only released claims against Associated Estates that HUD could bring. The Settlement Agreement did not compromise the ability of Justice to proceed with a claim by the United States or a claim under the False Claims Act. Settlements involving HUD that purport to resolve civil fraud claims can be brought by the United States, such as claims under the False Claims Act.

The Settlement Agreement only released Associated Estates from claims by HUD. No reference is made to claims that could be brought by the United States or to claims under the False Claims Act. HUD advised the United States Attorney's Office for the Northern District of Ohio that it does not consider that the Agreement compromised any claim that could have been brought by the United States and has offered its support should the United States Attorney's Office wish to pursue the case. HUD did not intend to compromise any claims that could be brought by the United States and lacks the authority to do so.

OIG Evaluation Of  
Auditee Comments

HUD released Associated Estates from any and all claims, except tax or criminal fraud contrary to the requirements of Titles 5 and 31 of the United States Code that prohibit Federal agencies from compromising the collection action on a claim that appears to be false. We did not cite HUD for violating its Handbook 1530.1 REV-4 CHG-2 relative

to the release of the multifamily equity skimming and civil false claims case against Associated Estates.

As previously mentioned, HUD's assertion that there was no referral to the United States Attorney's Office for the Northern District of Ohio to pursue a multifamily equity skimming and civil false claims case is totally incorrect.

The Settlement Agreement excluded HUD from pursuing action against Associated Estates under the Federal law regarding equity skimming. While the Settlement Agreement does not specifically address civil false claims, the Agreement released Associated Estates from any and all claims by HUD, except tax or criminal fraud. We agree that HUD's release of Associated Estates would not technically prohibit the Department of Justice from pursuing a civil false claims case against Associated Estates. However, for a practical matter, few if any Assistant United States Attorneys will pursue a civil matter involving HUD funding, unless HUD is in agreement with the action.

The Assistant United States Attorney for the United States Attorney's Office for the Northern District of Ohio, who accepted the case presented by HUD, said HUD's release of any and all claims against Associated Estates in the Agreement ended the case. He said HUD damaged the case to the point that his Office will not pursue the matter.

Our interpretation of Section 3711 of the United States Code Title 31 is not flawed since the Departmental Enforcement Center Team Leader determined that the civil false claims and equity skimming case against Associated Estates potentially exceeded \$71 million in recoveries for HUD.

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Auditee Comments

The Inspector General reports that a Project Manager in HUD's Cleveland Multifamily Program Center did a partial file review. Based upon the review, the Project Manager's calculation indicated that funds might be due to HUD. The Office of Inspector General points out that this was not considered in the settlement negotiations. The Cleveland Multifamily Program Center reviewed the file in question and concluded that there are no funds due to HUD. The confusion may stem from the fact that neither the Inspector



General's Office nor the Project Manager fully reviewed the matter.

The Office of Inspector General was not reporting on its own work, but was raising an issue that had not been fully examined by the Cleveland Multifamily Program Center. The Program Center now reports that this issue was resolved in 1991 after extensive consultation with Housing Headquarters by using a revised debt service factor that accounted for the savings due to HUD. This revised factor was used in all rent increases subsequent to October 1991. Therefore, there was no basis for HUD to pursue a \$402,000 claim against Associated Estates. This is an instance where the Office of Inspector General chooses to accept a tentative conclusion that had not been fully reviewed internally and is in fact false.

#### OIG Evaluation Of Auditee Comments

HUD provided no documentation to support its claim that the funds owed under the cost savings agreement were collected through a revised debt service factor. A Senior Project Manager and a Project Manager for HUD's Cleveland Multifamily Program Center informed us on September 11, 2000 that HUD had not recaptured the \$402,240 through the debt service factor. The Settlement Agreement released Associated Estates from any and all claims by HUD, including a cost savings agreement entered into in 1987 with Associated Estates. The Agreement did not account for the funds owed to HUD from the previous agreement. HUD never pursued Associated Estates to recover the savings nor did it use this as an offset against the funds paid under the Settlement Agreement.

A Project Manager for HUD's Cleveland Multifamily Program Center calculated that Associated Estates owed HUD \$402,240 due to the change in the cost savings between March 1990 and December 1993. The Project Manager did not calculate the cost savings due to HUD between April 1987 and February 1990. He had no idea how much Associated Estates owed HUD in total. We were unable to determine the actual amount due from Associated Estates because HUD's files did not contain the necessary documentation to calculate the total cost savings.

EVENTS SUBSEQUENT TO THE AGREEMENT

Associated Estates complied with the terms of the Settlement Agreement. HUD ensured that Associated Estates did not misuse funds from Rainbow Terrace, Longwood, and Park Village Apartments after executing the Agreement. HUD also ensured that Associated Estates provided the deeds-in-lieu of foreclosure for Rainbow Terrace and Park Village Apartments. Associated Estates submitted the audited financial statements and monthly accounting reports to HUD, supplied HUD with a list of identity-of-interest contracts, and obtained HUD's approval for all contracts and expenditures over \$50,000 as required by the Settlement Agreement. HUD paid Associated Estates the \$1,784,457 for settlement of the rent increase suit for Rainbow Terrace.

HUD Did Not Sufficiently  
Protect The Projects'  
Tenants

HUD did not take possession of Rainbow Terrace and Park Village Apartments as permitted by the Settlement Agreement until eight months after the Agreement was signed. HUD's Director of Asset Management (formerly Director of Portfolio Management) said HUD executed the Settlement Agreement to remove Associated Estates from the Projects and to protect the Projects' tenants. However, Associated Estates was allowed to continue managing the Projects for over eight months after the Settlement Agreement was executed. During this time, the Projects' tenants continued to be subjected to conditions that were not decent, safe, and sanitary.

While the Agreement required Associated Estates to transfer the Projects to a purchaser acceptable to HUD by April 11, 1999, HUD granted Associated Estates an extension until July 12, 1999 to find potential buyers. The Director of Asset Management said HUD did not request the deeds-in-lieu because it did not want to incur the costs associated with owning the Projects. He said HUD was also concerned that the City of Cleveland would require HUD to correct the City Code violations if HUD were to take possession of the Projects.

Associated Estates was unable to transfer ownership of Rainbow Terrace and Park Village Apartments to an acceptable purchaser in July 1999. Again, HUD did not pursue its option to take possession of the Projects because it did not want to incur the costs associated with owning them. Associated Estates was allowed to manage the Projects until November 30, 1999 at which time the tenants' living conditions had still not improved. HUD took possession of the Projects because Associated Estates advised that it would no longer manage the Projects, not

because HUD exercised its option under the Settlement Agreement.

While HUD allowed Associated Estates to continue managing Rainbow Terrace and Park Village Apartments, the tenants continued to live in conditions that were not decent, safe, and sanitary. In fact, tenants at Rainbow Terrace Apartments informed Associated Estates that they would withhold their October 1999 rent payments because their units were in deplorable condition and infested with rodents and roaches. The Director of the Cleveland Tenants Organization said Associated Estates fixed some problems, but the bulk of them were neglected. HUD's Director of the Cleveland Multifamily Program Center advised the Deputy Director of Asset Management in April 1999 that HUD should consider taking possession of the Projects. He also advised the Director and Deputy Director of Asset Management in August 1999 that conditions at Rainbow Terrace Apartments were deteriorating quickly.

HUD's Director of Asset Management said HUD did not take possession of Rainbow Terrace and Park Village Apartments because it did not want to incur the costs of owning the Projects. He also said Associated Estates was suppose to correct the life-threatening conditions while it continued managing the Projects. However, Associated Estates did not make the repairs and HUD allowed Associated Estates to continue managing the Projects. HUD's Director of the Cleveland Multifamily Program Center said his Office did not ensure that Associated Estates corrected the life-threatening conditions. He said his Office was advised not to inspect the Projects since HUD's Real Estate Assessment Center was responsible for inspecting all of HUD's projects. HUD's Director of Physical Inspections for the Real Estates Assessment Center said the Center has not inspected the Projects since November 1998. Thus, HUD had no assurance that Associated Estates corrected the life-threatening violations at the Projects.

American Management, Incorporated, HUD's contracted management agent, started managing Rainbow Terrace and Park Village Apartments in December 1999. We conducted site visits of the Projects in March 2000 to determine the physical condition of the Projects. We found that HUD's management agent had made improvements to the Projects;

however, the Projects were still not in good repair and condition. As of July 21, 2000, HUD has not sold the Projects. HUD's Director of the Cleveland Multifamily Program Center said HUD plans to sell Rainbow Terrace and Park Village Apartments to the City of Cleveland, which would then transfer the Projects to a non-profit organization.

HUD Took No Action To Correct The Conditions At Longwood Apartments

Associated Estates transferred its ownership in Longwood Apartments before the Settlement Agreement was executed in March 1999. The Finch Group replaced Associated Estates as the General Partner and immediately defaulted on the Project's mortgage. HUD allowed the Finch Group to defer making mortgage payments while it made repairs and developed a plan for the demolition and redevelopment of the Project. An October 4, 1999 physical inspection report by HUD's Real Estate Assessment Center showed that Longwood was still in poor condition. Necessary repairs were not being made because the Finch Group planned to demolish the Project.

A March 2000 plan submitted by the Finch Group to HUD's Cleveland Multifamily Program Center estimated total demolition and construction costs at \$159,000 per unit. HUD cannot subsidize the owners plans because the cost per unit exceeds what HUD can approve as an insured mortgage and provide as an up-front grant. As the owner continues to develop a plan for implementation, the tenants of Longwood Apartments are still residing in poor conditions. HUD also continues to pay Section 8 housing assistance for units not decent, safe, and sanitary.

As of May 31, 2000, HUD had not taken any action to remove the Finch Group or protect the tenants of Longwood Apartments because it is still hopeful the Finch Group or the City of Cleveland will provide a new plan that is affordable or provides funds to implement the plan. HUD's Director of the Cleveland Multifamily Program Center said HUD does not want to take possession of the Project due to the cost associated with rehabilitating or redeveloping the Project. Furthermore, the State of Ohio's Housing Finance Agency revised its tax credit structure to include Longwood Apartments for future tax credits. As of September 2000, HUD plans to transfer Longwood Apartments to the City of Cleveland, provide a grant of

over \$25 million for the redevelopment of the Project, and insure the Project once redevelopment starts at approximately \$50,000 per unit. In addition, the Finch Group will provide \$3 million in deferred developer fees for Longwood's redevelopment and the City plans to provide over \$20 million in funding and tax abatements. The completion of Longwood's redevelopment is expected in 2005.

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**Auditee Comments**

Excerpts paraphrased from HUD's comments on our draft audit memorandum follow. Appendix A, pages 52 to 60, contains the complete text of the comments.

The Inspector General's Office makes a judgment that HUD did not adequately protect the tenants. HUD's increased monitoring and eventual possession of Rainbow Terrace and Park Village Apartments improved conditions for the residents. The Office of Inspector General misconstrues the strategy involved and thereby misunderstands the emphasis placed on pursuing a private purchaser as solely a cost issue. HUD negotiated a Settlement Agreement that prioritized a private purchase, if possible, because that solution would be the most efficient. HUD as a property owner does not do major capital improvements. HUD does general repairs, provides security, and brings in responsive management while in ownership or possession. Most of the residents would report dramatic improvement in those areas since HUD's ownership of Rainbow and Park Village Apartments.

HUD will sell the Projects to a private or public owner, if feasible, who will undertake more significant rehabilitation activity, if required. The mandatory process of analysis, right of first refusal offer to the local government, a potential subsequent offer to the public, and sales completion can take approximately 18 months. If a private purchaser could have been found during the Settlement Agreement, that purchaser could have begun repairs and improvements much earlier than the regulated process that HUD's property sales allow. Since the Inspector General's Offices benefits from hindsight that HUD's Office of Multifamily does not enjoy, HUD could have known that no competent private sector purchaser with adequate resources would come forward. However, it was a reasonable

decision to pursue that option. During the Settlement Agreement, HUD's Cleveland Multifamily Program Center enhanced their oversight of the management and operations of the Projects to protect residents.

Second, the audit memorandum alleges that HUD took no action to correct the conditions at Longwood Apartments. This is incorrect. HUD negotiated the exit of Associated Estates from both management and ownership of the Project. HUD negotiated a capital contribution from the Project's limited partner and encouraged the limited partner to select an experienced property manager/developer as a new General Partner and management agent. HUD agreed to defer payments on the Project's mortgage to allow funds for the repairs and security. HUD has participated in ongoing meetings with the City of Cleveland on the future of the Project. No one thinks that the Project is in acceptable condition. HUD, the City, and the current management agent of the Project have worked cooperatively to correct and improve the conditions at Longwood.

#### OIG Evaluation Of Auditee Comments

HUD did not take possession of Rainbow Terrace and Park Village Apartments as permitted by the Settlement Agreement until eight months after the Agreement was signed. During this time, the Projects' tenants continued to be subjected to conditions that were not decent, safe, and sanitary. In fact, tenants at Rainbow Terrace Apartments informed Associated Estates that they would withhold their October 1999 (six months after the Settlement Agreement was signed) rent payments because their units were in deplorable condition and infested with rodents and roaches. HUD's Director of the Cleveland Multifamily Program Center advised the Deputy Director of Asset Management in writing that conditions at Rainbow Terrace Apartments were deteriorating quickly.

The Cleveland Multifamily Program Center did not ensure that Associated Estates made the necessary repairs as required. The Center was advised not to inspect Rainbow Terrace, Longwood, and Park Village Apartments since HUD's Real Estate Assessment Center was responsible for inspecting them. However, the Real Estates Assessment Center has not inspected the Projects since November 1998. Thus, HUD had no assurance that Associated Estates corrected the life-threatening violations at the Projects.

We conducted site visits of the Projects in March 2000 and August 2000 to determine the physical condition of Rainbow Terrace and Park Village Apartments. We found that HUD's management agent had made improvements to the Projects; however, the Projects were still not in good repair and condition.

HUD negotiated a capital contribution from the limited partner of Longwood Apartments and held discussions with the City of Cleveland regarding the Project's redevelopment. The capital contribution totaled over \$1.1 million as of June 2000. The contribution was used to pay over \$800,000 in expenses of the Finch Group and the cost of the redevelopment plans. The remaining \$301,000 of capital contributions was used for the Project's operations and maintenance. Nonetheless, an October 1999 physical inspection report by HUD's Real Estate Assessment Center showed that Longwood was still in poor condition. In addition, we conducted site visits of the Project in March 2000 and August 2000 to determine the physical condition. We found that the Project was not in good repair and condition.

HUD needs to take immediate action to ensure that the tenants of Rainbow Terrace, Longwood, and Park Village Apartments are residing in decent, safe, and sanitary conditions.

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### SUMMARY

As a result of absolutely awful communications, HUD's staff who negotiated the Settlement Agreement were not aware that the United States Attorney's Office for the Northern District of Ohio had previously accepted a civil false claims and equity skimming case against Associated Estates. They also were not aware of a previous cost savings agreement that required Associated Estates to share with HUD the savings from refinancing Rainbow Terrace Apartments' mortgage. In essence, the HUD negotiators did not know what they were negotiating away. The negotiators also violated Federal laws and HUD's own requirements by settling the civil suit and waiving civil actions against Associated Estates without the Department of Justice's approval.

HUD lacked documentation to justify most of the \$1.78 million settlement paid directly to Associated Estates. HUD staff said they made the payment to settle the lawsuit filed against it for not processing the 1995 rent increase request. Neither Rainbow Terrace Apartments nor its tenants benefited from the payment.

In addition, HUD paid Section 8 housing assistance to Associated Estates even though HUD was aware that Rainbow Terrace, Longwood, and Park Village Apartments' tenants lived in units that were not decent, safe, and sanitary. HUD took no action to ensure the poor physical conditions at Rainbow Terrace, Longwood, and Park Village Apartments were corrected.

While HUD enforced the terms of Settlement Agreement, it did not take possession of Rainbow Terrace and Park Village Apartments as permitted, but not mandated by the Agreement. HUD's Director of Asset Management said HUD did not want to take possession of the Projects because of the cost associated with repairing them. By not taking possession of Rainbow Terrace and Park Village Apartments, HUD contradicted one of its stated reasons for negotiating the Settlement Agreement and failed to protect the Projects' tenants from unhealthy and unsafe living conditions. Given that one of the primary reasons for negotiating the settlement was to remove Associated Estates from the Projects in order to protect the health and safety of the tenants, we find it incongruous that HUD could find \$1.78 million to pay a large real estate management company but was unwilling to find the funds needed to protect the tenants from unsafe and unsanitary living conditions.

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**Auditee Comments**

Excerpts paraphrased from HUD's comments on our draft audit memorandum follow. Appendix A, pages 52 to 60, contains the complete text of the comments.

The Office of Housing disagrees with Recommendation A regarding protocols, procedures and controls. It is based on the erroneous statement that a referral to the United States Attorney had been made by HUD. Existing protocols, procedures, and controls protect all parties where a referral has actually been made.

**OIG Evaluation Of  
Auditee Comments**

We believe our memorandum accurately presents the events related to the Settlement Agreement. Based upon what occurred, HUD needs to establish protocols, procedures, and controls.

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**Auditee Comments**

The Office of Housing disagrees with Recommendation B regarding establishing new controls regarding pending cases at the Department of Justice. When cases are actually referred to Justice by HUD, there are adequate existing controls regarding consultation.

**OIG Evaluation Of  
Auditee Comments**

The Office of Housing provided no evidence to support that controls are in place that will assure that HUD Departmental officials consult with the Department of Justice on any future proposed actions which could affect



pending cases at the Justice Department, and that Justice Department approval is obtained before proceeding with those actions. The facts surrounding the Settlement Agreement with Associated Estates shows HUD did not adequately consult or seek approval from the Department of Justice on actions affecting pending cases.

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Auditee Comments

The Office of Housing disagrees with Recommendation C on the basis that HUD has assumed ownership and hired a new management agent for Rainbow Terrace and Park Village Apartments. The Office of Housing is also working diligently with the City of Cleveland on a resolution for Longwood Apartments. The situation regarding Longwood has stabilized. The State of Ohio and the City have both committed substantial resources to a proposed redevelopment of Longwood Apartments and neighboring commercial and residential properties. The City of Cleveland has expressed an interest in purchasing all three Projects.

OIG Evaluation Of  
Auditee Comments

The residents of Rainbow Terrace, Longwood, and Park Village Apartments are residing in units that are not decent, safe, and sanitary. HUD has not conducted any physical inspections of Rainbow Terrace and Park Village Apartments since 1998. An October 1999 physical inspection of Longwood Apartments by HUD's Real Estates Assessment Center showed Longwood was in poor condition. Our visits to Rainbow Terrace, Longwood, and Park Village in March and August 2000 showed the Projects were still in need of repair.

HUD needs to take immediate action to ensure that the tenants of Rainbow Terrace, Longwood, and Park Village Apartments are residing in decent, safe, and sanitary conditions.

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Auditee Comments

The Office of Housing disagrees with Recommendation D. HUD officials held discussions with the United States Attorney's Office the Northern District of Ohio. The Office agreed that no apology was necessary and that no referral was made. The United States Attorney's Office for the District of Columbia was fully aware of settlement negotiations.

OIG Evaluation Of  
Auditee Comments

HUD provided no evidence that discussions were held with the United States Attorney's Office for the Northern District of Ohio where the Office allegedly agreed that no apology was necessary and no referral was made. As previously mentioned, several of HUD's staff attended meetings with the Assistant United States Attorney for the Northern District of Ohio and requested him to pursue a civil case against Associated Estates. The staff included the Director of the Cleveland Multifamily Program Center, the Director of the Columbus Multifamily Hub, a former Departmental Enforcement Center Team leader, and the Legal Counsel for the Cleveland Area Office. These individuals acknowledged to us that they requested the United States Attorney's Office to take action against Associated Estates. As a result of the meetings, the United States Attorney's Office opened a case (Case # USAO97-01948) and assigned two attorneys to it. A Supervisory Assistant United States Attorney for the United States Attorney's Office for the Northern District of Ohio told us his Office assigns case numbers only to matters that they accept for legal action.

Finally, in regards to HUD's claim that the United States Attorney's Office agreed that no apology was necessary, social and business etiquette would normally result in a person being asked whether an apology was necessary or not, responding in the negative.

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RECOMMENDATIONS

We recommend that the Assistant Secretary for Housing-Federal Housing Commissioner assures that HUD's Office of Multifamily Housing:

- A. Establishes protocols, procedures, and controls to ensure that when future settlement agreements are negotiated all applicable HUD Headquarters and Field Offices are contacted and requested to provide input about outstanding agreements and actions, any pending matters, and any other concerns that may impact, or be impacted by the agreements. The protocols and procedures should also assure that future settlement agreements: (1) are approved by the Department of Justice when required by Federal laws; and (2) do not compromise cases accepted by the Department of Justice.
- B. Establishes controls which will assure that HUD Departmental officials consult with the Department of Justice on any future proposed actions which could affect pending cases at

the Justice Department, and Justice Department approval is obtained before proceeding with those actions.

- C. Takes immediate action to ensure that the tenants of Rainbow Terrace, Longwood, and Park Village Apartments are residing in decent, safe, and sanitary conditions.
- D. Issues formal apologies to the United States Attorney's Offices for the District of Columbia and the Northern District of Ohio for failing to obtain their approval on the Settlement Agreement and/or for compromising cases they had accepted and were pursuing.

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# Auditee Comments

U.S. Department of Housing and Urban Development  
WASHINGTON, D.C. 20410-1000

SEP 7 2000

OFFICE OF THE ASSISTANT SECRETARY FOR  
CONGRESSIONAL AND INTERGOVERNMENTAL RELATIONS

MEMORANDUM FOR: Dale L. Chouteau, District Inspector General for Audit, 5AGA

FROM: William C. Apgar, Assistant Secretary for Housing - Federal Housing  
Commissioner, H

SUBJECT: Draft Audit Memorandum  
HUD's Settlement Agreement  
Associated Estates Realty Company

Thank you for the opportunity to comment on your draft audit memorandum reviewing Housing's work to resolve problems on several troubled properties in Cleveland, Ohio. Housing and the Departmental Enforcement Center believe that the resolutions arrived at were reasonable given the assessed risks and that there is no cause for change to controls and processes. Housing believes the IG has substantially misrepresented the facts which has led to erroneous conclusions about changes to controls and processes.

We appreciate that your office spent five months reviewing this complex and difficult transaction but are disappointed that there remain major omissions and errors of fact despite the openness of the Office of Housing and the Departmental Enforcement Center (DEC) in sharing information with the IG. We offer these comments in writing in hopes that these errors and omissions, and thereby the conclusions, findings and recommendations will be corrected in the final report.

In our comments we will show that there was no referral for affirmative litigation, that consultation, including discussion of the settlement, on the defensive litigation was ongoing, that action has been taken to remove the owners and improve conditions at the properties and that no apologies are necessary to any United States Attorney's Office.

Our response is organized by section of the draft report.

## Introduction (Pages 1 to 3)

It is important to note that HUD and the Assistant United States Attorney viewed chances of prevailing in the rent increase litigation as poor, therefore in negotiation HUD could get an uncontested exit by the owners giving an opportunity for new ownership or HUD to act to protect the residents and to work with the community to improve overall conditions for giving the rent increase HUD would have had to approve in any case. The Settlement Agreement

was entered into because HUD wanted to resolve long-standing problems at these Projects with a transfer from Associated Estates to qualified private parties. Failing that, owners would have to agree to give HUD ownership. (2)

For reasons described in more detail later, “apparently horrendous poor communication” is inappropriate regarding HUD program offices. Each of the supposed facts recited here will be shown to be substantially in error. In each case correct information was either given to the IG or was readily available in HUD files. (2)

HUD’s Director of Asset Management cited costs as one of several concerns, but did not cite costs as the sole concern in allowing the owners time to attempt to sell the property to a private party. In fact, the owners exited one property (Longwood) and HUD took prompt ownership of Vanguard. HUD also took ownership of Rainbow Terrace and Park Village, after exhausting the private sector options. Therefore the IG’s statement of incongruity is gratuitous. (2)

#### Associated Estates Realty Corporation and Projects in the Settlement Agreement (Pages 3 to 6)

These sections appear to be generally factual. The sections point out that three of the four projects were owned by entities affiliated with Associated Estates Realty Corporation, that two of those three were historically troubled properties, having been foreclosed previously by the Department. On the fourth, Vanguard, Associated Estates was hired as an independent management agent by the owner. All four properties were in physical distress.

#### Events Leading up to the Settlement Agreement (Pages 6 to 17)

In this section, while subject to factual errors, the IG summarizes information that makes two important points relevant to the decision to consider settlement to remove the owners. First it clearly shows that file documentation indicates inconsistent monitoring and failure to pursue timely resolution which would cloud litigation. These sorts of issues have been addressed prospectively with the establishment of the Real Estate Assessment Center for uniform physical assessments and uniform identification of financial compliance and performance issues, and the DEC to build better case files for potential litigation. Second, it shows that these are difficult issues and properties upon which to achieve problem resolution.

The audit also points out that in May of 1997 SWAT conducted management reviews and alleged that Rainbow Terrace received \$1.9 million in improper distributions of profits to owners between January 1994 and December 1996. While Housing agrees with the approach of the SWAT review, there are two problems with prevailing on it in a court of law. First this issue was not promptly identified or pursued by the Cleveland Office and second it depends entirely on establishing that the property was not in satisfactory condition in the time period when distributions were taken. While the audit points out some of the inconsistent approaches of the Cleveland Office in that time period, the audit does not point out at this point the full record of inspection ratings, including mortgagee inspections which further undermine HUD’s case regarding the disallowed distributions.

IG Assertion: Based upon a “request” by HUD’s Cleveland Multifamily HUB Director, and a Departmental Enforcement Center (DEC) Team Leader, the United States Attorney’s Office for the Northern District of Ohio “accepted the civil case from HUD”. (13)

Correction: As was carefully and repeatedly pointed out to the IG auditor, no referral was made to the U.S. Attorney's Office in this case, so there was nothing for that office to "accept." Neither the Director of the Cleveland Multifamily HUB nor the DEC Team Leader were authorized to make a referral to the U.S. Attorney. Neither person attempted to assert that authority. That authority has been delegated to the General Counsel or her OGC designee. See 54 Federal Register 4913, January 31, 1989; Paragraph 2-5, HUD Handbook 1530.1. Accordingly, although there were discussions between HUD staff and the U.S. Attorney's Office concerning Associated Estates, no formal referral requesting the filing of a civil action was ever made. Indeed, as late as September 10, 1998, the Assistant U.S. Attorney involved in this matter acknowledged this point in a letter to the Director of the Cleveland Multifamily HUB by asking "whether HUD still wants our office to review this matter for potential civil prosecution." An authorized, affirmative answer to that question would have been required to have been conveyed by the General Counsel or her designee to initiate litigation on behalf of HUD. No such affirmative request was ever made.

The draft then begins a generally accurate summary of concerns about the Rainbow litigation, and HUD's potential stance should it choose to make a referral for litigation. In reciting additional factors in HUD's decision not to terminate the Section 8 contract and relocated residents, however, the audit omits two factors discussed with the auditors. First, the residents themselves were strongly opposed to termination of project based assistance at the sites. In addition, the audit omits the fact that finding a competent Housing Authority with capacity to administer the issuance of 1800 vouchers and counsel the residents was problematic. In that regard, the audit implies that judgments about sufficiency of available and affordable alternate rental housing should have had a more rigorous analytical underpinning. It is true that the City of Cleveland did not conduct a separate study linked to the timing of the 1800 vouchers to support its concerns about the housing market. Cleveland housing officials have many sources of general information on vacancy rates and voucher success rates that do not depend on specific studies. It is difficult to believe that the IG is arguing that HUD should have concluded that sufficient housing to relocate nearly 1800 low income families, on top of the 313 families relocated from Vanguard in 1998, would be readily available to voucher holders. Housing has ample experience with relocation efforts to know that such an exercise would have been traumatic to residents and consume a significant period of time. The IG should familiarize itself with studies of the difficulty of relocation of low-income residents.

Based on the erroneous reporting of facts regarding referral and acceptance, the audit then suggests that HUD's staff negotiating the settlement should have known that a civil case against Associated Estates had been accepted by the United States Attorney. Since no case had been referred to the United States Attorney, and therefore no case accepted by the United States Attorney, the IG is suggesting that HUD staff should know something that did not, and does not exist. Further the IG asserts that the negotiators should have inquired if legal action was underway against Associated Estates. The system of controls over referrals for litigation allows counsel to be cognizant of referrals and pending litigation, so no inquiry was warranted regarding litigation. What the IG does not report is that the negotiators did inquire of staff of the IG if that office knew of any reason HUD should not execute a settlement with Associated Estates. The response was that there were no impediments to settlement. This written email response was given to the auditors, yet never mentioned. Given that staff from the IG's Office were present at discussions (which the IG now incorrectly chooses to characterize as "cases,")

the inquiry and the written response is material and its omission is symptomatic of the problems with the draft audit. (16)

After discussing at some length persons who did not know about or were not told about something that had not happened, the draft audit seemingly tries to make the case that there was a significant pattern of miscommunication because the Cleveland Office had to inquire who was handling the Associated Estates matter. In fact, the Departmental Enforcement Center and Housing both worked on the case, and the Cleveland Office was in frequent communication with Housing Headquarters. The second point made by the IG to buttress this issue is that the Cleveland Program Center allegedly wasn't given an opportunity to discuss the non-existent "acceptance" of a civil false claims and equity skimming case. (18)

#### The Settlement Agreement (Pages 18 to 28)

At the outset, it should be emphasized that the Settlement Agreement, by its terms, accomplished two very important objectives: First, it resolved enforcement actions that HUD had administratively begun against the four projects. Second, it resolved the civil action brought by AERC regarding HUD's failure to respond to its requests for rent increases at Rainbow Terrace. Both of these are positive outcomes.

The draft audit makes five negative assertions about the Settlement Agreement that will be addressed in order.

IG Assertion: HUD lacked documentation to justify the rent increase amount paid to Association Estates.

Correction: AERC's expenses were consistent with the certified, audited financial statements provided to HUD. In many cases, the owner supplied additional documentation requested by HUD of actual expenses within the appropriate time period for items included in the rent increase. In some cases, items were deleted from the rent increase because of failure to supply additional documentation. The Cleveland Office and Headquarters were in agreement that these represented actual expenses related to operation and management of the property.

IG Assertion: Rainbow Terrace did not benefit from the settlement payment. (23)

Correction: The settlement payment was not made until the owners had complied with the terms of the Settlement Agreement, which in part required them to find a capable owner or deed the property to HUD. Since a capable private owner was not located, they deeded the property to HUD. The acquisition by HUD was a benefit to the residents, and control of the asset was a positive development for HUD. There was no basis for a settlement wherein the owner would both give the property to HUD and HUD would give itself the deferred rent increase. Rainbow Terrace benefited from the settlement in that by its terms, HUD was able to monitor more closely the performance of AERC and subsequently to remove them from ownership and management.

IG Assertion: HUD did not provide the settlement agreement to Justice for Approval. (23)

Correction: As to the Rainbow Terrace litigation, as the IG itself notes (14), the Assistant U.S. Attorney (AUSA) for the DC United States Attorney's Office, which was handling the case, believed that HUD was vulnerable to the legal challenge because the Department had failed to process the project's rent increase requests. The Enforcement Center (EC) legal division agreed. Accordingly, in furtherance of Handbook 1530.01 the AUSA and the EC legal staff jointly recommended that HUD should process the rent increase requests, provide any increases that were warranted, and thereby render the lawsuit moot and subject to dismissal. The EC also informed the AUSA that there were other issues involving the three other projects that HUD desired to resolve as a package. Thereafter, in several court filings the AUSA represented that settlement discussions were occurring. At no time during the course of the negotiations did the AUSA request to see the settlement agreement. Instead, the EC believed that the AUSA was satisfied that HUD was reaching an administrative settlement, under which HUD would process the rent increases for Rainbow Terrace and pursuant to which, upon processing and payment of the increases, the lawsuit would be dismissed. That result was accomplished in the Settlement Agreement.

IG Assertion: HUD Inappropriately Released Associated Estates from any and all claims. This assertion has two aspects 1) that the Settlement Agreement "violated Federal laws and HUD's own requirements by settling the civil suit [challenging the failure to provide a rent increase to Rainbow Terrace] and waiving civil action without the Department of Justice's approval." (2); and 2) that the Settlement Agreement precluded DOJ from pursuing False Claims Act violations against AERC. (26)

Correction 1): As to the first aspect, the IG cites several sources for the alleged violations. First, it points to 28 U.S.C. Section 516. (24) That section provides that when an agency of the United States is sued, the Department of Justice is responsible for "the conduct of litigation." Next, the IG cites Executive Order 6166, which states that "[a]s to any case referred to Justice for prosecution or defense in the courts, the function of decision whether and in what manner to prosecute, or to defend, or to compromise, or to appeal, or to abandon prosecution or defend, now exercised by any agency or officer, is transferred to the Department of Justice." (24-25) IG then cites to 31 U.S.C. Section 3711, which requires the head of agencies "to try to collect a claim of the United States Government for money or property arising out of the activities of, or referred to, the agency," unless the claim "appears to be fraudulent, false, or misrepresented by a party with an interest in the claim . . . ." (25) Finally, the IG discusses HUD Handbook 1530.1 REV-4 CHG-2, Section 1-2b, which requires HUD to provide recommendations to DOJ regarding the conduct of litigation, and coordinate with DOJ (24).

None of these authorities supports the IG's allegation that the Settlement Agreement violated Federal law or HUD's requirements.

As discussed above, regarding the enforcement against the four projects, there was no "referral" to the Department of Justice requesting that affirmative litigation be filed in connection with any of those projects. The absence of any referral renders EO 6166 inapplicable, since that Order contains another provision, omitted by the IG in its audit, that states: "Nothing in this section shall be construed to affect the function of any agency or officer with respect to cases at any stage prior to reference to the Department of Justice for prosecution or defense." There was never any "referral" to the DOJ for affirmative litigation, the only "reference" to DOJ that existed was for conduct of the defensive litigation involving the Rainbow Terrace rent increases.



The IG's citation of 31 U.S.C. Section 3711 is also flawed. This provision is not even applicable to the settlement at issue. "Claim," as defined in the statute, means, in relevant part, any amount of funds or property determined by the agency to be owed to the Government. See 31 U.S.C. Section 3701. No "determination" that any specified amount of funds were owed to the United States was ever made in this matter, let alone that the "claim . . . appears to be fraudulent, false or misrepresented by a party with an interest in the claim."

Correction 2): As to the aspect of the assertion that the Settlement agreement precluded the DOJ from bringing a false claims case, the Settlement Agreement only released claims against AERC that **HUD** could bring in its own right. The Settlement Agreement **did not**, however, compromise the ability of DOJ to proceed with claims by the United States or a claims under the False Claims Act.

Settlements involving HUD that purport to resolve civil fraud claims that can be brought by the United States, such as claims under the False Claims Act, do so specifically and unambiguously. For example, HUD's 1996 settlement of a case in the Northern District of Illinois specifically provided that "*the United States* fully and finally releases [the defendant] from any civil claims *the United States* could have asserted against [the defendant] . . ." Consent Judgment, U.S. v. Blackstone Lowe Avenue Assoc., et al., No. 96-C-7594. Similarly, another recent settlement released the defendants "from any civil monetary claims *the United States* has or may have . . ." U.S. v. Westminster Development Company, Inc., et al.; see also Settlement Agreement, U.S. v. Brick Towers, et al. ("defendant released "from any civil or administrative monetary claims *the United States* has or may have against the [defendants], including claims under the False Claims Act, 31 U.S.C. 3729-3733").

In the settlement at issue, however, plaintiffs were only released "by HUD from any and all claims (other than tax or criminal fraud), including without limitation, claims under 12 U.S.C. 1715z-4a, the Regulatory Agreement, the mortgage note, HAP contract, or any other document relating to the ownership and operation of the four Projects." No reference is made to claims that could be brought by the United States or to claims under the False Claims Act.

HUD has advised the U.S. Attorney's office that it does not consider its settlement to have compromised any claim that could have been brought by the United States and has offered its support should the U.S. Attorney continue to have an interest in pursuing this case.

As the above language plainly shows, HUD did not intend to compromise any claims that could be brought by the United States and, indeed, lacks the authority to do so.

IG Assertion: The Settlement Agreement did not address funds owed to HUD. (27)

Correction: The IG reports that an individual in the Cleveland Office did a partial file review and based on that made a calculation that indicated funds might be due to HUD. The IG points out that this was not considered in the negotiation. The Cleveland Office reviewed the file on this point, and has concluded that there are no funds due to the Department. The confusion may stem from the fact that neither the IG nor the individual fully reviewed this matter. Therefore the IG was not reporting on its own work, but was raising an issue which had not been fully examined by the Cleveland Office. The Cleveland Office now reports that

this issue was resolved in 1991 after extensive consultation with Housing Headquarters, by a determination to use a revised debt service factor that accounted for the savings due HUD. This revised factor was used in all rent increases subsequent to October 1991. Therefore there was no basis for HUD to pursue a \$402,000 claim against AERC. Further, as opposed to another alleged incident of poor communications, or HUD not knowing what it was negotiating away, this is an instance where the IG chooses to accept a tentative conclusion which hadn't been fully reviewed internally and is in fact false.

#### Events Subsequent to the Settlement Agreement (Pages 28 to 31)

In this section the IG makes two points, both of which understate and misconstrue HUD's strategy and actions. First, it makes a judgment that HUD did not adequately protect the project's tenants. HUD's increased monitoring and eventual acquisition of Rainbow Terrace and Park Village improved conditions for the residents. The IG misconstrues the strategy involved and thereby misunderstands the emphasis placed on pursuing a private sector purchaser as solely a cost issue. HUD negotiated an agreement that prioritized a private sector purchase, if possible, because that solution would be the most efficient. Cost is simply a measure of efficiency for a transaction. HUD as a property owner does not do major capital improvement programs. HUD does general repairs, provides security and brings in responsive management while in ownership or possession. If the IG asked them, most residents would report dramatic improvement in those areas since HUD's ownership of Rainbow and Park Village. If feasible, HUD will sell the properties to a private or public owner who will undertake more significant rehabilitation activity, if required. The mandatory process of analysis, right of first refusal offer to local government, a potential subsequent offer to the public and sales completion can take eighteen months, or more. If a private purchaser could have been found during the settlement agreement, that purchaser could have begun repairs and improvements much earlier than the regulated process of HUD property sales would allow. With hindsight, which the IG benefits from but Housing does not enjoy when making decisions, HUD could have known that no competent private sector purchaser with adequate resources would come forward. However, it was a reasonable decision to pursue that option, and during the settlement agreement the Cleveland Office enhanced their oversight of management and operations of the property to protect residents.

Second, the audit alleges that HUD took no action to correct the conditions at Longwood Apartments. That is incorrect. HUD negotiated the exit of Associated Estates from both management and ownership of Longwood. HUD negotiated a capital contribution from the limited partner. HUD encouraged the limited partner to select an experienced property manager/developer as a new general partner and manager, and the limited partner did so. HUD agreed to defer payments on its mortgage to augment cash flow to deal with repairs and security. HUD has participated in ongoing meetings with the City of Cleveland on the future of Longwood. No one thinks that Longwood is in acceptable condition, but HUD, the City and the current management of Longwood have worked cooperatively to correct and improve the conditions at Longwood.

#### Summary (Pages 31 to 32)

The IG Report claims that several of its findings occurred because of "absolutely awful" or "horrendous communication" between the Office of Multifamily Housing and the Departmental Enforcement Center. (2, 17, 18, 31)

Correction: The IG wholly ignores three very important facts in making this charge. First, the allegation rests on two misstatements of fact. One is that there was an “accepted” case of which negotiators should have been aware. There was no such case. The second basis is the alleged funds owed under a cost savings agreement. Those funds were not owed.

Third, as was also explained to the IG auditor, the Director of Asset Management contacted the Office of IG to inform him of the proposed settlement. The Director of Portfolio Management identified the entities involved and inquired whether the IG would have a problem with moving forward. OIG responded that they did not have a problem. Therefore, if the IG believes that the settlement was inappropriate, there was a problem with communication within the IG’s office. Housing would recommend that the IG establish a central clearing point for consultation with program areas where written clearance would be given regarding program activities where the IG has some involvement. This is a problem not only on Associated Estates, but other areas where the IG has an investigative or audit interest and program decisions have to be made.

The IG also charges that the Settlement Agreement lacked merit because “HUD negotiators did not know what they were negotiating away,” (31, 2-4, 12, 14, 18, 20, 23). First, HUD did not negotiate away any DOJ claim. Second, in fact, as explained to the IG auditor, the DEC and the Office of Multifamily Housing had carefully examined and analyzed the administrative record and the strengths and weaknesses of any HUD claims of unlawful distributions.

Among other things, the DEC in conjunction with Multifamily Housing, commissioned an analysis of this project owner’s alleged unauthorized distributions and to assess the validity of their contention that they had advanced millions of dollars into three properties. The conclusion of this report was that as a whole the owners had, in fact, made substantial advances to the projects. The findings in this report were important factors that played a significant role in the decision to settle the matter.

The Settlement Agreement provided the most expeditious manner to resolve the health and safety problems at the project. While Associated Estates continued to manage the properties, they were under an obligation to immediately correct life-threatening conditions. Throughout this time, HUD was in constant contact with the owners to ensure that these items were corrected.

Moreover, the decision to pursue a voluntary transfer of the projects - a key ingredient of the Settlement Agreement - was programmatically sound. As evidenced by the Rainbow Terrace lawsuit, these owners were prepared to resist HUD’s attempt to unilaterally assume control over the projects. The owners were prepared to drag the entire process into protracted litigation. Accordingly, the decision to negotiate with the owners was correct in light of the lack of proof of significant unlawful distributions, the owners advances, and the stated objective to provide for the most expeditious manner to bring these projects into compliance for the benefit of the tenants.

#### Recommendations (Page 32)

A. Establish protocols, procedures, and controls.

Housing disagrees with Recommendation A regarding protocols, procedures and controls. It is based on the erroneous statement that a referral to the United States Attorney had been made by HUD. Existing protocols, procedures and controls protect all parties where a referral has actually been made.

B. Establish controls which will assure that HUD Department officials consult with Justice.

Housing disagrees with Recommendation B regarding establishing new controls regarding pending cases at the DOJ. When cases are actually referred to the DOJ by HUD, there are adequate existing controls regarding consultation.

C. Take immediate action on Rainbow Terrace, Longwood and Park Village.

Housing disagrees with Recommendation C on the basis that action has already been taken on two projects and on the third all parties are actively engaged. Housing has already taken ownership and hired new management of Rainbow Terrace and Park Village. Housing is working diligently with the City of Cleveland on a resolution for Longwood. The situation there is stabilized and the State of Ohio and the City have both committed substantial resources to a proposed redevelopment of Longwood and neighboring commercial and residential properties. The City of Cleveland has expressed an interest in purchasing all three properties. This degree of commitment and cooperation in improving and maintaining the assisted housing stock would not have been possible had HUD continued with its initial proposal to voucher out the properties.

D. Issues formal letters of apology to the United States Attorney's Offices.

Housing disagrees with Recommendation D. HUD officials have discussed this matter with the United States Attorney's Office the Northern District of Ohio and he agrees that no apology is necessary. The Ohio Office agrees that no referral had been made there The District of Columbia Office was fully aware of settlement negotiations because of the frequent consultations on the pending litigation at Rainbow.

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