



U.S. Department of Housing and Urban Development  
Office of Inspector General for Audit  
Great Plains District, 7AGA  
Gateway Tower II - 5<sup>th</sup> Floor  
400 State Avenue  
Kansas City, Kansas 66101-2406

AUDIT MEMORANDUM  
2001-KC-1803

September 28, 2001

MEMORANDUM FOR: Herman Ransom, Director, Kansas City Multifamily HUB, 7AHM

*Roger E. Niesen*

FROM: Roger E. Niesen, District Inspector General for Audit, 7AGA

SUBJECT: Review of Oak Tree Park Apartments  
Overland, Missouri  
Project No. 085-11052

We have completed a review of the operations of Oak Tree Park Apartments for the period from November 1998 until the transfer of physical assets on August 28, 2000. We performed this review at the request of your office. We reviewed Oak Tree Apartment's use of project funds to determine if the owners complied with the terms of their Regulatory Agreement. We did not review any other operations of the property.

We determined that the owners, G & K Properties, used \$222,012 in violation of the Regulatory Agreement during the audit period. This includes tenant rental payments that were never deposited to the project bank account and disbursements for uses that were ineligible or not documented. Although the owners were also the HUD-approved management agent, they never accrued or paid themselves a management fee. As the management agent, they earned a management fee of \$57,299 during our audit period that they should have paid themselves but did not. We offset the \$57,299 against the \$222,012 and determined the net diversion was \$164,713. This memorandum contains two recommendations.

Within 60 days please provide us, for each recommendation in this memorandum, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Also, please furnish us copies of any correspondence or directives issued because of the audit.

Should you or your staff have any questions, please contact me at (913) 551-5870.

## **Background**

Under the 223(f) program, HUD insured a \$2,720,000 mortgage refinance for Oak Tree Apartments. Oak Tree Apartments is located in Overland, Missouri and consists of 140 two-bedroom units in 35 buildings. G & K Properties, a profit-motivated partnership, was the owner of Oak Tree during our audit period. On May 28, 1997, HUD endorsed the mortgage for insurance upon completion of repairs and G & K signed its Regulatory Agreement. After completing required repairs, the owners submitted the certificate of actual cost in October 1998.

We received a referral from HUD's staff on July 31, 2000 regarding diversion of funds by the owners of Oak Tree Apartments. According to the referral, G & K Properties diverted funds from the project. The diversion came to HUD's attention after HUD reviewed audited financial statements submitted by the project as part of a transfer of physical assets application. As a result, HUD required the owners to escrow \$200,000 for correction of potential deficiencies as a condition of the transfer. HUD's Kansas City Office of Housing referred this matter to HUD's Enforcement Center and requested an OIG review. On August 28, 2000, Gundaker Commercial Group, as Oak Tree Associates, L.P., assumed ownership of the property. Our audit covered the period between the cost certification and the transfer of physical assets.

## **Objectives, Scope and Methodology**

The overall audit objective was to determine whether project officials used project funds for purposes other than reasonable operating expenses and necessary repairs, except for allowable distributions from surplus cash. To achieve our objective, we reviewed the project's bank statements, canceled checks, and invoices. We reviewed tenant records maintained by the new owners at the project office. We interviewed the prior owners. We also reviewed HUD guidelines deemed appropriate to accomplish our objective. The audit covered the period from November 1, 1998 through August 28, 2000.

## **Audit Results**

We found that the owners, G & K Properties, used \$222,012 in violation of the terms of their Regulatory Agreement. This includes tenant rental payments that were never deposited to the project bank account and disbursements of funds for uses that were ineligible or not documented. Although the owners were also the HUD-approved management agent, they never accrued or paid themselves a management fee. As the management agent, they earned a management fee of \$57,299 during our audit period that they should have paid themselves but did not. As a result, we offset the \$57,299 against the \$222,012 spent in violation of the Regulatory Agreement to arrive at a net diversion of \$164,713.

The owners did not keep adequate records of the income received by the project. Based on the limited information available to us, \$100,767 in rents should have been deposited to the project's bank account, but was not. The owners only provided receipts evidencing \$971 in cash payments. Therefore, the difference of \$99,796 is unaccounted for.

The Regulatory Agreement requires that all rents and other receipts of the project must be deposited in the project bank account. HUD guidelines require that all disbursements must be supported by approved invoices/bills and that appropriate controls must be in place over receipts and disbursements.

The owners did not have an appropriate control over cash receipts. The only evidence that collections were received was a handwritten list of amounts received with a deposit ticket stapled to the back. The amount on the list frequently exceeded the amount deposited. Sometimes, notes were made on the handwritten list that indicated cash payments were made, but there were not receipts or other records to support the payments. The owners said they had to hold out cash from their deposits because it was the only way they could get cleaning people. A review of the amounts on the handwritten list versus the amounts deposited showed the owners retained \$35,537 in cash. In addition, there was no control to ensure rent collections were not omitted or understated on the list and not deposited in the account. By reviewing information available in the tenant files and from the housing authority, we identified \$65,230 in tenant rents that should have been collected and deposited, but were not. As previously mentioned, the owners improperly retained \$99,796 in project funds and either used the funds for ineligible purposes or could not support how the funds were used.

Further, the owners spent project funds that were deposited to the project account for purposes other than reasonable operating expenses and necessary repairs of the project. These unallowable and unsupported disbursements totaled \$122,216.

The owners spent \$36,301 for ineligible purchases, including payments related to a Ford Explorer for one owner, payments for invoices not billed to Oak Tree, payments on a \$50,000 loan taken out for project improvements but not approved by HUD, and payments for other ineligible purposes. The owners said the payments on invoices not billed to Oak Tree were in fact used for the project, but they could not provide documentation to support the connection. In addition, the owners spent \$165,212 for expenses that they could not support. Of this amount, \$132,549 was paid to CERJ, a related company of the owners' that was also used to pay the Oak Tree payroll. Although the individual checks were not supported by documentation tying them to specific payroll and other reimbursements, a review of the CERJ bank account revealed that \$79,297 was spent by CERJ to pay Oak Tree payroll and other expenses. Therefore, we subtracted this amount from the unsupported expenses.

The owners said that all the money that was disbursed from the operating account was solely for the benefit of the project. They said that all expenses were paid upon receipt of an invoice from a company or supplier, and if invoices were missing, they did not know what happened to them. The owners said that they did not follow HUD's rules and regulations because they were not aware of them. They said HUD should have taught them.

The following table summarizes the information described above:

Unallowable Expenses	\$36,301
Unsupported Expenses	\$165,212
Less: Total for Oak Tree paid out of CERJ	\$79,297
<b>Total Amount Unallowable and Unsupported</b>	<b>\$122,216</b>
Undeposited Rent Collections	\$100,767
Less: Receipts for Cash Purchases	\$971
<b>Total Amount Unaccounted for</b>	<b>\$99,796</b>
<b>Total Amount Unallowable, Unsupported, and Unaccounted for</b>	<b>\$222,012</b>
Less: Management Fee that the Project was Allowed	\$57,299
<b>Total Amount due from Owners</b>	<b>\$164,713</b>

In August 2000, the owners escrowed \$200,000 to guarantee payment for the correction of deficiencies identified by the financial statement auditors. Of this amount, \$39,277 was immediately transferred to the new owners to cover under funded security deposits. The balance of \$160,723 was kept in the escrow fund to be paid to the project should HUD determine reimbursement is necessary. This escrow balance is insufficient to cover the total amount we determined was inappropriately used by the owners. In addition to the escrow amount, another \$3,990 is required from the owners to cover the deficiencies.

### **Auditee Comments**

Excerpts from G & K Properties' comments on our draft finding follow. Appendix A contains the complete text of the comments.

*G & K believes that upon the sale of the project to the new owners, all accounts related to the project were funded at appropriate levels from investment returns to the owners of the Company and according to agreements reached with a division of HUD in connection with the preliminary approval for the sale of the project. The project, has been made whole by the owners of the project from the proceeds of the return on their investment in the project. Since the project has been made whole from the personal resources of the owners of the Company, HUD, in essence, is requesting that the owners now make the project whole from their own personal resources an inappropriate second time.*

### **OIG Evaluation of Auditee Comments**

As a condition for approving the sale of the property, HUD required G & K to establish a \$200,000 escrow account to guarantee payment for correction of deficiencies that HUD

determines occurred under the Regulatory Agreement. The escrowed funds were to be used to reimburse the buyer for under funded security deposits and to reimburse the project for disbursements of project funds that were not for reasonable and necessary project expenses and exceeded the amount of surplus cash that was available. Funds to reimburse under funded security deposits were immediately transferred to the new owner upon closing. Our audit determined \$164,713 is needed to satisfy the inappropriate disbursements when surplus cash was not available. Transferring the funds out of the escrow account according to the escrow agreement is not requiring the owners to repay the project a second time.

### **Auditee Comments**

*G & K disputes our finding that they could not account for \$99,796 in rent receipts. They claim that substantial portions of this amount (at least \$35,573) relates to them having to pay cleaning personnel in cash. G & K said they retained residents of the project to perform maintenance services. The workers were paid in cash. The payments were small in nature, and the Company does not believe that any one person was paid more than \$600 in any one year. The Company indicated that it attempted to make notations of the cash paid to individuals on calendar year 1999 reports. G & K said since this issue was brought to their attention, cash amounts paid were documented and reconciled from total amounts collected and compared to amounts deposited in the bank. The Company believes that the balance of the amounts questioned by HUD in this category relate to scheduled rent payments that were not actually received by the Company.*

### **OIG Evaluation of Auditee Comments**

The Regulatory Agreement requires that all project funds must be promptly deposited in the project bank account. Therefore, holding cash out of the deposits is improper. G & K was not able to provide us with proof of cash payments. They did not have receipts and could not give us dates, payment amounts, or even the names of workers. The only documentation available to support the payments was notations made on the deposit tickets, such as "1100 cleaning people". There were 15 such notations made from May 1999 through August 2000 totaling \$14,857. These are not adequate evidence of proper project expenses.

G & K said the balance of the amounts questioned were rent payments not actually received by the Company. We were not able to substantiate whether the collections were actually made because G & K did not have, or destroyed applicable rent receipts. However, in the one case where we had a tenant's rent receipt and G & K records, we found the tenant paid her full rent, but only a portion of it was recorded as received on G & K records. If tenants were in fact not paying rent, as G & K said, G & K files should have contained delinquency notices, bad debt expenses should have been recorded, and tenants should not have been permitted to continue occupancy. For example, one tenant occupied her unit until the sale in August 2000, although G & K did not record any rent collections after June 1999. Owners of projects have a responsibility to operate projects efficiently. Additionally, HUD requires owners to maintain proper accounting records to support their operations.

### **Auditee Comments**

*G & K has no objection to HUD's request for reimbursement for the automobile expenses, but the company disputes reimbursing other items. G & K said project funds were only used to purchase items for the project. G & K admits to using accounts from related entities, but only for the purpose of taking advantage of preferred customer credit and pricing and for administrative expediency and economy. For example, it was not possible for G & K to obtain "good-customer" pricing and credit from vendors while using the name of the recently formed company with no operating history or financial background. These financial advantages that G & K provided to the project caused record-keeping challenges that have been identified by HUD. The financial record-keeping challenges should not cause HUD to overlook the intent of G & K to advance the financial well-being of the project. At the time in question, G & K and related affiliates owned only two properties – the project (a residential facility) and a commercial building. The receipts for the purchases show the purchase of materials for a residential facility. The owners of the G & K are willing to provide sworn statements from them and vendors as to the use of the products purchased by the Company directly and through an affiliate.*

### **OIG Evaluation of Auditee Comments**

The Regulatory Agreement required G & K to maintain its documents in reasonable condition for proper audit and that books and accounts shall be kept in accordance with the Secretary's requirements. HUD Handbooks require that all disbursements must be supported by approved invoices/bills or other supporting documents. G & K's records were not properly maintained. When invoices indicated that a purchase through an affiliate was in fact for the project, due to the shipping address or customer name being listed as that of Oak Tree or G & K, we accepted those payments. But, in the absence of documents indicating the products purchased were for Oak Tree, we cannot assume that because the payments were to a plumbing company or a building supply company, that the payments were for allowable expenses of the project.

### **Auditee Comments**

*G & K argued that with respect to the funds used to repay a loan from Enterprise Bank in the amount of \$50,000, the Company began conducting negotiations with Enterprise Bank prior to HUD's approval of the project. The loan discussions were prompted by the need to raise required capital to respond to HUD's and the City of Overland, Missouri directives as a precondition to obtaining occupancy permits. Accordingly, the Company believed in good faith that the already contemplated loan was essential to the viability of the project, the loan was effectively grand fathered, and it was proper to repay the loan from project receipts. This assumption was based, in part, on the fact that the need for the loan was dictated by governmental requirements, including requirements of HUD. Even if HUD takes the position that the Enterprise Bank loan was not grand fathered since the transaction was clearly contemplated prior to the closing, it is inconceivable that HUD would require expenditures to make repairs and then not allow the owners to repay the loan that produced the repairs.*

### **OIG Evaluation of Auditee Comments**

HUD's Commitment to Insure Upon Completion, dated April 11, 1997 and revised April 23, 1997, does require that repairs must be completed as a condition of receiving mortgage insurance from HUD. However, it also requires in the Special Conditions that the Second Deed of Trust and Line of Credit borrowing must be paid off, and neither may be reestablished in a manner that encumbers the property. Oak Tree Apartments did not secure the Enterprise Loan, dated September 8, 1997, and the loan should not have been repaid out of project funds. The Regulatory Agreement prohibits paying project funds for other than reasonable operating expenses and necessary repairs, except from Surplus Cash. Development costs are neither operating expenses nor repairs. Therefore, repayment of this loan, even if it was used toward development costs, is not allowed from project funds.

### **Recommendations**

We recommend the Director, Office of Kansas City Multifamily Housing HUB:

- 1A. Take appropriate steps to recover the \$164,713 in project funds that were used for ineligible expenses or for which the use is unsupported. Any funds transferred to project accounts should be put in a reserve account over which HUD has control to ensure they are used to benefit the project and its tenants.
- 1B. Take appropriate administrative actions against G & K Properties for their mismanagement of Oak Tree funds.

# Auditee Comments

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LAW OFFICES

**BLUMENFELD, KAPLAN & SANDWEISS, P.C.**

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September 24, 2001

Roger E. Niesen  
District Inspector General for Audit  
U.S. Department of Housing and Urban Development  
Office of Inspector General for Audit  
Great Plains District, 7AGA  
Gateway Tower II - 5<sup>th</sup> Floor  
400 State Avenue  
Kansas City, Kansas 66101-2406

Dear Mr. Niesen:

This law firm represents G & K Properties (the "Company"). The Company has asked us to send this response to your August 31, 2001 draft letter regarding the audit conducted by the United States Department of Housing and Urban Development's Office of Inspector General for Audit ("HUD") in connection with the Oak Tree Park Apartments (the "Project"). On behalf of the Company, set forth below is a response to your draft correspondence.

As the outset, please be advised that, upon the sale of the Project to the new owners, all accounts related to the Project were funded at appropriate levels from investment returns to the owners of the Company and according to agreements reached with a division of HUD in connection with the preliminary approval for the sale of the Project. The Project, then has been made whole by the owners of the Project from the proceeds of the return on their investment in the Project, and, accordingly, we urge HUD to take this factor into account in assessing any amounts owed to the Project by the Company and/or the owners. Since the Project has been made whole from the personal resources of the owners of the Company, HUD, in essence, is requesting that the owners now make the Project whole from their own personal resources an inappropriate second time.

**A. Findings.** *We found that the owners, G & K Properties, used \$222,012 in violation of the terms of their Regulatory Agreement during our audit period. This includes tenant rental payments that were never deposited to the [P]roject bank account and disbursements of funds for uses that were ineligible or not documented. Although the owners were also the HUD-approved management agent, they never accrued or paid themselves a management fee. As the management agent, they earned a management fee of \$57,299 during our audit period that they should have paid themselves but did not. As a result, we offset the \$57,299 against the \$222,012 spent in violation of the Regulatory Agreement to arrive at a net diversion of \$164,713.*

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*The owners did not keep adequate records of the income received by the [P]roject. Based on the limited information available to us, \$100,767 in rents should have been deposited to the [P]roject's bank account, but was not. The owners only provided receipts evidencing \$971 in cash payments. Therefore, the difference of \$99,796 is unaccounted for.*

*The Regulatory Agreement requires that all rents and other receipts of the [P]roject must be deposited in the [P]roject bank account. HUD guidelines require that all disbursements must be supported by approved invoices/bills and that appropriate controls must be in place over receipts and disbursements.*

*The owners did not have an appropriate control in place over cash receipts. The only evidence that collections had taken place was a handwritten listing of checks received with a deposit ticket stapled to the back. The amount on the listing frequently exceeded the amount deposited. Sometimes, notes were made on the handwritten listing that cash payments were made, but there were not receipts or other records to support payments were actually made. The owners said they had to hold out cash from their deposits because it was the only way they could get cleaning people. A review of the amounts listed versus the amounts deposited showed that the owners held out \$35,537 in cash. In addition, there was no control over rent collections being omitted or understated on the listing and not deposited to the account. By reviewing information available in the tenant files and from the housing authority, we identified \$65,230 in tenants rents that should have been collected and deposited, but were not. As previously mentioned, the owners improperly retained \$99,796 in [P]roject funds and either used the funds for ineligible purposes or could not support how the funds were used.*

On behalf of the Company, we dispute your finding of \$99,796 in unaccounted-for rent receipts. Substantial portions of this amount (at least \$35,573) relate to the circumstances reported by the Company that it experienced problems with retaining reliable help in cleaning the units in the Project. In response to these conditions, the Company retained residents of the Project to perform maintenance consulting services. The workers were paid in cash. The payments were small in nature, and the Company does not believe that any one person was paid more than \$600 in any one year. The Company indicated that it attempted to make notations of the cash paid out to individuals on the reports in calendar year 1999. The Company also reports that, since this issue was brought to the attention of the Company, cash amounts paid were documented and reconciled from total amounts collected and compared to amounts deposited in the bank.

The Company believes that the balance of the amounts questioned by HUD in this category relate to scheduled rent payments that were not actually received by the Company. The Company is in the process of reviewing HUD's work papers to provide additional information on these amounts.

**B. Additional Findings.** *In addition, the owners spent [P]roject funds for purposes other than reasonable operating expenses and necessary repairs of the [P]roject. These unallowable and unsupported disbursements totaled \$122,216.*

The owners spent \$36,301 for ineligible purchases, including payments related to a Ford Explorer for one owner, payments for invoices not billed to Oak Tree, payments on a \$50,000 loan taken out for project improvements but not approved by HUD, and payments for other ineligible purposes. The owners claimed that the payments on invoices not billed to Oak Tree were in fact used for the [P]roject, but they could not provide supporting documentation proving the purchases were used for these purposes. In addition, the owners spent \$165,212 for expenses that they could not support. Of this amount, \$132,549 was paid to CERJ, a related company of the owners' that was also used to pay the Oak Tree payroll. Although the individual checks were not supported by documentation tying them to specific payroll and other reimbursements, a review of the CERJ bank account revealed that \$79,297 was spent by CERJ to pay Oak Tree payroll and other expenses. Therefore, this amount was netted against the unsupported checks.

The owners said that all the money that was spent from the operating account was solely for the benefit of the [P]roject. They said that all expenses were paid upon receipt of an invoice from a company or supplier, and if invoices were missing, they did not know what happened to them. The owners said that they did not follow HUD rules and regulations because they were not aware of them. They said HUD should have taught them.

The following table depicts the information described above:

<i>Unallowable Expenses</i>	<i>\$36,301</i>
<i>Unsupported Expenses</i>	<i>\$165,212</i>
<i>Less: Total for Oak Tree paid out of CERJ</i>	<i>\$79,297</i>
<i>Total amount Unallowable and Unsupported.</i>	<i>\$122,216</i>
<i>Undeposited rent collections</i>	<i>\$100,767</i>
<i>Less: receipts for cash purchases</i>	<i>\$971</i>
<i>Total amount Unaccounted for</i>	<i>\$99,796</i>
<i>Total Unallowable, Unsupported and Unaccounted</i>	<i>\$222,012</i>
<i>Less: Management fee that the project was allowed</i>	<i>\$57,299</i>
<i>Total Amount due from owners</i>	<i>\$164,713</i>

The Company has no objection to HUD's request for reimbursement for the automobile expenses. The Company, however, disputes the other items raised by HUD. The owners of the Company have represented that Project funds were only used to purchase items for the Project. The owners admit to using accounts from related entities, but only for purpose of taking advantage of preferred customer credit and pricing and for administrative expediency and economy. For example, it was not possible for the owners to obtain "good-customer" pricing and credit from vendors while

using the name of the Company, a recently formed business with no operating history or financial background. The owners thus used an affiliated entity in order to provide the Project with the best financial conditions that the owners could. These financial advantages that the owners provided to the Project caused record-keeping challenges which have been identified by HUD. The financial record-keeping challenges should not cause HUD to overlook the intent of the owners of the Project to advance the financial well-being of the Project by utilizing affiliated entities with established credit.

Please also note that, at the time in question, the Company and related affiliates owned only two properties – the Project (a residential facility) and a commercial building. The receipts for the purchases show the purchase of materials for a residential facility. From a practical standpoint the materials would have been used only at the Project and not at the owner's residential facility. The owners of the Company are willing to provide sworn statements from them and vendors as to the use of the products purchased by the Company directly and through an affiliate. Under the circumstances described in this letter, equity requires use of collateral evidence.

With respect to the funds used to repay a loan from Enterprise Bank in the amount of \$50,000, please note that the Company began conducting negotiations concerning the Enterprise Bank loan prior to HUD's approval of the Project. The loan discussions were prompted by the need to raise required capital to respond to HUD directives to improve grading and drainage at the Project and directives from the City of Overland, Missouri, for the Company to implement street improvements in the form of various paving services as a precondition to obtaining occupancy permits. Accordingly, the Company believed in good faith that the already contemplated loan was essential to the viability of the Project, that the loan was effectively grand fathered, and it was proper to repay amounts on the loan from Project receipts. This assumption was based, in part, on the fact that the need for the loan was dictated by governmental requirements, including the requirement of HUD. Even if HUD takes the position that the Enterprise Bank loan was not grand fathered since the transaction was clearly contemplated prior to HUD closing, it is inconceivable that HUD would require expenditures to make repairs and then reject effort on the part of the owners to repay the loan that produced the repairs.

Thank you for your cooperation. Please call us if you require additional information.

Sincerely,



Charles R. Saulsberry  
CRS/slw

cc: Edward Kifer  
Riley Geitz

# Distribution

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