



U.S. Department of Housing and Urban Development
Office of Inspector General for Audit
Great Plains Region, 7AGA
Gateway Tower II - 5th Floor
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Kansas City, Kansas 66101-2406

MEMORANDUM NO: 2003-KC-1803

March 24, 2003

MEMORANDUM FOR: Charles Hester, Director, St. Louis Multifamily Program
Center, 7EHM

Roger E. Niesen

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

SUBJECT: Richmond Terrace Retirement Center
Richmond Heights, Missouri
(FHA # 085-43068)

INTRODUCTION

We have completed a review of the Richmond Terrace Retirement Center. The review was initiated as a result of our local audit planning and concerns raised by the St. Louis Multifamily Program Center. Our objective was to determine if bond funds and project funds were properly handled.

We found that the mortgagee provided key certifications at initial closing that contained incorrect cost amounts, causing mortgage proceeds to be drawn down and used for unsupported expenses. These acts exposed HUD's mortgage insurance fund to unnecessary risk because the owner did not have adequate funds at initial closing. We also identified residual bond funds that were improperly held by the Bond Trustee. During our review, we coordinated with the Office of Housing and the Office of General Counsel to explain HUD's legal claim to the residual bond funds. As a result, HUD collected \$50,063 in residual bond funds from the Bond Trustee.

We recommend that the St. Louis Multifamily Program Center take appropriate legal and administrative actions in coordination with the Region 7 Regional Counsel/Office of Program Enforcement.

METHODOLOGY AND SCOPE

To gather background information on Richmond Terrace, we interviewed the management agent, bond issuer, bond trustee, project architect, and appropriate HUD and Mortgagee staff. We also analyzed the following documentation to determine if project officials complied with HUD requirements and to identify residual bond funds:

- Mortgagee files and records.
- St. Louis Multifamily Program Center's files and records.
- Richmond Terrace Retirement Center's bank statements, cancelled checks, and deposit and wire transfer documents.
- Richmond Terrace's Certified Public Accountant's cost certification and work papers.
- The Bond issuer's files and records.

Our review covered the period January 1, 1996 through October 31, 2000.

BACKGROUND

On December 23, 1997, the Department of Housing and Urban Development held an initial closing of Richmond Terrace Retirement Center's \$5,510,000 Section 232 mortgage. This project is a 99-bed intermediate care facility located in Richmond Heights, Missouri.

Geri Care Inc., a not-for-profit corporation, owns the facility, which was financed through the issuance of both tax exempt and taxable bonds. This bond financing involved three different bond issues governed by a single trust indenture.

The Richmond Terrace mortgage was assigned to HUD after the mortgagor, Geri Care, Inc., defaulted in repayment of the mortgage loan. Consequently, HUD paid the mortgage insurance claim for the outstanding loan balance. Insurance proceeds were used to fund the redemption of outstanding bonds issued under the trust indenture. After foreclosure and sale, HUD incurred a \$4,222,640 loss.

RESULTS OF REVIEW

We found that the initial closing of the Richmond Terrace project involved certifications that contained incorrect amounts. These documents certified to HUD that at least \$50,000 more debt had been paid from the first draw than what actually occurred. If the correct certifications had been made, the auditee would not have had adequate funds to close the loan. In addition, we identified \$50,063 in residual bond funds improperly held by the bond trustee after all outstanding bonds were redeemed with mortgage insurance proceeds.

Incorrect Certifications

As part of the initial closing on December 23, 1997, HUD approved an Application of Insurance Advance of Mortgage Proceeds (HUD-92403) for Richmond Terrace. We identified the following incorrect certifications made in relation to this Application:

- ❖ The Mortgagee's Vice President signed HUD form 92403 containing the amounts approved by HUD for disbursement, but these were not the amounts disbursed on the first draw. This included a processing fee that was overstated by \$10,000 on the HUD Form 92403.
- ❖ The architect signed the Mortgagor's and Architect's Certificate attesting to receiving the full payment of \$202,125. The Architect actually received \$162,125 (\$148,625 from the first draw plus \$13,500 pre-paid prior to closing).
- ❖ The President of Geri Care also signed the incorrect Mortgagor's and Architect's Certificate.
- ❖ The Second Vice President of Geri Care signed the incorrect HUD Form 92403. The amounts approved by HUD for disbursement were not the amounts actually disbursed.

These documents certified to HUD that at least \$50,000 more debt had been paid from the first draw than what actually occurred. This caused the amounts needed to close to decrease by \$50,000 since HUD believed these costs were already paid. If the correct certifications had been made, the auditee would not have had adequate funds to close Richmond Terrace. HUD requires accurate certificates at closing to provide assurance that a project has the necessary assets to be successful.

Residual Bond Funds

Following HUD's payment of the insurance claim and after all the outstanding bonds had been redeemed, the bond trustee improperly held residual bond funds. We coordinated with the Office of Housing and the Office of General Counsel to claim these residual bond funds from the bond trustee. The provisions of the trust indenture normally provide guidance on the distribution of funds in the event of a default; however, in this situation, the guidance was not adequate. As a result, HUD had to establish its claim to the residual funds. The Office of General Counsel argued that HUD was entitled to these residual funds under:

- ❖ The Federal Priority Statute, 31 U.S.C. § 3713. This statute affords an absolute priority to HUD's claim for repayment of the mortgage debt before ownership property may be voluntarily transferred to any other party. The residual funds are arguably the owner's property under Section 4.10 of the trust indenture. Therefore, the Priority Statute

requires that these funds be paid to HUD so they can be applied toward the mortgage indebtedness.

- ❖ The project's various mortgage loan documents, such as the security agreement, the Uniform Commercial Code financing statements and the regulatory agreement. These documents serve as liens against certain mortgaged property covered by them to further secure repayment of the mortgage debt. The residual funds constitute mortgaged property under these documents. Hence, these mortgage documents afford HUD the right to apply the residual funds to the defaulted mortgage loan.
- ❖ The principles of equity and fairness. The owner's default on the mortgage loan caused HUD to pay the mortgage insurance claim. While the loan was non-recourse as to the owner, the mortgage instruments and regulations obligated HUD to pay mortgage insurance benefits upon default and submission of the resulting claim. Furthermore, the owner's default caused HUD to realize a significant financial loss in paying this claim. The amount HUD lost far exceeds the amount of the residual funds.

After reviewing HUD's arguments, the bond trustee issued a \$50,063 check to HUD's Atlanta Lock Box.

RECOMMENDATION

We recommend that the Director, St. Louis Multifamily Program Center:

- 1A. Take appropriate legal and administrative actions in coordination with the Region 7 Regional Counsel/Office of Program Enforcement.

In accordance with HUD Handbook 2000.06 REV-3, within 60 days please give us, for each recommendation without a management decision, 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. Additional status reports are required at 90 and 120 days after report issuance for any recommendation without a management decision. Also, please furnish us copies of any correspondence or directives issued because of the audit.

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS PUT TO BETTER USE

<u>Recommendation Number</u>	<u>Type of Questioned Cost</u>		<u>Funds Put to Better Use 3/</u>
	<u>Ineligible 1/</u>	<u>Unsupported 2/</u>	
1A			\$50,063
<u>1/</u>	Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law, contract or Federal, State or local policies or regulations.		
<u>2/</u>	Unsupported costs are costs charged to a HUD-financed or HUD-insured program or activity and eligibility cannot be determined at the time of audit. The costs are not supported by adequate documentation or there is a need for a legal or administrative determination on the eligibility of the costs. Unsupported costs require a future decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of Departmental policies and procedures.		
<u>3/</u>	Funds Put to Better Use represent money collected and deposited into the insurance fund to offset outlays (claims).		

Appendix B

DISTRIBUTION OUTSIDE OF HUD

Chairman, Committee of Governmental Affairs
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