



Issue Date	April 8, 2004
Audit Case Number	2004-AT-1004

TO: Karl H. Kucen, Acting Director, Memphis HUB, 4KPH

James D. McKay

FROM: James D. McKay
Regional Inspector General for Audit, 4AGA

SUBJECT: Cookeville Housing Authority
Cookeville, Tennessee

INTRODUCTION

We have completed a review of the Cookeville Housing Authority's (Authority) activities with its related nonprofit organization, Holladay Homes, Incorporated (HHI) and Judge O.K. Holladay Homes, L.P. The review focused on the Authority's development of Willow Heights, a mixed-financed public housing development. We performed the review as part of our audit of the Department of Housing and Urban Development's (HUD) oversight of Public Housing Agency development activities with related nonprofit entities. Our objective was to determine whether the Authority complied with laws and regulations and properly safeguarded resources when it conducted business with HHI and Judge O.K. Holladay Homes, L.P.

To accomplish our objective, we reviewed applicable HUD regulations, the Authority's Annual Contributions Contract (ACC), and other requirements. We also interviewed Authority management and staff and reviewed various documents including: financial statements, general ledgers, bank statements, minutes from Board meetings, check vouchers, and invoices. We also reviewed HHI's general ledgers, bank statements, and bank loan documents.

We performed our on-site review from June 9, 2003, through June 12, 2003, and covered the period October 1, 1999 to May 31, 2003. We performed our review in accordance with generally accepted government auditing standards.

We discussed our review results with the Authority during our review and met with them for an exit conference on February 20, 2004. We received the Authority's written comments to our draft on March 12, 2004. The Authority generally disagreed with the draft, but did not provide

sufficient evidence to support significant changes to the draft. Based on the Authority's comments, we removed our discussion pertaining to the Authority's failure to allocate costs and made other minor changes to the Finding and recommendations.

In accordance with HUD Handbook 2000.06 REV-3, within 60 days, please provide us, for each recommendation without 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 days 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.

Should you or your staff have any questions, please contact me at (404) 331-3369, or Gerald Kirkland, Assistant Regional Inspector General for Audit, at (865) 545-4368.

SUMMARY

Authority management violated its ACC with HUD by inappropriately guaranteeing performance by its related nonprofit corporation. Also in violation of its ACC, the Authority advanced \$392,861 to Judge O.K. Holladay Homes, L.P. prior to obtaining approval of its mixed-finance proposal from HUD Headquarters. Further, the Authority incurred questionable costs of \$367,067, \$42,772 for the LP's operating costs and \$324,295 for development costs in excess of HUD approved expenditures. Additionally, the Authority's Executive Director, who was also the Executive Director and Secretary/Treasurer of HHI, violated conflict of interest restrictions. These actions occurred because the Board of Commissioners did not establish sufficient controls to monitor the nonprofit and ensure transactions adhered to Federal regulations.

We recommend the Director of the Office of Public Housing:

- Of the ineligible costs of \$42,772, require the Authority to furnish evidence of repayment from Judge O.K. Holladay Homes, L.P. for remaining ineligible costs of \$18,015, and discontinue advancing funds for operating expenses;
- Require the Authority to provide written evidence of HUD Headquarter's approval to fund cost overruns, provide support for the source of the \$324,295 in excess of the amounts originally authorized by HUD, and repay any unauthorized amounts to the Authority from non-Federal sources;
- Require the Authority to obtain written HUD approval prior to any future pledge or encumbrance of Authority assets;
- Ensure the Board of Commissioners takes appropriate measures to prevent future conflict of interest situations; and,
- Require the Board of Commissioners to establish adequate controls to monitor Authority interactions with its nonprofit and ensure transactions comply with the ACC and other HUD requirements.

BACKGROUND

The Authority was organized under the laws of the State of Tennessee. The Authority was to develop and operate public housing units in compliance with its ACC with HUD. A seven-member Board of Commissioners governed the Authority with members appointed by the Mayor of Cookeville. Leon Delozier was the Board Chairman and C. Dow Harris was the Executive Director during our audit period.

On July 19, 2001, the Authority's Executive Director created HHI, a non-profit organization, to serve as the general partner in the limited partnership (LP), Judge O.K. Holladay Homes, L.P. The other partner was Apollo Housing Capital, LLC (Apollo). The LP was created by the Authority to develop 30 public housing units to replace 30 previously demolished units at the Willow Heights development, formerly known as Judge O.K. Holladay Homes. The new units would be financed with funds from several sources, including Capital Funds, Operating Reserves, and low-income housing tax credits. The Authority served as the developer. The Authority's Board members also served as HHI's Board and the Authority's Executive Director was HHI's Secretary/Treasurer.

The Authority's financial records were maintained primarily at its central office located at 235 West Jackson Street, Cookeville, Tennessee.

Finding 1 - The Authority Inappropriately Guaranteed Performance, Advanced Funds Prior to Approval, and Incurred Questionable Costs of \$367,067

Authority management violated its ACC with HUD by inappropriately guaranteeing performance by its related nonprofit corporation. Also in violation of its ACC, the Authority advanced \$392,861 to the LP prior to obtaining approval of its mixed-finance proposal from HUD Headquarters. Further, the Authority incurred questionable costs of \$367,067, \$42,772 for the LP's operating costs and \$324,295 for development costs in excess of HUD approved expenditures. Additionally, the Authority's Executive Director, who was also the Executive Director and Secretary/Treasurer of the nonprofit, violated conflict of interest restrictions. These actions occurred because the Board of Commissioners did not establish sufficient controls to monitor the nonprofit and ensure transactions adhered to Federal regulations.

Criteria

Part A, Section 7 of the ACC, Covenant Against Disposition and Encumbrances, states that with the exception of entering into dwelling leases with eligible families for dwelling units in the projects covered by this ACC, and normal uses associated with the operation of the project(s), the housing authority shall not in any way encumber any such project, or portion thereof, without the prior approval of HUD. In addition, the housing authority shall not pledge as collateral for a loan the assets of any project covered under this ACC.

Part A, Section 9 of the ACC, Depository Agreement and General Fund, states that the Authority may withdraw funds from the General Fund only for: (1) payment of the costs of development and operation of the projects under ACC with HUD; (2) the purchase of investment securities as approved by HUD; and, (3) such other purposes as may be specifically approved by HUD.

Part A, Section 19 of the ACC, Conflict of Interest, prohibits the Authority from entering into any contract or arrangement in connection with any project under the ACC in which any Authority employee who formulates policy or who influences decisions with respect to the project(s), has an interest, direct and indirect, during his or her tenure or for one year thereafter.

The Authority Inappropriately Guaranteed Nonprofit Performance

In violation of its ACC, the Authority inappropriately guaranteed HHI's performance and agreed to fund any development cost overruns. On March 1, 2002, the Authority's Executive Director signed an Affiliate Guaranty (Guaranty Agreement) between the Authority and Apollo. The Guaranty Agreement was part of the Partnership Agreement between HHI (the general partner) and Apollo. The Guaranty Agreement provided that in order to induce Apollo to enter into the Partnership, the Authority would irrevocably and unconditionally fully guarantee the due, prompt and complete performance of each of the following obligations:

- payment and performance by the general partner, HHI, of each and every obligation of the general partner due under the Partnership Agreement;

- payment and performance by the Developer (the Authority) of each and every obligation of the Developer under the Development Agreement; and,
- prompt and complete payment of all costs and expenses incurred by Apollo in collection of the enforcement of this Guaranty Agreement against the Guarantor.

The Guaranty Agreement also granted to Apollo, in its uncontrolled discretion, and without notice to the Authority, the power and authority to take several actions, including:

- (a) modifying or waiving any terms of the Partnership Agreement, the Development Agreement and/or any other obligations guaranteed hereby;
- (b) taking and holding security for the payment of the indebtedness and/or performance of the other obligations guaranteed hereby and to impair, exhaust, exchange, enforce, waive or release any such security; and,
- (c) directing the order or manner of sale of any such security as Apollo, in its discretion, may determine.

The one-sided Guaranty Agreement is an open-ended contingent liability for the Authority and violates the ACC. An attorney for the Cookeville Housing Authority expressed concerns about the Guaranty Agreement. In his December 18, 2001, memorandum to the Authority, the attorney wrote in part,

“...affiliate status means that Cookeville Housing Authority irrevocably and unconditionally guarantees any and all obligations of the General Partner under the Partnership agreement. This guaranty is made for the ‘benefit of’ Apollo, the Limited Partner. In addition, the guaranty grants Apollo the unfettered discretion to modify, accelerate, or to take and order the sale of security with regard to any indebtedness or obligations guaranteed by Cookeville Housing Authority. Also, the Guaranty provides that the Cookeville Housing Authority waives practically every defense imaginable...this agreement is extremely one sided...it places all potential liability on Cookeville Housing Authority while giving Cookeville Housing Authority seemingly no way to challenge it, even meritorious defenses.”

The attorney expressed several other concerns; however, despite his legal advice, the Authority’s Executive Director signed the agreement.

In addition, the Authority entered into a Development Agreement with the LP in which it pledged to fund cost overruns for the project. This agreement required the Authority to make loans to the partnership for funding cost overruns during construction. According to this agreement, any such loans could only be repaid to the Authority under certain circumstances. Any amounts not reimbursed after final closing could not be reimbursed or charged to the limited partners, but would have to be borne by the Authority.

The Authority Incurred Questionable Costs

Title 24 of the Code of Federal Regulations (CFR), Part 941, Subpart F, provides requirements for developing mixed-financed housing. It requires in part that prior to developing such housing, authorities must obtain approval by HUD Headquarters. Title 24, Part 941.306, provides that no funds can be used in excess of approved amounts without written approval from HUD. Further, Part 941.602(c), provides that any action or approval that is required by HUD shall be done by HUD Headquarters unless the field office is authorized in writing by Headquarters to carry out a specific function. On March 14, 2001, the Authority submitted a mixed-finance proposal to HUD's Office of Public Housing Investments for the development of Willow Heights. HUD subsequently approved the proposal including the projected use of \$641,213 of operating reserves and \$412,989 of Capital Funds. However, prior to submitting the proposal or obtaining HUD approval, the Authority spent \$559,361 for the project. It spent \$166,500 from a HOPE VI demolition grant and \$392,861 of public housing funds. While the use of the \$166,500 of HOPE VI funds was authorized by the grant agreement, the use of the public housing funds was not. Thus, the Authority violated Part A, Section 9 of the ACC. Authority management acknowledged that they did not get HUD involved until after plans and construction had begun.

The Authority entered into a Reimbursement Agreement with the LP on December 31, 1999. The Agreement required the LP to reimburse the Authority for all obligations incurred in connection with the development. We also found the Authority obtained a \$1.8 million line of credit bank loan to fund project development costs pending receipt of tax credit funds. As of May 31, 2003, the Authority had withdrawn \$1,754,978 from the line of credit. As the Authority paid expenses from the loan proceeds, it increased the amount due from the LP. The Authority also recorded the payments made from the HOPE VI grant, Capital Funds, and other sources as amounts due from the LP.

As of July 31, 2003, the LP owed the Authority \$1,563,012. However, HUD only approved the use of \$1,220,702. Thus, the Authority spent \$342,310 more than the amount approved. Further, the Authority spent \$42,772 for the LP's salary expenses, which were ineligible costs. The LP had reimbursed \$22,956 of the ineligible expenses, and the Authority made adjustments of \$1,801. Thus, the unpaid balance of the ineligible expenses was \$18,015. We question the additional \$324,295 the Authority spent.

Unpaid balance due the Authority:	
Public housing funds	\$ 1,267,977
HOPE VI funds	166,500
Capital funds	<u>128,535</u>
Total unpaid balance due the Authority	\$ 1,563,012
Less HUD approved funding	<u>1,220,702¹</u>
Excess expenditures	\$ 342,310
Less remaining ineligible expenses	<u>18,015</u>
Unsupported costs	<u>\$ 324,295</u>

¹ \$641,213 operating reserves + 412,989 Capital Funds + \$166,500 HOPE VI = \$1,220,702.

Conflict of Interest

The Executive Director violated ACC conflict of interest restrictions. As previously discussed, on March 1, 2002, the Executive Director signed a Guaranty Agreement, as part of a Partnership Agreement, whereby he placed Authority assets at substantial risk to the benefit of Apollo. He also signed the Development Agreement between the Partnership and the Authority on behalf of both the LP and the Authority. At the time, the Development Agreement put Authority assets at further risk because it committed the Authority to advance funds to the Partnership to pay any development cost deficiencies. In another instance, he signed a Reimbursement Agreement with the Partnership on behalf of both the Authority and the LP.

Inadequate Controls

The Office of the Inspector General's Program Integrity Bulletin for Public Housing Commissioners provides that the Commissioners have ultimate responsibility for public housing operations including approving policies and procedures, and ensuring that the public housing agency acts legally and with integrity in its daily operations. Our review showed that weak controls contributed to the ACC violations. Specifically, the Board had not established sufficient controls to effectively monitor the nonprofit and ensure transactions adhered to Federal regulations.

AUDITEE COMMENTS

The Authority did not agree with the Finding. Generally, the Authority claimed that all of its development activity was performed with full approval and knowledge of the Nashville HUD Field Office. The Authority also clarified that portions of the Finding incorrectly referred to HHI when the discussions should have stated the LP.

Regarding the inappropriate guarantees, the Authority makes several arguments. The Authority claimed that the guaranty agreement between the Authority and Apollo Capital, LLC, while extremely one-sided and onerous in its language, presented minimal risks to the Authority. Similarly, the Authority claims that the risk associated with its guarantee to fund cost overruns was minimal. The Authority also provided a discussion pertaining to HUD's authorization of a \$1.8 million loan the Authority obtained. The Authority explained that HUD entered into two Subordination Agreements and a Memorandum of Understanding with the bank, thus allowing the Authority to acquire the loan.

The Authority explained that cost overruns did occur, but that HUD approved \$200,000 for cost overruns. It stated that another \$112,000 being held in retainage by Apollo was not approved. However, elsewhere in its comments, page 7, it claimed that all excess costs were approved by HUD.

The Authority believed that since no director or officer of the Authority had any material or non-material financial interest with the non-profit, there was no conflict of interest.

The Authority claimed that it properly allocated costs.

OIG EVALUATION OF AUDITEE COMMENTS

We considered the Authority's comments pointing out that we had incorrectly discussed some items, such as the amounts paid and the balance owed the Authority for development costs as being attributable to HHI. We have corrected the Finding to show the funds were paid on behalf of and are owed by the LP.

While the Authority's risk pursuant to the various guarantees may have been minimal, the fact remains that its ACC prohibited such guarantee agreements without prior HUD approval. Regarding the \$1.8 million loan, we were aware that HUD had entered into the agreements with the bank. Thus, we did not question whether the Authority encumbered assets to obtain the loan. Our discussion in the Finding about the \$1.8 bank loan is presented for informational purposes to explain the source of funds and how transactions were recorded. Thus, the Authority's discussion about HUD knowledge for the loan is moot.

The Finding questioned the source of \$324,295. The Authority's explanation that \$312,000 of cost overruns occurred may account for the costs. The Authority claimed it obtained HUD approval for \$200,000 of the cost overruns. According to 24 CFR 941.602(c), any such approval was required to be made by HUD Headquarters, unless the field office was authorized in writing to grant approval. The Authority did not provide evidence of HUD approval. As such, we did not revise the Finding.

While the Authority Board and Executive Director may not have had any financial interest in the non-profit, they did have an interest. While that interest may have been primarily fiduciary, the ACC clearly prohibits any interest, direct or indirect. To allow the Executive Director to sign documents on behalf of multiple entities that place the Authority at risk is clearly a conflict. Fortunately, at least to this point, the only actual loss to the Authority was that it had to fund cost overruns, which still have not been fully repaid. We did not revise this portion of the Finding.

During our review, the Authority's controller told us the Authority did not allocate certain costs. As stated in the draft report, we did not review the allocations of costs, but because of the controller's statement, we recommended that HUD review the Authority's cost allocation for reasonableness and require the Authority to repay any costs that were not properly allocated. We removed the discussion and the recommendations from the Finding.

Since the developments are completed, the future risk to the Authority is substantially reduced. As such, we revised the recommendation requiring the Authority to terminate the guarantee agreements.

RECOMMENDATIONS

We recommend the Director of the Office of Public Housing:

- 1A. Of the ineligible costs of \$42,772, require the Authority to furnish evidence of repayment from Judge O.K. Holladay Homes, L.P. for remaining ineligible costs of \$18,015, and discontinue advancing funds for operating expenses.
- 1B. Require the Authority to provide written evidence of HUD Headquarter's approval to fund cost overruns, provide support for the source of the \$324,295 in excess of the amounts originally authorized by HUD, and repay any unauthorized amounts to the Authority from non-Federal sources.
- 1C. Require the Authority to obtain written HUD approval prior to any future pledge or encumbrance of Authority assets.
- 1D. Ensure the Board of Commissioners takes appropriate measures to prevent future conflict of interest situations.
- 1E. Require the Board of Commissioners to establish adequate controls to monitor Authority interactions with HHI and the Partnership and ensure transactions comply with the ACC and other HUD requirements.

MANAGEMENT CONTROLS

Management controls include the plan of organization, methods and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance

We determined the following management controls were relevant to our audit objectives:

- Safeguarding Resources – Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss and misuse.
- Compliance with Laws and Regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

To assess the relevant controls, we:

- interviewed Authority staff;
- reviewed Authority general ledgers, bank statements, and other accounting and administrative records;
- reviewed HHI general ledgers, bank statements, loan documents; and,
- reviewed the Authority's financial statements.

A significant weakness exists if management controls do not provide reasonable assurance that resource use is consistent with laws, regulations, and policies; and, that resources are safeguarded against waste, loss, and misuse.

Based on our review, we identified the following significant weaknesses:

- Safeguarding Resources - Authority management inappropriately pledged Authority assets and guaranteed HHI performance and agreed to fund any cost overruns (Finding, pages 4, 5).
- Compliance with Laws and Regulations - Authority management violated its ACC with HUD by inappropriately guaranteeing performance (Finding, pages 4, 5) by its related nonprofit corporation and advancing \$392,861 to HHI prior to obtaining HUD approval of the mixed-finance proposal. Further, the Authority incurred questionable costs of \$342,310, \$18,015 for HHI's operating costs and \$324,295 for development costs in excess of HUD approved expenditures. (Finding, page 6). Also, the Authority's Executive Director, who was also the Executive Director of the nonprofit, violated conflict of interest restrictions.

FOLLOW-UP ON PRIOR AUDITS

This is the initial OIG audit of this Authority. Kendall L. Davis, Certified Public Accountant, completed the most recent audit of the Authority's financial statements for the 12-month period ended September 30, 2001. His report did not contain any findings.

SCHEDULE OF QUESTIONED COSTS

<u>Recommendation</u>	<u>Ineligible</u> ²	<u>Unsupported</u> ³
1A	\$ 42,772	
1B		\$ 324,295

² Ineligible costs are those that are questioned because of an alleged violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the expenditure of funds.

³ Unsupported costs are those whose eligibility cannot be clearly determined during the audit since such costs were not supported by adequate documentation. An administrative determination may be needed on these costs.

AUDITEE COMMENTS

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Jeffrey G. Jones, Member

March 8, 2004

David Butcher
Senior Auditor
U.S. Department of Housing and Urban Development
Office of Inspector General
John Duncan Federal Bldg.
710 Locust St., S.W.
Knoxville, TN 37902

Re: Cookeville Housing Authority OIG Inspection
Meeting at Cookeville Housing Authority
February 20, 2004

Dear David:

Pursuant to our conversation of February 20, 2004, enclosed is a copy of Cookeville Housing Authority's Response to OIG's Audit. I wanted to forward you a copy for your files. If there are any questions, please do not hesitate to give me a call.

After you have had an opportunity to review the same, please give me a call so that we may discuss how to proceed. I look forward to hearing from you.

Sincerely,

Jeffrey G. Jones
For the Firm

JGJ/jk

AFFILIATED FIRMS

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GREENVILLE, SOUTH CAROLINA

RESPONSE TO AUDIT REPORT

**OFFICE OF INSPECTOR GENERAL FOR AUDIT
U. S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT**

March 8, 2004

**TO: David Butcher
U.S. Department of Housing and Urban Development
Office of Inspector General**

**Maxie W. Walls, CFE
U.S. Department of Housing and Urban Development
Office of Inspector General**

**Gerald Kirkland
U.S. Department of Housing and Urban Development
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710 Locust St., S.W.
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**Sonya D. Lucas
Acting Assistant Inspector General for Audit
U.S. Department of Housing and Urban Development
Office of Inspector General**

**Charles T. Barnett
Acting Director of Memphis HUB, 4KPH**

**Mike Farley
U.S. Department of Housing and Urban Development
Nashville, Tennessee Office**

**Leon T. Delozier
Chairman, Board of Directors
Cookeville Housing Authority**

INTRODUCTION

The foregoing document is a response to the audit performed by the Office of Inspector General. Pursuant to a meeting with Maxie W. Walls and David Butcher of the Office of Inspector General on February 20, 2004, the aforementioned auditors had had access to all of the information

mentioned in the foregoing response. Furthermore, pursuant to the meeting with the aforementioned auditors at the Cookeville Housing Authority in Cookeville, Tennessee, on February 20, 2004, the explanation detailed in the foregoing response was presented to Mr. Walls and Mr. Butcher.

RESPONSE

The Cookeville Housing Authority was organized under the laws of the State of Tennessee. The Authority was to develop and operate public housing units in compliance with its ACC and HUD. A seven (7) member Board of Commissioners governs the Authority with members appointed by the Mayor of the City of Cookeville, Tennessee. During the relevant period, Leon Delozier was the Board Chairman, and C. Dow Harris was the Executive Director. The Cookeville Housing Authority has consistently received "high performer" status from HUD.

Although the Cookeville Housing Authority was chartered in the City of Cookeville, Tennessee, at its inception in the 1950's, the Cookeville Housing Authority operates fourteen (14) different developments in three (3) different counties in Middle Tennessee. Of the developments that the Housing Authority has operated, the worst development was located on Vaughn Drive in Cookeville, Tennessee. This development was a management problem for a number of different reasons. First, the development was not in as top flight a condition as other projects operated by the Cookeville Housing Authority. Secondly, the geographic location of the development in the City of Cookeville made it very difficult to control in terms of drug related activity and other crime. With only one road leading into and out of the development, tenants engaging in criminal activity could very easily see law enforcement approaching the units. Accordingly, the Cookeville Housing Authority experienced its highest eviction rate from tenants in the Vaughn Drive development. Furthermore, in a span of four (4) years, nine (9) units were destroyed by fires of a suspicious nature. Consequently, after the last five units were destroyed by fire, the Board of Directors for the Cookeville Housing Authority decided changes must be made with this particular development.

Accordingly, the Board of Directors decided in 1999 that application would be made for a HOPE VI demolition grant to demolish existing units. In place of the demolished units, the Cookeville Housing Authority would construct new and attractive public housing for the elderly. As a part of the project, not only would housing be replaced, but the layout and the roads into the development would be changed, as well. This would accomplish three major goals. First, it would provide low income public housing for the elderly for which there is a tremendous need in the Putnam County, Tennessee area. Secondly, it would give a badly needed "facelift" to the development accomplishing the HUD mandated goal of operating units with more "curb appeal." Lastly, it would solve the management problems (ie crime, eviction, etc.) experienced by the Cookeville Housing Authority from the Vaughn Drive development. In making the decision to transform the Vaughn Drive project to elderly housing, the Board of Directors decided that the best way to finance the project would be to draw from several sources, including capital funds, operating reserves, and low income tax credits.

In 1999, the Cookeville Housing Authority made application to the Tennessee Housing Development Agency for the tax credits that ultimately funded the construction of the new

development, Willow Heights. One of the requirements of the tax credit program from THDA was that the Cookeville Housing Authority had to have the construction on the new development totally complete and ready for occupation by December 1, 2001, or the Cookeville Housing Authority would lose the tax credits.

Even though the Housing Authority knew that it had a deadline of December 1, 2001, the tax syndication process took much longer than anticipated. For a number of reasons, including but not limited to declines in the stock market, locating a syndicator to purchase the tax credits was an extremely lengthy and difficult process. Due to the problems of finding a purchaser for the aforementioned tax credits, the Cookeville Housing Authority had no choice but to make arrangements to proceed with construction in light of the December 1, 2001, deadline. All of the aforementioned problems were made known to HUD Nashville. In discussing the situation with HUD Nashville, it was decided and approved by HUD for the Cookeville Housing Authority to obtain a bridge loan/construction loan to begin construction on the development. It was contemplated that the construction loan would be repaid by the syndication of the tax credits through a limited partnership once the development was completed. Accordingly, the Housing Authority entered into a reimbursement agreement with a limited partnership, which was organized to syndicate the tax credits, on December 31, 1999. The agreement required the limited partnership to reimburse the Authority for all obligations incurred with connection to the development.

Throughout the entire process, the Department of Housing and Urban Development, as well as the Board of Directors of the Cookeville Housing Authority knew of the actions throughout the process. This was accomplished through many items of correspondence, numerous telephone conversations, and various face to face meetings both in Nashville and in Cookeville. As evidenced by the resolutions and the minutes of the Board of Directors for the Cookeville Housing Authority, the Board of Directors was well aware of the steps in this process. In order to obtain the bridge loan/construction loan from Union Planters Bank, the Cookeville Housing Authority was required by the bank to collateralize the loan of \$1.8 million. The Cookeville Housing Authority was able to accomplish this by granting Union Planters a deed of trust on its former office location. However, the Department of Housing and Urban Development had two declarations of trust encumbering the office space. In order to effectuate the aforementioned deeds of trust to Union Planters, the Department of Housing and Urban Development had to enter into two separate Subordination Agreements and a Memorandum of Understanding to Union Planters allowing the Cookeville Housing Authority to enter into the bridge loan/construction loan. Consequently, the Department of Housing and Urban Development approved any encumbrances and loans prior to the Cookeville Housing Authority entering to the same.

As stated earlier, in order to effectuate the syndication of the tax credits, a limited partnership was established, Judge O.K. Holliday Homes, LP. Originally, the Cookeville Housing Authority was the general partner for the limited partnership, with Walnut Village, Inc. being the limited partner. Subsequently, Apollo Housing Capital, LLC was substituted as the limited partner in the limited partnership with Cookeville Housing Authority remaining as the general partner and developer of the project. For tax purposes, a separate entity was created to serve as general partner, Holliday Homes, Inc. Holliday Homes is a one hundred percent (100%) wholly owned subsidiary of the

Cookeville Housing Authority. The Authority's Board Members serve as Holliday Homes, Inc.'s Board. Furthermore, the Executor Director of the Cookeville Housing Authority is the Secretary/Treasurer for Holliday Homes, Inc. Furthermore, the Board of Directors authorized the Executor Director of the Cookeville Housing Authority to execute documents on behalf of Holliday Homes, Inc. According to the by-laws of Holliday Homes, Inc., no director nor any officer shall receive any compensation for any duty performed on behalf of Holliday Homes, Inc. Furthermore, Holliday Homes, Inc. is a Tennessee non-profit corporation with no assets. Accordingly, no director nor any officer of the Cookeville Housing Authority has any material or non-material financial interest with the non-profit corporation, Holliday Homes, Inc.

The Cookeville Housing Authority submitted a mixed finance proposal to HUD which estimated that the project in question could be built for approximately \$2.1 million, including \$1.2 million in HUD funds. The Department of Housing and Urban Development subsequently approved the use of \$1.2 million. However, as stated earlier, this was only a *projected* cost. As with many construction projects, there were cost overruns. Accordingly, the total construction cost was approximately \$2.4 million. However, pursuant to an agreement with the Department of Housing and Urban Development, approximately \$200,000.00 of cost overruns was approved/ratified. This left an outstanding amount not approved being nearly \$112,000.00. The aforementioned amount of \$112,000.00 is the amount held in retainage by Apollo Housing Capital, LLC, the limited partner in the limited partnership, to guarantee a six (6) months performance by the limited partnership. Accordingly, once the retainage is paid by Apollo Housing Capital, LLC, to the Cookeville Housing Authority, there will be virtually no amount of money that has not been approved by HUD or paid by the syndicator.

As part of the syndication process, many documents were required to be executed to allow the syndicators to sell tax credits on the secondary market. One of the documents signed by the Executive Director on behalf of the limited partnership, the Cookeville Housing Authority, and Holliday Homes, Inc. was an option contract. The reason for the execution of this option contract was to protect the Cookeville Housing Authority. The Cookeville Housing Authority had maintained from the outset that the limited partnership would never own in fee simple the property on the Willow Heights Development was located. Rather, it was contemplated at the outset that this property would be leased to the limited partnership for a term that would coincide with a fifteen (15) year payout of a tax credit purchase. However, in late December 2001, it was reported to the Cookeville Housing Authority by the syndicator that in order to be eligible for tax deductions, the limited partnership would have to own the property in fee simple. There was much objection by the Cookeville Housing Authority to such a transfer due to insurance and liability reasons, as well as issues of ownership. In order to continue the tax syndication process but protect the Cookeville Housing Authority, the Executive Director entered into ninety-nine (99) year ground lease for the property in question, but wisely retained an option contract for a period of twenty (20) years so that the Cookeville Housing Authority could repurchase the property at its discretion for the amount of \$10.00. Again, this document was executed to protect the Housing Authority if the limited partner did not "hold up its end of the bargain."

One of the other documents for which execution was required by the tax syndicator and for which there has been much concern as stated in the local and national report from OIG, was a guaranty agreement between the Cookeville Housing Authority and Apollo Capital, LLC. The guaranty agreement provided that the Cookeville Housing Authority would irrevocably and unconditionally fully guarantee the due, prompt and complete performance of several obligations. The default provisions of the guaranty agreement most certainly are onerous. In fact, attorneys for the Cookeville Housing Authority expressed the fact that the language in the guaranty agreement was extremely one-sided. However, in presentation of his concerns about the guaranty agreement to the Cookeville Housing Authority after December 18, 2001, the attorney for the Cookeville Housing Authority expressed that whenever an attorney reviews a contract, the same is reviewed with a jaundiced eye, looking for the worse case scenario. Once such an evaluation is made, it is then up to the client to make a business decision as to whether or not to enter into an agreement based on the risks. In the case at hand, even though the affiliate guaranty agreement was rather onerous in its language, the risks to the Cookeville Housing Authority were rather minimal for a number of reasons:

- 1) The limited partner, Apollo Housing, LLC, owned 99.9% of the limited partnership. The general partner, Holliday Homes, Inc., only owns **1/10 of 1% of the limited partnership.**
- 2) The capital contribution of the general partner, Holliday Homes, Inc., is only \$250.00.
- 3) The only obligations of the general partner in the limited partnership has to do with management of the development for the limited partnership. The development, however, is managed by the Cookeville Housing Authority pursuant to a management agreement entered into between the limited partnership and Cookeville Housing Authority.
- 4) Holliday Homes, Inc. has no assets and its directors and officers receive no salaries.
- 5) The construction phase of the project had already been completed at the time of the signing of the affiliate guaranty agreement. Consequently, the Cookeville Housing Authority knew its financial exposure to the penny.
- 6) The Cookeville Housing Authority encumbered no real property interest in executing the guaranty agreement. No assignments of any lease nor any deeds of trust (mortgages) have been executed to guarantee the performance of the general partner, Holliday Homes Inc.

Because the Cookeville Housing Authority had already assumed prior to the affiliate guaranty agreement all of the duties enumerated in the partnership agreement, the risks to the Cookeville Housing Authority from the guaranty agreement was virtually nothing. Accordingly, it was decided

that the document would be executed.

According to the findings of the OIG, on March 1, 2002, the Executive Director signed a guaranty agreement as part of the partnership agreement whereby he placed the Authority's assets at substantial risk to the benefit of Apollo. However, this is incorrect when looking at the project as a whole. As stated earlier in this response, pursuant to the directives of the tax credit program and the Tennessee Housing Development Agency, the project in question was required to be completed by December 1, 2001. When the guaranty agreement was executed on March 1, 2002, all of the project costs had been completed and paid for with funds from Union Planters Bank pursuant to the bridge loan/construction loan. Consequently, no Authority assets were at risk nor did funds have to be advanced because the project was already complete. Accordingly, the practical effect of a guaranty regarding cost overruns was zero. Furthermore, the guaranty agreement states that it will automatically expire after six (6) months once the management agency, Cookeville Housing Authority, certifies that there are six (6) months of positive cash flow and no cash shortage. This has been completed.

The Cookeville Housing Authority understands that the Office of Management and Budget Circular A-87 establishes principles and standards for determining cause for federal awards carried out through grants, cost reimbursement, and other agreements with state and local government and federally recognized Indian tribal governments. In the case at hand, the OIG has questioned whether or not cost was properly allocated to non-profit activities. In the case at hand, Holliday Homes, Inc. has no revenues, no employees, and no assets. Operations by the Cookeville Housing Authority for the limited partnership were conducted pursuant to the development agreement and management agreement entered into by the Cookeville Housing Authority and Judge O.K. Holliday Homes LP. Costs have been properly allocated to *limited partnership* from its inception. The costs allocated to Holliday Homes, Inc. have been fairly minimal because, as stated earlier, development and management responsibilities have been the responsibility of the Cookeville Housing Authority. The only expenses attributable to Holliday Homes Inc. are the filing fees for chartering the corporation and related fees. The audit reflected that the Cookeville Housing Authority spent \$42,772.00 for Holliday Homes Inc. salary and expenses. However, as shown from the records at the Cookeville Housing Authority, costs have been properly allocated to the *limited partnership*, not Holliday Homes Inc.

SUMMARY

Concerns

1. Require the Housing Authority to obtain repayment from HHI for unreimbursed ineligible costs of \$18,015 and discontinue advancing funds for operating expenses.

Response: The Guaranty Agreement between the general and limited partner is moot. The Housing Authority lent funds to Holliday Homes, Inc. to defray initial costs. The site is developed, the loans closed, and the Cookeville Housing Authority is now managing the site. The Cookeville Housing Authority no longer lends funds to Holliday Homes, Inc. The funds have been paid back and the site

is self sufficient.

2. Require the Authority to provide to HUD support for the source of the \$324,295 in excess of the amounts authorized by HUD or repay any unsupported amounts to the Authority from non-Federal Sources.

Response: The funds from Mixed Finance Program, Capital Fund Program, HOPE VI Program, and Operating Fund for Willow Heights were approved, audited by IPA, and closed. All excess costs within the separate programs were approved by HUD.

3. Require the Authority to terminate the inequitable guaranty agreement with Apollo Housing Capital LLC. Should the Authority refuse to terminate the agreement, refer the Authority to the PIH Assistant Secretary for default of its ACC.

Response: As noted in Concern 1 and 2, the Guaranty Agreement is moot and was moot when this OIG review was conducted. The conditions have been met by all parties and expired. The site is self sufficient. This concern be stricken from the report.

4. Require the Authority to obtain HUD approval prior to any future pledge or encumbrance of Authority assets.

Response: As noted above, all actions and encumbrances were approved prior to execution or expense by either HUD Headquarters or the Nashville Program Center.

5. Ensure the Board of Commissioners takes appropriate measures to prevent conflict of interest situations.

Response: Holliday Homes, Inc. has no assets nor employees. There is no conflict of interest. Neither the Board nor the Executive Director had anything to gain financially or otherwise. Furthermore, the Board was aware of all actions.

6. Require the Authority to develop a reasonable method for allocating costs.

Response: All cost allocations were projections by the Cookeville Housing Authority, the Architect, or the limited partner, Apollo LLC. As stated above, all costs have been allocated to the Limited Partnership, Judge O.K. Holliday Homes, LP. All costs and allocations were approved by HUD.

7. Determine whether the Authority properly allocated costs and if the costs were not properly allocated, require the Authority to reimburse the appropriate program account from nonfederal funds.

Response: As cited in the background and in Concern 6, all programs have been audited and closed. OIG would have made this determination if allowed to be on site longer.

8. Require the Board of Commissioners to establish adequate controls to monitor Authority interactions with its nonprofit and ensure transactions comply with ACC and other HUD requirements.

Response: The Board of Commissioners for the Cookeville Housing Authority acts as the Board for Holliday Homes, Inc. All transactions are discussed and approved via resolution. It is our understanding that Mr. David Butcher revisited the ACC, specifically Sections 7 and 9 - referencing encumbrances and conflict of interest. HUD approval negates the concerns relating to encumbrances. Holliday Homes, Inc. having no assets nor staff negates any conflict of interest.

CONCLUSION

Based on the information provided to the OIG staff at the close-out and in the foregoing response, we request that all concerns be closed.