



MAGNOLIA LANE APARTMENTS
PROJECT MANAGEMENT OPERATIONS
CONWAY, SOUTH CAROLINA


2002-AT-1001
JUNE 5, 2002

OFFICE OF AUDIT
SOUTHEAST/CARIBBEAN REGION



Issue Date	June 5, 2002
Audit Case Number	2002-AT-1001

TO: Glenda L. Fesperman, Acting Director, Columbia Multifamily Program
Center, 4EHM

FROM: Nancy H. Cooper 
Regional Inspector General for Audit-Southeast/Caribbean, 4AGA

SUBJECT: Magnolia Lane Apartments
Project Management Operations
Conway, South Carolina

We completed an audit of Magnolia Lane Apartments, Conway, South Carolina. We conducted the audit pursuant to a request by your office. This report contains two findings that require follow-up action by your office to implement appropriate corrective action.

You have completed final action on recommendation No. 1A. Within 60 days please provide us, for recommendations 1B and 1C in this report, 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 questions, please contact Terry A. Cover, Assistant Regional Inspector General for Audit, or Senior Auditor, Narcell Stamps, at (404) 331-3369.

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Executive Summary

We conducted the audit of Magnolia Lane Apartments in response to a request by the Department of Housing and Urban Development (HUD), Columbia State Office, Multifamily Program Center. We reviewed certain aspects of project operations for compliance with HUD requirements. Specifically, the audit objective was to determine if the mortgagor used project-operating funds in compliance with the Regulatory Agreement and HUD requirements specifically related to the distributions of earnings. We did not audit project construction activities and costs.

The owner/manager of Magnolia Lane misused project operating and trust funds, and encumbered project assets in violation of its Regulatory Agreement. Although funds were available for at least six mortgage payments, the owner made no payments, causing the mortgage default and subsequent assignment to HUD. Throughout the period of default, the owner ignored HUD's repeated requests for monthly accounting reports it needed to monitor project revenues and disbursements. Also, the owner did not remit net project cash (funds remaining after payment operating expenses) to HUD's lock box as HUD requested.

The owner disbursed \$185,129 in project operating and trust funds for ineligible distributions (\$166,364), unreasonable and unnecessary costs (\$15,558), and unsupported costs (\$3,207.) The distributions included \$148,625 paid after the mortgage default, constituting an equity skimming violation. The owner directly benefited from \$82,434 of the ineligible disbursements. The owner improperly encumbered a project escrow account for \$100,000 to secure unspecified notes, and spent \$43,225 in tenant security deposits and prepaid rent which were required to be held in trust accounts to cover the corresponding project liabilities. We attribute these conditions to the owner's failure to abide by HUD requirements specified in the Regulatory Agreement that he signed.

We recommend that your office obtain mortgagee-in-possession (action completed) to secure and protect HUD's interest in this project. We further recommend that your office debar the mortgagor and its individual principals from future participation in HUD programs; require the owner to reimburse the project operating and trust accounts for \$166,364 of ineligible disbursements and \$15,558 of costs found to be unreasonable and unnecessary; and require adequate documentary support, or reimbursement, for \$3,207 of unsupported costs.

We discussed the violations with the owner during the audit and at an exit conference on April 25, 2002. The owner provided written responses to the draft report on May 9, 2002. The owner disagreed with certain conclusions reached in finding 1 but he basically agreed with finding 2. The owner's written comments, minus the lengthy exhibits, are presented in Appendix D. We considered the owner's response in finalizing the report. The owner's comments are summarized within each finding. We will provide the owner's comments with exhibits to your office under separate cover.

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Abbreviations

HUD United States Department of Housing and Urban Development

Introduction

Background

Magnolia Lane Apartments, located in Conway, South Carolina, is a 48-unit profit motivated project owned by Magnolia Lane Inc, (Mortgagor). HUD authorized and financed the project under section 221(d)(4) of the National Housing Act. The stockholders in the mortgagor entity were James C. Hicks, President (48 percent); Margaret L. Hester, Vice President (48 percent); and Superior Construction Greenville LLC, general contractor (4 percent). Ms. Hester and Mr. Hicks are sister and brother. Mr. Hicks (herein referred to as “owner”) managed, controlled, and directed all aspects of the project and maintained the project’s books and records.

On November 2, 2000, the owner signed the substantial completion certificate for this newly built project. However, after signing the certificate, he questioned the adequacy and completeness of the general contractor’s work and refused to pay the contract retainage. On January 29, 2002, the general contractor filed suit against the mortgagor seeking payment and damages. We did not audit these issues since they were known to HUD and were being reviewed by HUD’s Columbia State Office staff.

The owner made no mortgage payments from project operating revenues and allowed the mortgage to go into default on April 1, 2001. The lender paid the only payments made on the mortgage. For February and March 2001, the lender paid mortgage payments from the project’s operating deficit and working capital reserve account. The lender filed an assignment of the mortgage to HUD on July 10, 2001. HUD provided the mortgagor with an opportunity to submit a workout plan to bring the mortgage current. The mortgagor submitted a work out plan, but HUD rejected it because it did not meet requirements. As a result, the Columbia State Office recommended foreclosure on the mortgage. Subsequently, HUD’s Headquarters’ Office decided to sell the project in the upcoming July 2002 note sale versus foreclosure.

While the audit was in process, the Columbia State Office referred the mortgagor to HUD’s Enforcement Center, issued limited denials of participation against the owner and his sister (co-owner), and initiated steps to debar them. Also during the audit, the HUD Office of General Counsel, working with the Enforcement Center, contacted the owner and demanded that he turn over control of the project to HUD. Immediately following the April 25, 2002, exit conference HUD’s staff again met with the owner and his attorney concerning the mortgagee in possession agreement. The owner signed HUD’s mortgagee in possession agreement on April 25, 2002, granting HUD control of the project. HUD’s contract manager arrived on site on April 26, 2002, to take physical control of the project and assumed management of project operations.

Audit objectives and scope

The audit objective was to determine if the mortgagor used project-operating funds in compliance with the Regulatory Agreement and HUD requirements specifically related to the distributions of earnings. We did not audit project construction activities and costs.

To accomplish the objective, we reviewed project records at HUD's Columbia, South Carolina, office and at the office of an attorney representing the owner/manager of Magnolia Lane Apartments in Conway, South Carolina. The owner/manager arranged for us to review project records at the attorney's office. We also interviewed officials at HUD's Columbia and Atlanta offices, the owner/manager, the owner's attorney, and four tenants.

The audit covered the period December 1, 2000, through December 15, 2001. During this period, the project disbursed \$244,194 from its operating account. We reviewed \$201,603, or 83 percent of the disbursements. We selected and reviewed disbursements based on the dollar amount and the type or name of the payee. We conducted the audit from December 2001 through March 2002 in accordance with generally accepted government auditing standards.

Mismanagement of Project Funds and Assets Contributed to Mortgage Default and Assignment

Magnolia's managing owner improperly disbursed \$185,129 in project operating and trust funds, while not making mortgage payments and ignoring HUD's requests for monthly accounting reports. The questioned disbursements consisted of \$166,364 for ineligible distributions, \$15,558 for unreasonable costs, and \$3,207 for unsupported costs. The ineligible distributions included \$148,625 disbursed after mortgage default and \$108,162 after HUD specifically warned the owner about improper distributions. The owner also encumbered project assets for \$100,000 to secure unspecified notes. The misuse of funds contributed to the mortgage default and HUD's recommendation to foreclose on the mortgage. We attribute these conditions to the owner's failure to abide by HUD requirements.

Owner not responsive to HUD

At HUD's request, the owner shall furnish monthly occupancy reports and shall give specific answers to questions upon which information is desired from time to time relative to income, assets, liabilities, contracts, operations, conditions of the property, and the status of the insured mortgage (Regulatory Agreement Section 9(f)). HUD provided the owner with the form "Monthly Report for Establishing Net Income" used to prepare monthly reports. The form provided for detailed reporting of project cash balances, disbursements, and accounts payable.

The owner did not comply with HUD's repeated requests for monthly accounting reports and to HUD's request to remit net cash, after payment of operating costs, to HUD's lock box. The owner's noncompliance was significant considering that he made no mortgage payments and used project funds for unauthorized purposes. HUD made the following requests for monthly accounting reports and remittance of project net cash:

Date	Type Request	Nature of HUD's Request
March 12, 2001	Letter	Monthly Accounting Report
May 22, 2001	Letter	Monthly Accounting Report

Finding 1

July 18, 2001	Letter	Monthly Accounting Report
July 18, 2001	Letter	Remit net cash (cash remaining after payment of costs for operations and maintenance) to HUD's lock box.
September 6, 2001	Meeting	Monthly Accounting Report

The owner did provide HUD with limited financial information (balance sheet and operating statements) during a September 6, 2001, meeting. However, the owner never provided the requested monthly reports. This violation deprived HUD of the financial information it needed to monitor project revenues, disbursements and obligations.

Near the completion of the audit, the owner also became unresponsive to our requests for information. The owner initially cooperated and provided information we requested for the audit. However, as we prepared to finalize on-site audit work, the owner did not respond to our written request and repeated telephone calls to schedule a final visit to update financial information through January 31, 2002. We terminated on-site work without obtaining updated financial data. We decided to report our findings based on the information through December 15, 2001, rather than delay the report while seeking additional records via legal enforcement processes.

Ineligible distributions

Distributions means any withdrawal or taking of project cash or any assets of the project including the segregation of cash for subsequent withdrawal, excluding payments for reasonable expenses incidental to the operations and maintenance of the project (Regulatory Agreement, Section 13(g)). Without HUD's prior written permission, owners shall not make or receive and retain any distribution of assets or any income of any kind of the project except surplus cash. Owners shall not make distributions from borrowed funds, prior to completion of the project, or when

there is any default under the Regulatory Agreement or under the note or mortgage (Regulatory Agreement, Section 6(e)). Any owner receiving such funds in violation of the Regulatory Agreement shall hold such funds in trust (Regulatory Agreement, Section 9(g)).

The owner disbursed \$166,364 from project operating funds for ineligible distributions, including \$82,434 that directly benefited the owner. Appendix B provides a detailed listing of the expenditures summarized below:

Description of Distributions	Improper Distribution	Characteristics of the Distributions		
		Portion After Mortgage Default	Portion After Written Warning	Amount Benefiting Owner
Transfers to Money Market Account	\$53,000	\$ 53,000	\$ 53,000	\$19, 832
Payments To or For Owner	38,828	32,886	15,103	38,828
Washers and Dryers	29,337	23,247	17,052	0
Repayment of Loans	20,589	19,389	11,247	20,589
Legal Fees	13,501	12,301	9,411	0
Other	11,109	7,802	2,349	3,185
Totals	\$166,364	\$148,625	\$108,162	\$ 82,434

Transfers to Money Market Account - The owner transferred \$53,000 from the operating account to a money market account maintained in the name of the mortgagor entity, Magnolia Lane, Inc. The owner subsequently disbursed \$19,832 to an identity-of-interest firm, H&H Investments as partial payment on four loans totaling \$53,154, which the owner recorded on the project books. The owner stated that he also owned H&H Investments and that the loans resulted from amounts H&H paid for project contractor fees and construction costs. The loans were subordinate to the defaulted mortgage. The owner also disbursed \$15,000 for a legal retainer fee in a suit against the general

Finding 1

contractor. The legal fee was a mortgagor expense versus an expense incident to the operation and maintenance of the project. As of December 15, 2001, the owner had not spent the remaining \$18,299 (including interest).

The construction cost (\$53,154) H&H paid with proceeds from the four loans were not included in the independent public accountants report of the mortgagor actual cost to construct Magnolia Lane. The owner recorded the \$53,154 cost and loans between January 2 and 4, 2001, by debits to the building asset account and credits to notes payable. The transactions occurred the week after the independent public accountant's December 31, 2000, audit cut-off date. The costs, if related to construction, should have been included in the independent public accountant's certified costs.

The owner's written response to the finding did not list and specify the costs H&H paid for construction. We did not pursue the issue because even if the expenditures were for legitimate construction costs the owner was prohibited from using operating funds to pay for them.

Payments To or For Owner - The \$38,828 included \$18,178 for excessive and ineligible 2001 management fees, \$18,900 for ineligible management fees attributed to the prior year (2000), \$1,335 for a duplicate payment, and \$415 for owner medical expenses.

The excessive 2001 management fee exceeded the allowed fee based on the five percent fee rate stipulated in the management certification the owner executed with HUD. The owner claimed that he earned the 2000 fee due to the extraordinary time spent dealing with construction problems. The owner received separate compensation for managing construction through the \$267,724 profit and risk allowance paid from mortgage proceeds and included in the project's certified construction cost. The duplicate payment was for a cost the owner paid from project funds to a vendor (check number 1242) and subsequently reimbursed himself for the same cost by check number 1298.

Washers and Dryers - The \$29,337 required HUD's approval as a capital purchase. HUD staff stated they did not authorize the owner to use project-operating funds to purchase the units.

Repayment of Loans - The \$20,589 was for payments on a \$50,000 personal note the owner obtained from a local bank on January 12, 2001. The owner did not deposit the loan proceeds to the project's operating account and we did not determine what the owner did with the funds. The loan payments were not related to project operations and they were subordinate to the defaulted mortgage.

Legal fees - The \$13,501 was for legal fees related to construction issues between the mortgagor entity and contractor. These costs do not qualify as project operation and maintenance expenses.

Other - The \$11,109 was for various costs attributed to construction or the mortgagor entity versus expenses for project operations and maintenance. The payments included \$5,789 for construction work and an extension fee, \$2,309 for non-mortgage interest, \$2,135 for office furnishings, and \$876 for cash transferred to bank accounts of the mortgagor and an affiliate, H&H Investment Inc.

The above distributions violated the project Regulatory Agreement and are subject to the double damages remedy for unauthorized use of multifamily housing project assets and income (12 USC 1715z-4). The \$148,425 paid after mortgage default is subject to remedy under the equity stripping statute (12 USC 1715z-19). The distributions included \$108,162 disbursed after a HUD letter dated July 18, 2001, specifically warned the owner about using project funds for improper purposes. The letter stated that until the mortgage was current, you are prohibited from taking any owner distributions, repaying any funds advanced to the project, or repaying either interest or principal on any project obligation junior to the HUD mortgage. The letter cited the Federal Statutes related to equity stripping and double damages.

We interviewed the owner and his attorney to determine why the owner continued to make improper distributions after receiving the HUD notice. The owner claimed that he did not receive the notice. HUD's files show that it sent the letter to the owner by certified mail at two different addresses. The owner signed certified receipts for the both copies of the letter, one on July 23, and the other on July 27, 2001.

Unreasonable and unsupported costs

The owner executed a Management Certification with HUD whereby he agreed to ensure that all expenses of the project are reasonable and necessary. Section 9(c) of the Regulatory Agreement provides that the mortgage property, equipment, building, plans, office, apparatus, devices, books, documents, and other papers thereto, shall at all times be maintained in reasonable condition for proper audit and inspection. The owner shall keep copies of all written contracts or other instruments that may be subject to inspection and examination. HUD Handbook 4370.2, Financial Operations and Accounting Procedures, paragraph 2-6E, provides that all disbursements from the regular operating account (including checks, wire transfers and computer generated disbursements) must be supported by approved invoices, bills, or other supporting documentation.

The owner disbursed \$18,765 for costs that were not necessary and reasonable (\$15,558) and for unsupported costs (\$3,207). Appendix C provides a detailed listing of the unreasonable and unsupported costs discussed below:

- Management fee \$8,140 - We question management fees paid to the owner/manager because he did not fulfill management responsibilities. He did not comply with the management certification, and with HUD requests for information and to obtain professional management. The owner caused significant violations as noted by the audit. We calculated the \$8,140 fee based on the 5 percent fee rate applied to project revenues as stipulated in the management certification.

- Vehicle expenses \$4,421 – The owner paid another entity, Armfield, \$4,000 for a 1993 model truck he sold to the mortgagor entity, Magnolia Lane Apartments, Inc. The owner provided a title that showed he owned the truck and that he signed the title over to Magnolia Lane. We did not determine why the owner made the check payable to Armfield versus to himself. The owner also paid \$255 for insurance and a \$165 tag fee for the truck. HUD should assess the reasonableness of the price the project paid for the truck and whether the 48-unit project needed the truck.
- Realty fees \$2,997 - The owner paid fees to a firm that assisted with renting up the project. The owner did not execute a contract for the services. HUD questioned the need for the services in a finding from its July 2001 monitoring of project operations. The owner did not maintain invoices for some of the payments. In some instances, the owner offset the fee against collections and did not write checks for the payments. The owner posted adjusting entries to record the non-check transactions.

The owner also disbursed \$3,207 for costs not supported by invoices. Absent invoices showing the nature and purpose of the expenses, eligibility cannot be determined. The unsupported costs included \$2,177 the owner paid to himself for travel and other unspecified costs and \$1,030 paid to vendors.

**Unauthorized
encumbrance of
assets**

Without HUD's prior written permission, owners shall not convey, transfer, or encumber any of the mortgaged property, or permit the conveyance, transfer or encumbrance of such property (Regulatory Agreement, Section 6(a)).

On February 1, 2001, the owner pledged \$100,000 of the project's escrow account for operating deficit and working capital as partial collateral for unspecified notes owed to an individual. The owner executed an \$80,000 personal note with the individual on January 7, 1999, and another \$50,000 personal note on February 15, 2000. The notes

were not recorded in the project's general ledger. Subsequently, the individual filed suit against the owner for non payment of the note. The complaint showed the owner used his home and project assets to secure the note.

**Auditee comments
(summary)**

“Although the audit did not include a review of construction activities and costs, it is imperative that such issues be considered in order to ensure that a fair and just conclusion is reached regarding the project's financial records and expenditures. From the very inception of the construction process, the owner, in addition to everyday management activities associated with the property, was forced to address significant problems brought on by the contractor's refusal to comply with the contract of construction and other HUD requirements. To attempt to analyze the project's financial records outside this context is both unfair and misleading. Particularly where many of the obstacles the owner was forced to overcome were perpetuated, if not directly caused by, the actions of certain HUD representatives.”

The owner acknowledged that his lack of sophistication regarding the regulatory requirements of HUD-insured loans, as well as a corresponding lack of internal controls did lead to several violations of the Regulatory Agreement. “Any and all failures to adhere to said regulations were either inadvertent or the result of the owners extreme frustration experienced because of HUD's refusal to assist the property by helping him ensure the health, safety, and welfare of his tenants.” The owner stated that at no point did he ever intend to be anything but open and forthright with regard to the management of project assets. The owner stated that many of the irregularities noted in the audit were made necessary by the negligence of the contractor as well as HUD's refusal to hold the contractor accountable. The owner asks only that the findings and recommendations made by the audit be considered in the context of the situation in which he was placed. Given the extreme shortage of revenue during the initial months of operation the owner contends that he performed his management and maintenance duties as best he could with what was available to him.

OIG response

The project's owner, not HUD, has the responsibility to address and resolve all problems associated with the project's development and construction. The owner's responsibility included but was not limited to pursuing legal actions, if warranted, to assure contractor performance; providing the cash needed to fund the project's construction and operations; and assuring compliance with the Regulatory Agreement and related HUD requirements. The owner claimed that many of the irregularities noted in the audit were made necessary by the negligence of the contractor as well as HUD's refusal to hold the contractor accountable. The owner's comments reflect an unwillingness to recognize that it was his responsibility to address and resolve those issues.

Generally, the owner's written response reiterated information and arguments we considered while conducting the audit. We did revise the report to reduce unsupported costs by \$1,019 (\$75 for check 1075 and \$944 for check 1206). The owner produced information that showed vendors reimbursed the amounts to the project's operating account.

Recommendations

We recommend

- 1A. Continue ongoing efforts to complete the mortgagee-in-possession to secure and protect HUD's interest in this project. (HUD has completed final recommended action.)
- 1B. Debar the mortgagor and its individual principals from future participation in HUD Programs.
- 1C. Require the owner to reimburse the project operating and trust accounts for \$166,364 of ineligible disbursements and \$15,558 of costs found to be unreasonable and unnecessary. Also, require adequate documentary support, or reimbursement, for \$3,207 of unsupported costs. You should coordinate action on this recommendation with our office.

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Misuse of Security Deposits and Prepaid Rent

The owner improperly spent \$43,225 of tenant security deposits and prepaid (last month) rent. The owner was not authorized to collect last month rent from tenants. As a result, project liabilities to tenants are not funded in trust accounts as prescribed by HUD regulations. Furthermore, the unauthorized collection of prepaid rent placed an unnecessary financial burden on tenants who moved into or wanted to move into the project. We attribute this violation to the owner's failure to abide by HUD requirements.

Without HUD's prior written permission, owners shall not require as a condition of occupancy, any consideration or deposit other than the prepayment of the first month rent plus a security deposit in an amount not in excess of one month's rent. Any funds collected as security deposits shall be kept separate and apart from all other funds in a trust account. The amount of the trust account shall at all times equal or exceed the aggregate of all outstanding obligations under said account (Regulatory agreement, Section 6(g)).

At move-in, the owner required tenants to pay a security deposit and prepay the last month of occupancy rent. HUD requirements allow collection of security deposits, but HUD procedures do not allow, nor did HUD approve, the collection of prepaid rent.

The owner deposited the \$43,225 of security deposits and prepaid rent into the project operating account. As of December 15, 2001, the cash balance in the operating account was only \$5,713, substantially less than the \$43,225 liability for security deposits (\$23,950) and prepaid rent (\$19,275) at that date. The balance in trust accounts should have equaled or exceeded the aggregate of all outstanding obligations reflected by the liability accounts. As of December 15, 2001, the general ledger trust account for security deposits contained a zero (\$0) balance.

The certified public accountant's audit of the mortgagor's cost certification, dated February 19, 2001, contained a finding concerning the owner's failure to maintain a separate trust account to fund security deposits. The report indicated that the owner would establish and fund a separate trust account for security deposits.

The owner stated that he spent the funds versus depositing them in trust accounts because the project needed the money to pay operating costs. We disagree. The project generated sufficient cash to pay all routine costs of project operations, fund trust accounts, and pay some mortgage payments. The ineligible and unnecessary costs identified in Finding 1 (\$181,922) would have funded the \$43,225 trust account plus six \$21,132 mortgage payments. We conclude that the owner did not make a good faith effort to pay any mortgage payments and his mismanagement of project funds was a significant cause of the mortgage default.

Finding 2

Auditee comments

The OIG is correct, the funds have since been repaid in full and a separate account has been established as required under the Regulatory Agreement.

OIG response

The owner provided documentation indicating that it had funded the security deposit account. However, the owner's comments did not address actions, if any, taken to resolve the prepaid rent issue.

Recommendations

Recommendations under Finding 1 address all needed recoveries. No further recommendations for Finding 2 are deemed necessary. The prepaid rent trust accounts should be funded with the funds recovered under Recommendation 1C and the money should be returned to the tenants.

Management Controls

In planning and performing our audit, we considered management controls systems of Magnolia Lane Apartments to determine our auditing procedures and not to provide assurance on management controls. Management control includes the plan of organization, methods and procedures adopted by management to ensure that its goals are met. Management controls include the process for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

We assessed the following management control category that we determined to be relevant to our audit objectives:

- Controls over compliance with laws and regulations
- Controls over the safeguarding of resources

A significant weakness exists if management control does not give reasonable assurance that the entity's goals and objectives are met; that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data are obtained, maintained, and fairly disclosed in reports.

Significant weaknesses in the assessed controls existed with respect to the owner controlling and managing the project without regard for HUD program requirements and prudent financial management. We placed no reliance on the controls and instead sampled a large proportion of project disbursements. The control weaknesses were the primary causal factors for Findings 1 and 2.

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Follow-Up On Prior Audits

This was the first Office of Inspector General audit of Magnolia Lane Apartments mortgagor operations.

The latest independent audit of Magnolia Lane Apartments was for the Mortgagors Certificate of Actual Cost for the period ended December 31, 2000. The report contained one finding concerning the owner's failure to establish a separate trust account to fund security deposits collected from tenants. The owner did not resolve the finding as reported in Finding 2 of this report.

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Issue Needing Further Study and Consideration

As discussed in Finding 1, the owner pledged \$100,000 of the project's escrow account for operating deficit and working capital as partial collateral for notes made from an individual. HUD staff state they were not aware of the transactions that occurred before during and after the period of project development (initial processing through construction). We did not audit the project's processing and construction. However, the transactions involved a lack of disclosures that may have impacted HUD's assessment of the owners' ability to meet minimum equity requirements when it approved the project. We believe HUD should review this issue and assess its impact on the decisions HUD made relative to the owner and project.

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Summary Of Questioned Costs

Recommendation Number 1C	Type of Questioned Costs		
	<u>Ineligible¹</u>	<u>Unreasonable²</u>	<u>Unsupported³</u>
	\$166,364	\$15,558	\$3,207

- ¹ Ineligible - Costs that are questioned because of an alleged violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other document governing the expenditure.
- ² Unreasonable - Costs that are questioned because they exceed the costs that would be incurred by an ordinary prudent person in the conduct of a competitive business.
- ³ Unsupported - Costs charged to a HUD-funded or insured program or activity whose eligibility cannot be determined at the time of audit since such costs were not supported by adequate documentation.

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Schedule Of Ineligible Distributions

Date	Check Number	Payee	Ineligible Costs	Portion Paid After Default	Portion Paid After HUD Warning Letter
Transfers to Other Accounts					
10/26/01	1301	Conway National Bank	\$ 20,000	\$20,000	\$20,000
11/06/01	1310	Conway National Bank	10,000	10,000	10,000
11/27/01	1322	Conway National Bank	5,000	5,000	5,000
12/4/01	1333	Conway National Bank	8,000	8,000	8,000
12/12/01	1340	Conway National Bank	10,000	10,000	10,000
Subtotal			\$53,000	\$53,000	\$53,000
Unauthorized Payments to or for Mr. Hicks					
Various	Various	James Hicks	\$18,178	\$12,651	\$9,568
06/15/01	1204	James Hicks	10,000	10,000	
07/20/01	1223	James Hicks	4,700	4,700	
08/9/01	1245	James Hicks	4,200	4,200	4,200
10/15/01	1298	James Hicks	1,335	1,335	1,335
1/18/01	1083	Conway Hospital	276		
1/31/01	1091	Conway Anesthesia Associates	41		
3/3/01	1117	Carolina Radiology	98		
Subtotal			\$38,828	\$32,886	\$15,103
Unauthorized Payment for Washers and Dryers					
2/2/01	1095	Colortyme	3,045		
3/15/01	1119	Colortyme	3,045		
4/20/01	1153	Colortyme	105	105	
5/31/01	1185	Colortyme	6,090	6,090	
8/03/01	1240	Colortyme	3,045	3,045	3,045
8/07/01	1244	Colortyme	3,045	3,045	3,045
8/17/01	1253	Colortyme	1,827	1,827	1,827
9/10/01	1270	Colortyme	4,263	4,263	4,263
10/5/01	1290	Colortyme	4,872	4,872	4,872
Subtotal			\$29,337	\$23,247	\$17,052
Unauthorized Repayment of Loans					
1/12/01	1080	Conway National Bank	1,199		
4/3/01	1133	Conway National Bank	3,321	3,321	
4/18/01	1151	Conway National Bank	1,607	1,607	
5/16/01	1179	Conway National Bank	1,607	1,607	
7/2/01	1212	Conway National Bank	1,607	1,607	
7/25/01	1225	Conway National Bank	1,607	1,607	1,607
9/05/01	1268	Conway National Bank	4,820	4,820	4,820
11/7/01	1316	Conway National Bank	4,820	4,820	4,820
Subtotal			\$20,589	\$19,389	\$11,247

Schedule Of Ineligible Distributions

Date	Check Number	Payee	Ineligible Costs	Portion Paid After Default	Portion Paid After HUD Warning Letter
Unauthorized Payment of Legal Fees					
1/2/01	1059	Stuart Adramson	500		
1/19/01	1084	Thompson Law Firm	700		
5/16/01	1178	Thompson Law Firm	1,890	1,890	
6/20/01	1205	Richard Lovelace	1,000	1,000	
8/16/01	1251	Richard Lovelace	4,000	4,000	4,000
9/18/01	1274	Richard Lovelace	1,411	1,411	1,411
9/18/01	1272	James Hicks	1,000	1,000	1,000
10/3/01	1285	Richard Lovelace	1,000	1,000	1,000
10/31/01	1308	Richard Lovelace	1,000	1,000	1,000
12/3/01	1330	Richard Lovelace	1,000	1,000	1,000
Subtotal			\$13,501	\$12,301	\$9,411
Other Unauthorized Payments					
1/5/01	1066	Magnolia Lane Inc.	300		
1/5/01	1067	Magnolia Lane Inc.	200		
1/5/01	1068	H&H Investments	376		
1/9/01	1076	Prudential Huntoon Paige	2,431		
5/3/01	1171	Lowes	2,134	2,134	
7/6/01	1217	Conway Air	2,569	2,569	
7/18/01	1222	Taryn McElhannon	750	750	
8/10/01	1246	James Hawkins	2,309	2,309	2,309
8/11/01	1247	Taryn McElhannon	40	40	40
Subtotal			\$11,109	\$7,802	\$2,349
Total			\$166,364	\$148,625	\$108,162

Schedule Of Unreasonable and Unsupported Costs

Magnolia Lane Apartments

Date	Check No.		Unnecessary/ Unreasonable Costs	Unsupported Costs
Various	Various	James Hicks	\$ 8,140	
1/24/01	1088	Agnis Armfield	4,000	
2/26/01	1110	SCDPS	165	
3/27/01	1130	State Farm	256	
4/27/01	1158	Ray Realty	350	
5/3/01	1168	Ray Realty	350	
8/9/01	None	Ray Realty	375	
8/9/01	None	Ray Realty	375	
9/18/01	None	Ray Realty	395	
9/28/01	None	Ray Realty	375	
11/6/01	1313	Ray Realty	370	
12/11/01	None	Ray Realty	407	
1/5/01	1061	James Hicks		\$ 300
2/21/01	1101	James Hicks		300
2/26/01	1109	James Hicks		300
5/21/01	1180	James Hicks		400
8/22/01	1257	James Hicks		377
9/5/01	1265	James Hicks		500
3/28/01	1131	CANNON'S		30
6/2/01	1187	Delaney Richardson		500
6/9/01	1198	Delaney Richardson		500
Total			\$ 15,558	\$3,207

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Auditee Comments

RICHARD M. LOVELACE, JR.
MATTHEW R. MAGEE

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VIA E-MAIL & FEDERAL EXPRESS

Nancy H. Cooper
District Inspector General
U.S. Department of Housing and Urban Development
Richard B. Russell Federal Building
75 Spring Street, SW, Room 330
Atlanta, Georgia 30303-3388

**Re: Auditee Comments - Magnolia Lane Apartments
HUD Project No. 054-35593**

Dear Ms. Cooper:

Enclosed herewith, please find the auditee's response to the draft audit report performed on Magnolia Lane Apartments, HUD Project No. 054-35593. As indicated above, a hard copy of the response with the attached exhibits will follow via Federal Express. Once the findings and recommendations have been finalized, I would appreciate your forwarding me a copy at your earliest convenience.

In the meantime, if I can be of any further assistance please do not hesitate to contact me at the address or phone number above.

With kindest regards, I remain

Yours very truly,

**LAW OFFICES
RICHARD M. LOVELACE, JR., P.A.**

Matthew R. Magee
Matthew R. Magee

MRM/sjp

AUDITEE COMMENTS**I. Introduction**

The following represents the owner's response to the findings and recommendations reached as a result of that certain audit performed on Magnolia Lane Apartments by the Office of the Inspector General on or about December 18, 2002. Although the audit did not include a review of construction activities and costs, it is imperative that such issues be considered in order to ensure that a fair and just conclusion is reached regarding the project's financial records and expenditures. From the very inception of the construction process, the owner, in addition to everyday management activities associated with the property, was forced to address significant problems brought on by the contractor's refusal to comply with the contract of construction and other HUD requirements. To attempt to analyze the project's financial records outside this context is both unfair and misleading. Particularly where many of the obstacles the owner was forced to overcome were perpetuated, if not directly caused by, the actions of certain HUD representatives.

That being said, however, it must be acknowledged that the owner's lack of sophistication regarding the regulatory requirements of HUD-insured loans, as well as a corresponding lack of internal controls did lead to several violations of the Regulatory Agreement. Nevertheless, at all times during the course of his ownership Jim Hicks has made the maintenance of the project as well as the safety and well-being of his tenants his number one priority. There can be little doubt that the current success and economic viability of the project is solely attributable to the efforts of Jim Hicks. While under his control, virtually all of the property's management, landscaping, pool maintenance, plumbing, and electrical repairs were performed by Mr. Hicks. As the following narrative and chronology of events demonstrates, Mr. Hicks management of Magnolia Lane Apartments, while irregular, allowed the project to survive in the face of great adversity.

II. Background

As stated above, the difficulties the owner encountered began almost immediately. Pursuant to the contract of construction, the project was scheduled to commence on or before November 19, 1999. The contractor, Superior Construction, LLC, however, did not initiate work until November 29, 1999. (See Exhibit 1). As Mr. Hicks would later discover, such delays were only the beginning of the contractor's bad faith and incompetence.

Further complicating matters was the fact that no HUD inspector visited the property for the months of November, 1999 through February, 2000. After repeated calls from both Mr. Hicks and the lender, Prudential Huntoon Paige, HUD representatives stated that current funding was inadequate to cover the costs of inspections and that inspections would not be provided. Mr. Hicks

was skeptical of such claims due to the fact that the initial loan disbursement included funds earmarked for the cost of inspections.¹

Unfortunately, had HUD representatives conducted the inspections as required, many of the construction defects that plagued the property may have been avoided and/or corrected without significant expense. For instance, the retention pond was dug too deep and failed to drain properly, and the stub-out for riser condensation lines was not installed in a drain field, which later caused significant flooding in first floor units. While the absence of HUD inspections was by no means solely responsible for such defects going unnoticed, it established a pattern of HUD apathy that ultimately led to Mr. Hicks's extreme frustration and reluctance to cooperate with HUD demands.

In early January, 2000, Pat Patterson of Superior Construction arrived at the project and conducted his own survey of the property for the layout of the buildings. Fortunately for Mr. Hicks, project superintendent, Carl Cooke, arrived approximately one week later and discovered that Patterson's survey was seriously flawed and needed to be redone. Had the foundation been poured prior to the discovery of Patterson's incompetence, the entire foundation would have been too short and would have had to have been removed and repoured. Despite the discovery of Patterson's significant and potentially costly mistake, Patterson later informed Cooke that the project's general requirement account should be "padded" to increase the charges attributable to the job. Mr. Hicks believes it was Patterson's intent from the beginning to defraud both the lender and himself into accepting costs that were not properly attributable to the project.

On or about February 17, 2000, Mr. Hicks was informed that the City of Conway required a state-regulated DHEC permit before it could issue a City Permit allowing the project to connect to the city's water supply. To the amazement of Mr. Hicks, no one at the project possessed the required permit. Later that day during a telephone conversation, Pat Patterson of Superior Construction informed Mr. Hicks that he, as owner, was responsible for obtaining all necessary permits. However, Carl Cooke, Superior's on-site project supervisor showed Mr. Hicks that pursuant to the specification manual the contractor, rather than the owner, was responsible for the issuance of all permits. Moreover, the contract of construction provided Article 5, Paragraph A, that "the contractor shall furnish at its own expense, all building and other permits, licenses, tools, equipment and temporary structures necessary for the construction of the project." (See Exhibit 1).

The DHEC permit application required substantial information from both the contractor and the project's architect. It took approximately forty-five (45) days to assemble the necessary information. However, despite the unforeseen setback work on the project progressed as planned until mid June, 2000.

¹ Although HUD inspections did begin in March 2000, no refund was made for the previous four months.

Early in the month of June, Mr. Hicks met with two prospective tenants who were interested in renting units at the project. Both individuals were students at nearby Coastal Carolina University and desired to move in at the beginning of the fall semester, approximately September 1, 2000. Project Supervisor Carl Cooke assured Mr. Hicks that the project was still on schedule and that building one (1) would be complete in the first week of September and that building two (2) would follow within two to three weeks thereafter. Based upon this representation, tenants Winston Edmund and Alex Drexel signed leases for units 117 and 118, respectively. Both planned to begin their occupancy in the first week of September.

Shortly thereafter, Carl Cooke terminated his employment with Superior Construction. Cooke informed Mr. Hicks that Superior had not lived up to its promises regarding salary and other benefits and that he had received a more attractive offer to work elsewhere. Following Cooke's departure, during the last two weeks in June and the entire month of July, neither the plumbing nor the electrical subcontractors performed any work at the site. When questioned by Mr. Hicks, a representative of the electrical subcontractor reported that Pat Patterson instructed him to cease work at the site. Patterson later told Mr. Hicks that the delay was caused by his failure to secure the DHEC permit and the resulting lack of water at the site. When Mr. Hicks relayed Patterson's comments to the electrical subcontractor he was incredulous and informed Mr. Hicks that it was absurd. In any event, water was available at the project by way of a high-pressure hose.

Despite the significant cessation of activity during the months of June and July, construction draws for both months were requested and approved. Pat Ianelli, the project's architect, however, informed Patterson that the delay in the obtaining water permit would not justify an extension of the contract. Shortly thereafter, work at the project resumed in full with Pat Patterson as the on-site manager.²

As of September 1, 2000, both apartment buildings outwardly appeared complete. However, a majority of the units' interiors still required substantial carpeting, painting, and finishing. There was no landscaping at the site, and the pool had been dug but not poured. The project's scheduled date of completion, September 9, 2000, came and went; habitability continued to be months away.

Because Magnolia Lane Apartments is located in close proximity to Coastal Carolina University, students were targeted to comprise the vast majority of the project's tenants. Fall semester classes at the university begin in approximately mid September and students typically move in to their housing at the first of the month. Superior's failure to complete construction on schedule in early September was, therefore, an extreme economic hardship on the project. As the rent rolls indicate, August and September are by far the most productive leasing months. (See Exhibit 2). Without a guarantee of timely completion by mid September, many of the project's potential tenants

² Although prior to the issuance of the permit, water was made available at the project on or about August 31, 2000. The required permit followed on or about October 6, 2000.

were forced to turn elsewhere. For the few tenants that were willing to assume the risk and sign leases, Mr. Hicks was forced to provide them with accommodations at another nearby complex.

A little over one month later, on or about October 16, 2000, Mr. Hicks received a request for a change order from Pat Patterson seeking an extension of time as a result of the waterline delay. (See Exhibit 3). Although not explicit in his threat, Chip Clardy of Superior indicated that if Mr. Hicks failed to sign the order, Superior would not call for the substantial completion inspection and would walk off the project. Because Mr. Hicks knew that all change orders must be signed and approved by the architect, he reluctantly agreed to execute the document, pending the architect's approval. (See Exhibit 3). True to his word, on or about October 18, 2000, the architect refused to sign the change order.

Despite the veiled threats to walk off the site, Superior called for the inspection on November 2, 2002. Present at the site were: Pat Patterson, contractor; Leon Babridge, HUD Inspector; Bob Peeler, HUD Representative; Pat Ianelli, architect; and Jim Hicks. (See Exhibit 4). At the time, Mr. Hicks was recovering from hernia surgery and had significant difficulty walking. He, therefore, remained outside while the others walked through the units. Following the inspection, Patterson informed the HUD inspector that he had several change orders he needed to submit. He then requested that Babridge delay processing the paper work until he had time to submit the change orders. As all were aware, change orders were required to be submitted prior to the date of substantial completion. The architect Pat Ianelli consented to a short delay, but informed Patterson that it should not be more than two weeks. All agreed and later departed.

Despite the fact that Superior's cost certification was required to be submitted within thirty (30) days of the date of substantial completion, as of December 2, 2000, Mr. Hicks had yet to receive either the change orders or the cost certification. In approximately the second week of December, a representative of Prudential Huntoon Paige contacted Mr. Hicks inquiring about the status of the project. Mr. Hicks informed her that the substantial completion inspection had taken place on November 2, 2000, but that he had not received any paper work to that effect and had not received the contractor's cost certification. Mr. Hicks inquired whether there was anything the lender could do to pressure Superior into submitting the required paperwork. The lender responded that he would need to contact HUD. However, calls to HUD also proved to be of no value.

Shortly thereafter, the project's architect contacted Babridge, the HUD inspector, about the substantial completion paperwork. He failed to receive any response. On or about December 15, 2000, the architect received several requests for change orders from Superior. Most were returned due to a lack of necessary documentation. Through the months of December, 2000 and January, 2001, the lender continued to inquire about the status of the project and the need to progress to final endorsement.

As referenced earlier, due to the project's inability to capitalize on the critical opportunity to lease to students before the start of the fall term, Magnolia Lane was severely undercapitalized during the first few months of operation. As of January, 2001, only eight units had been rented.

(See Exhibit 2). Due to the unanticipated shortfall in revenues, Mr. Hicks was also extremely eager to proceed to final endorsement so that the balance of the loan proceeds could be disbursed, enabling him to cover operating costs and maintain the economic viability of the project until the fall 2001 rental season. This was made impossible by Superior's refusal to submit its paperwork as required. Despite numerous calls to both HUD and the lender, neither were willing to assist Mr. Hicks in any way.

Based upon a substantial completion date of November 2, 2000, the lender began assessing mortgage payments in January, 2001. Due to the revenue shortfall, the payments for January, February, and March were withdrawn by the lender from the project's operating deficit escrow account and the capital escrow account.

On or about January 20, 2000, Superior overnighted a change order to Mr. Hicks, again requesting a sixty-day (60) extension. (See Exhibit 5). Partly due to Mr. Hicks desperate attempt to get to final endorsement and partly due to his knowledge that no change orders would be accepted after substantial completion, Mr. Hicks signed the order. As he would later discover, his rationale was flawed on both counts. The change order was later reduced to fifty-four (54) days and was signed by HUD representative Wayne Wells on January 29, 2001; almost ninety (90) days after the date of substantial completion. (See Exhibit 5).

True to his promise to hold up the paper work in favor of Superior Construction, HUD Inspector Leon Babridge forwarded the substantial completion paperwork to the HUD office two weeks later on or about February 15, 2001.³ (See Exhibit 4). Other than Superior's unreasonable request to delay the processing of the paperwork, there is no explanation as to why Babridge held the form for over ninety days after the inspection took place.

Also during the months of January and February 2001, Mr. Hicks began to discover numerous and significant construction defects existing throughout the property. Due to the low occupancy rates, the problems were slow to appear but gradually increased in both number and severity. The most pressing problem being the overall malfunctioning of the units' HVAC systems.

By June 11, 2001, twenty-nine of forty-eight units had experienced some type of HVAC installation failure or defect. (See Exhibit 6). The problems that the project experienced, especially those associated with the heat and air conditioning, seriously damaged the project's image; particularly with regard to the local student population. Moreover, as the letter from Toni Montondo of Ray Realty indicates, the property suffered damage in more professional circles as well. (See Exhibit 7). On or about July 30, 2001, when Ms. Montondo entered unit 209 in order to show it to a prospective tenant, she discovered that the entire apartment was flooded. The water damage was caused by a back-up in the condensation riser line. As discussed earlier, the back-up was the result of Superior's failure to install a drain field.

³ The Certificate of Occupancy was issued shortly thereafter on or about February 23, 2001.

In mid March, Mr. Hicks notified the lender of the problems he had discovered and of his belief that significant work still needed to be performed by the contractor. Despite numerous phone calls, again neither HUD nor the lender seemed concerned or offered any assistance.

On or about April 3, 2002, Superior finally submitted its cost certification. (See Exhibit 8). It was now almost one hundred fifty (150) days after the reported date of substantial completion. By that time, Mr. Hicks was unable to make the monthly mortgage payments and was being forced to correct substantial construction defects at the property with an already severely insufficient gross revenue. Neither the lender nor HUD offered any assistance, and Mr. Hicks requests to revisit the issue of substantial completion were ignored.

Due to Superior's unreasonable delay in submitting its cost certification, Mr. Hicks was unable to obtain the balance of the loan proceeds he desperately needed to correct construction defects, meet operating expenses, and service debt. By the time the cost certification was submitted, final endorsement was impossible because the loan was in default.

Strangely, at the time this was of some comfort to Mr. Hicks because (1) it meant Superior would be unable to obtain its retainage; and (2) for the first time since the project began both HUD and the lender were taking notice of the project's problems.⁴

Yet, despite an HVAC failure rate of over fifty (50%) percent during the months of March, April, May, and June 2001, Superior refused to return to the property until it received its retainage. Mr. Hicks found the contractor's position astonishing in light of the fact that it was Superior's intentional delay that prevented final endorsement in the first place.

On July 5, 2001, HUD representatives Wayne Wells, Jim Proctor and Paul Serwacki toured the property with Mr. Hicks. Serwacki's Trip Report described not only the documented mechanical and electrical problems with the HVAC systems, but also the improper wiring of switches, the faulty installation of weatherstripping along the door thresholds, defective mirrors, faulty tub assemblies, improper construction of the retention pond, and the inadequate sanding and painting of a majority of units. All present agreed that the project was in need of significant work and repair. (See Exhibit 9). This certainly was an indication of the quality of Superior's work, given that through June 2001, only eighteen of the forty-eight units were occupied and had been lived in.

Serwacki's Trip Report stands in stark contrast to the that issued by Leon Babridge on November 2, 2000. (See Exhibit 4). Babridge reported that the project was "100%" complete and that "all work had been performed in an acceptable manner." One could hardly argue that an apartment complex without heat or air conditioning in Conway, South Carolina is in a habitable

⁴ Although HUD has since disbursed the retainage to Superior Construction, Mr. Hicks continues to believe Superior was not entitled to the issuance of the funds due to the untimely, incompetent, and incomplete nature of the work performed.

condition. The only conclusion that can be reached regarding Babridge's inspection is that he performed it without testing half of the HVAC systems, half of the electrical switches, or even entering half of the units. While Mr. Hicks certainly recognizes that others, including himself, were culpable in failing to detect many of the defects, he is incredulous that HUD continues to take the position that the project was in fact complete in early November, 2000. Even Paul Serwacki verbally stated that the project should never have been certified as "substantially complete." As Mr. Hicks had suspected all along, it was not until the assignment of the mortgage from Prudential Huntoon Paige to HUD was imminent that HUD began to take his claims seriously and investigate.⁵

On July 14, 2001, an HVAC subcontractor returned to the property. Over the next four days, the sub repaired installation defects in every unit at the project. (See Exhibit 6).

Finally, and largely through the assistance of HUD representatives, Superior returned to the property on July 19, 2001. As a result of a second inspection conducted by HUD officials on July 19, 2001, Superior began to finish construction on the items remaining on the list. Between July 19 and August 24, 2001, many of the problems in the vacant units were corrected. Despite an agreement between the parties to carry on and finish the work in the occupied units, Pat Patterson reneged on the promise, alleging that the problems with the occupied units were the result of tenant damage and were the responsibility of the owner. Patterson stated he would not continue any work until he received his retainage. Again, his demand was extremely ironic considering it was his delay that prevented final endorsement.

Although Mr. Hicks is certainly cognizant that it is his responsibility to enforce his contractual rights against the contractor, the assistance of HUD was critical in enabling him to do so. All Mr. Hicks requested was that HUD: (1) adhere to its own regulations and refuse to accept a change order after substantial completion; and (2) accept some accountability and admit that the project was not substantially complete in November, 2000. Not only did HUD representatives refuse any assistance in that regard, but they also buried Mr. Hicks in penalties and late fees incurred as a result of his inability to service the property's debt. Even assuming Mr. Hicks was successful in a suit against the contractor, by the time a judgment was obtained the property would have long been sold at foreclosure.

It is undeniable that HUD representatives were at best complacent with Superior's refusal to timely submit project paperwork. At worst, HUD Inspector Leon Babridge actively assisted Superior Construction in wrongfully delaying final endorsement, and in ensuring that significant defects in the property went unnoticed and uncorrected. Although Mr. Hicks's lack of cooperation with HUD is by no means excusable, given his experience it is certainly understandable.

⁵ The mortgage was assigned to the Secretary of the Department of Housing and Urban Development on July 10, 2001.

In light of the foregoing, Mr. Hicks submits the following response to the audit findings of the Inspector General's office for the period beginning December 1, 2000 and ending December 15, 2001.

III. Response to the Audit Findings of the Inspector General's Office

A. Owner Not Responsive to HUD

The first finding of the Inspector General's Office (IGO) posits that Mr. Hicks was unresponsive to HUD's requests for information. Specifically, the IGO alleges that Mr. Hicks failed to submit monthly accounting reports as well as the net cash over operating costs to HUD's lockbox as required in the Regulatory Agreement. As to the allegation regarding monthly accounting reports, during a September 6, 2001 meeting with HUD representatives in Columbia, South Carolina, Mr. Hicks provided HUD with a detailed balance sheet and operating statement for the months of January, 2001 through July, 2001.

As for the failure to remit net cash to HUD's lockbox, Mr. Hicks deposited all excess operating funds in an interest-bearing money market account which possessed the same tax identification number as the operating account.

The IGO also alleges that near the completion of the audit Mr. Hicks became unresponsive to requests for further information. Mr. Hicks strenuously denies this allegation. During the initial on-site conference, on or about December 18, 2001, Mr. Hicks took great pains to provide the auditor with every document requested. After the initial conference, additional documents requested by telephone were faxed to the office of the IGO on or about January 28, 2002. During the audit period, Mr. Hicks made every effort to make himself available and accommodate the scheduling needs of the auditor. As for the second and final on-site visit, the auditor expressed a desire to travel to Conway, South Carolina at some point during the week February 11, 2002. Although Mr. Hicks acknowledges that he received several messages on his answering machine one day that week requesting a meeting, due to the unavailability of his attorney and other scheduling conflicts Mr. Hicks did not respond.⁶ Despite the inability to schedule a second meeting, no further requests for information from the IGO were made.

Although Mr. Hicks concedes that violations of the Regulatory Agreement did occur, any and all failures to adhere to said regulations were either inadvertent or the result of the extreme frustration that Mr. Hicks experienced because of HUD's refusal to assist the property by helping him ensure the health, safety, and welfare of his tenants. At no point did Mr. Hicks ever intend to be anything but open and forthright with regard to the management of project assets.

⁶ The attorney present during the initial audit conference was out of the country between February 9 through February 16, 2002. Any breakdown in communication regarding the scheduling of a second meeting is the responsibility of the attorney's office and should not reflect negatively on Mr. Hicks.

B. Ineligible Distributions

The IGO next alleges that Mr. Hicks disbursed \$166,364.00 from operating funds for ineligible distributions in contravention of the Regulatory Agreement. In accordance with the IGO's audit report, said disbursements can be broken down into the following six categories:

1. Transfers to Money Market

As stated above, rather than transferring the project's net cash into HUD's lockbox, Mr. Hicks instead transferred the funds into an interest-bearing money market account. As audit attachment five (5) demonstrates, five deposits totaling \$53,000.00 were made between the months of October and December, 2001. From the funds deposited into the account, two disbursements were made. The first, totaling \$19,832.00 constituted repayment of a loan from H&H Investments, LLC for construction costs and fees actually incurred in building the project. Although said costs should have been included in the owner's certified costs, Mr. Hicks at the time was unaware of the proper method of accounting for the debt.

The second disbursement in the amount of \$15,000.00 constituted a retainer fee for a lawsuit against the contractor for damages related to the construction of the project. Although the IGO characterizes the fee as a mortgagor expense rather than an expense incident to the operation and maintenance of the project, Mr. Hicks in reality had little other option other than to forego any right to damages. Because the contractor's negligence and breach of contract were the proximate cause of the project's inability to service its debt, the only way to recover lost revenue and bring the debt current was to sue the contractor. Although Mr. Hicks should have obtained approval for the expenditure prior to the disbursement, the expense was critical to ensuring that the loan was repaid quickly and in full. Mr. Hicks fully intends to apply any proceeds obtained in a judgment against the contractor to the amounts owed HUD under the loan.

2. Payments To Owner

The IGO next asserts Mr. Hicks received excessive management fees for the years 2000 and 2001 in the amount of \$18,178.00 and \$18,900.00, respectively. However, given the extraordinary amount of time and labor Mr. Hicks spent at the property performing all manner of services, said fees were wholly justified. Despite the fact that the property was less than one year old, due to the contractor's incompetence it required a significant amount of maintenance. Although invoices were admittedly not prepared for the work Mr. Hicks performed on marketing, landscaping, pool maintenance, electrical and plumbing repair, and the cleaning of common areas, the current condition of the property and the lack of tenant complaints is evidence that the work was actually performed. Moreover, as an inspection of other operating expenses would reveal no other outside entity was hired to do the work. Additionally, the total management fee allowed from the budget plan approved by both HUD and the lender for the years 2000, 2001, and 2002 was \$43,650.00. As of December 2001, the total management fees paid amounts to \$38,828.00.

In addition to work performed at the site, Mr. Hicks also contributed financially to the project. On or about May 12, 2000, Mr. Hicks advanced the project \$8,613.00 to cover an operating expense deficit. To date much of the compensation owed to Mr. Hicks has yet to be repaid. (See Exhibit 10).

Without more specific allegations regarding individual payments it is impossible to address every disputed expenditure. Nevertheless, Mr. Hicks would offer the following:

- a. Check 1204 in the amount of \$10,000.00 constituted the management fee as provided in the HUD approved budget for the months of June through half of October.
- b. Check 1223 in the amount of \$4,700.00 constituted the management fee as provided in the HUD approved budget for the balance of October, November, and January.
- c. Check 1245 in the amount of \$4,200.00 constituted the management fee as provided in the HUD approved budget for the months of April and May

As to check number 1298 in the amount of \$1,335.00, this was in fact a duplicate payment and is admittedly a mistake. The expense was incurred as a result of the need to purchase a new computer due to a lightening strike. (See Exhibit 11).

Checks numbered 1085, 1091, and 1117 in the total amount of \$415.00 constitute reimbursement to Jim Hicks for medical costs incurred as a result of his need for hernia surgery. Mr. Hicks suffered the hernia while performing services for the property.

3. Washers and Dryers

The IGO next alleges that the \$29,337.00 expended on washers and dryers constitutes an unauthorized capital purchase. On or about November 4, 2000, when Mr. Hicks's mobility was restored and he was finally able to enter the units, he discovered that no washers or dryers had been provided. When he questioned Superior about the matter, Pat Patterson informed him that the appliances were not included in the specifications. Although Mr. Patterson was correct, the washers and dryers do clearly appear on the drawings for the project.⁷ Because the advertising approved for Magnolia Lane included washers and dryers and there was no commercial facility within close proximity, Mr. Hicks was obligated to make good on his promise. Furthermore, the appliances were critical in maintaining a competitive edge with other rental properties in the area.

⁷ Superior's failure to provide the washers and dryers as provided for in the project's drawings is an issue involved in current litigation.

Although no request for a capital purchase was made, HUD did in fact authorize a change order for the washers and dryers on January 29, 2001. (See Exhibit 12). Subsequent to the approval, however, HUD notified Mr. Hicks that a deposit would be required. Because Mr. Hicks had planned to use the excess loan proceeds disbursed at final endorsement to make the purchase, he was unable to produce the required deposit. As discussed earlier, the inability to proceed to final endorsement was directly caused by Superior's refusal to submit the required paperwork. In any event, Mr. Hicks submits that the expenditure was an integral and necessary part of the operation of the project and should have been included in the actual cost of construction.

4. Repayment of Loans

The IGO next alleges Mr. Hicks improperly expended operating funds to repay a \$50,000 personal note obtained from Conway National Bank. Although Mr. Hicks's accounting of the transaction was highly irregular, the payments actually constituted reimbursement to H&H Investments for the remainder of construction costs and fees actually incurred in building the project. Like the initial disbursement from the money market fund, Mr. Hicks was unaware of how to properly account for the transaction. Said costs should actually have been included in the IA's report of actual mortgagor costs.

5. Legal Fees

As with the aforementioned retainer fee, the IGO alleges that the \$13,501.00 spent in legal fees do not qualify as a project operation expense. Although Mr. Hicks concedes that the amount is in excess of those normally incurred in this type of project, the fees were made necessary by the extraordinary need to enforce the project's rights against the contractor. The only alternative was to wait and hope that HUD would intervene and assert any rights that the project may have after assignment. However, given HUD's previous apathy toward the project's physical condition, Mr. Hicks felt compelled to act in the interests of both the property and his tenants.

6. Other

Finally, the IGO alleges that Mr. Hicks wrongfully spent \$11,109.00 on various costs described in audit attachment five (5) attributed to construction rather than operation or maintenance. Mr. Hicks disputes the IGO's characterization of all the expenditures and would offer the following explanation:

- a. Check 1066 in the amount of \$300.00 was transferred to project account 66001 in order to maintain a minimum balance and keep the account open. (See Exhibit 13). When the account was finally closed, said funds were deposited into the project's money market account.

- b. Check 1067 in the amount of \$200.00 was transferred into the project's money market account in order to minimally fund the account and keep it open. (See Exhibit 13).
- c. Check 1076 in the amount of \$2,431.00 was used to pay loan extension fees to the lender that were incurred as a result of Superior's failure to timely submit project paperwork. (See Exhibit 14).
- d. Check 1171 in the amount of \$2,134.00 was used to acquire pool furniture which was a necessary and integral part of the operation of the project. Admittedly, Mr. Hicks should have requested authorization for the capital purchase.
- e. Check 1217 in the amount of \$2,569.00 was used to pay a local subcontractor for HVAC repair work made necessary because of the original subcontractor's refusal to perform warranty work. The subs refused to return to the property until Superior paid them the balance of the monies they were owed. (See Exhibit 15).
- f. Check 1222 in the amount of \$750.00 was used to cover the cost of cleaning several units that had been damaged by various forms of leaks existing throughout the property. Mr. Hicks was expressly directed by HUD representative Wayne Wells to clean the units in early July, 2001. (See Exhibit 16).
- g. Check 1246 in the amount of \$2,309.00 was used to purchase built-to-fit furniture for the leasing office. Like the pool furniture, it was an expense necessary for the project's operation, but admittedly should have been authorized before-hand.
- h. Check 1247 in the amount of \$40.00 was also used for the cleaning of a unit that was missed in the earlier check for water damage.

C. Unreasonable and Unsupported Costs

As described in audit attachment six (6), the IGO next alleges Mr. Hicks wrongfully expended \$15,558.00 for unreasonable and unsupported costs not associated with the operation and maintenance of the project. As set forth below, however, all the expenditures alleged to have been improper were both reasonable and necessary:

- 1. The \$8,140.00 paid to Mr. Hicks in management fees were well within the amount approved in the budget plan and were made necessary by the extreme

amount of time and labor required to address problems created by the contractor.

2. Mr. Hicks spent \$4,421.00 (Checks 1088; 1110; and 1130) to purchase a vehicle and acquire its tag and insurance. The expenditure was made necessary by the need to transport chemicals to and from the property as well as remove various forms of refuse. South Carolina's Department of Health and Environmental Control does not allow the storage of chemicals on the property. Moreover, the chemicals chlorine and muriatic acid are unsafe to transport in a closed vehicle. Admittedly, Mr. Hicks should have acquired authorization prior to the purchase, but the expense was reasonably necessary for the operation and maintenance of the project. (See Exhibit 17).
3. Due to the extreme loss of revenue caused by the contractor's failure to timely complete the project, assistance was needed to rapidly find tenants for the property. Realty fees in the amount of \$2,997.00 were a reasonable expense incurred as a result of the broker's efforts in generating revenue. Said fee represents a 4.2% cost on a yearly rental. In order to maintain an actual representation on the tenant's ledger, the project showed a deposit for the entire amount due, then made a general journal entry reflecting the commission. When advised by the auditor that this was an improper method for accounting for the transaction, Mr. Hicks contacted his management program supplier for an alternative method. Since that time, the charges are posted to the tenant account, giving them a credit for the commission fee as provided for in the written agreement between Mr. Hicks and Ray Realty. (See Exhibit 18).
4. Although not properly documented with an invoice, check 1075 in the amount of \$75.00 was spent for the cost incurred in repairing an electrical outlet in unit 207. Said cost was reimbursed by ATSCO on January 18, 2001 as indicated in the project's general ledger. (Exhibit 19)
5. Although not properly documented with an invoice, check 1131 in the amount of \$30.00 was spent for the cost incurred in repairing a weed-eater. (See Exhibit 20).
6. Although not properly documented with an invoice, checks 1187 and 1198 in the total amount of \$1,000.00 were spent for the costs incurred in pressure cleaning buildings one and two. Said cleaning was made necessary due to the inordinate amount of dust and debris that accumulated on the buildings from a nearby construction project. (See Exhibit 21).

7. Although not properly documented with an invoice, check 1206 in the amount of \$944.00 was spent for the cost incurred in acquiring materials to resurface the pool. The repairs had to be completed quickly to ensure that the pool would be available for tenant use. Said costs were later refunded by Carolina Custom Pool on July 17, 2001 as indicated in the project's general ledger. (See Exhibit 22).

E. Improper Encumbrance of Project Assets

The IGO next alleges Mr. Hicks wrongfully encumbered project assets without HUD's prior written permission. The \$100,000.00 note described in the audit was a personal note and was secured with a second mortgage on Mr. Hicks's home. Mr. Hicks used his interest in both project accounts as partial collateral on the initial note. Shortly thereafter, however, the funds contained in the accounts were withdrawn by the lender to service mortgage payments on the property.

F. Misuse of Security Deposits and Prepaid Rent

Finally, the IGO alleges Mr. Hicks wrongfully spent funds from the tenant security deposit account. Although the IGO is correct, the funds have since been repaid in full and a separate account has been established as required under the Regulatory Agreement. As stated earlier, because Superior wrongfully prevented Mr. Hicks from proceeding to final endorsement, Mr. Hicks was unable to access the funds he needed to secure washers and dryers for the property. He, therefore, used the available funds in the Security Deposit account, intending to repay them from the disbursement of the remaining loan proceeds. Although Mr. Hicks's actions were admittedly in violation of the Regulatory Agreement, his reasons for doing so were born out of necessity. As he had been forced to do throughout his ownership of the property, Mr. Hicks improvised and made due with what he had, acting as always, in the best interest of his tenants.

IV. CONCLUSION

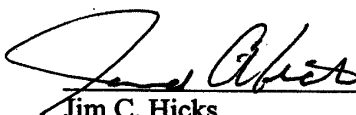
Although it is conceded that many of the accounting practices required by HUD's Regulatory Agreement were not complied with, Mr. Hicks at all times was motivated by his desire to act in the best interests of the project and his tenants. Many of the irregularities noted in the audit performed by the IGO were made necessary by the negligence of the contractor as well as HUD's refusal to hold the contractor accountable. Mr. Hicks asks only that the findings and recommendations made by the IGO be considered in the context of the situation in which Mr. Hicks was placed. Given the extreme shortage of revenue during the initial months of operation, Mr. Hicks performed his management and maintenance duties as best he could with what was available to him.⁸

⁸ Since the date of the audit, Mr. Hicks willingly surrendered possession of the property to HUD. (See Exhibit 23).

STATE OF SOUTH CAROLINA)
)
COUNTY OF HORRY)

VERIFICATION

PERSONALLY appeared before me the undersigned, Jim C. Hicks, President, Magnolia Lane, Inc., who, being duly sworn, deposes and says that he has read the foregoing document and that the matters and things alleged therein are true of his own knowledge, except for those matters on information and belief, and as to those he believes them to be true.



Jim C. Hicks

Title: President, Magnolia Lane, Inc.

SWORN to before me this
9th day of May, 2002.



(L.S.)
Notary Public for South Carolina

My Commission Expires: 12/12/11.

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