



U.S. Department of Housing and Urban Development

District Office of the Inspector General
Richard B. Russell Federal Building
75 Spring Street, SW, Room 700
Atlanta, GA 30303-3388
(404) 331-3369

March 28, 1996

Audit-Related Memorandum

96-AT-212-1810

TO: Robert A. Rifenerick, Director, Multifamily Housing Division, 4EHM

FROM: Kathryn Kuhl-Inclan
District Inspector General for Audit-Southeast/Caribbean, 4AGA

SUBJECT: Limited Review of
Bentley Court (BC)
Columbia, South Carolina

INTRODUCTION

In our initial survey, we found indications of irregular transactions using project funds. Also, the partnership was in default during August 1994 to April 1995 on its BC mortgage, and the project had not earned a profit nor generated surplus cash since it began operations in August 1991.

This limited review's purpose was to establish whether there were any improper distributions of project assets; and if so, relationship to the mortgage default. Our review was conducted May through September 1995 with updating during March 1996 for status information.

BACKGROUND

Bentley Court Apartments are owned by Bentley Court II Limited Partnership. The two general partners (GP) are Edwin Lewis, II and Canal Court II Limited Partnership. The Limited Partners are Boston Financial Qualified Housing Tax Credits LP IV and SLP 89, Inc. The apartment complex is managed by Brookstone Ltd. of Columbia, an affiliate of GP Lewis. The mortgagee is American Capital Resource, Inc. (ACR).

BC is HUD insured and consists of 272 1 to 3 bedroom units. All units are available to low and moderate income persons because they qualify for the Low Income Housing Tax Credit Program.

SCOPE

During this limited review for distributions of project assets, we reviewed 1991 through 1994 project financial statements*, and related documentation. Discussions were held with the managing GP and the affiliated management agent, and with HUD staff at the Columbia field office. We also reviewed the status of the mortgage and the reserve for replacement fund. Our limited review did not provide full audit coverage for any of the project's activities.

* * * *

We found that:

- The GP made unauthorized distributions of \$305,551, and
- The reserve for replacement escrow was underfunded.

More details on our findings and recommendations for corrective actions are in Attachment 1. We provided a draft to you and GP Lewis on September 7, 1995. We received comments from Mr. Lewis which are summarized following each finding and included in full as Attachment 3.

Within 60 days, please furnish this office, for the recommendations in Attachment 1, a status report on: (1) corrective action taken; (2) proposed corrective actions and the date to be completed; or (3) why actions are considered unnecessary. Also, furnish us copies of any correspondence or directives issued because of our review. Please keep in mind the recent emphasis for timely management decisions on audit findings within set periods.

We are providing GP Lewis a copy of this report.

Should you or your staff have questions, please call Ted E. Drucker, Assistant District Inspector General for Audit (404 -331-3369), or Senior Auditor Richard Pirsig in Columbia (765-5784).

Attachments:

- 1 - Findings and Recommendations
- 2 - Summary of Unauthorized Distributions
- 3 - Auditee Comments
- 4 - S c h e d u l e o f I n e l i g i b l e C o s t s
- 5 - Report Distribution

* OIG Note

At March 19, 1996, HUD had not received BC's audited Financial Statements for 1995, which were overdue.

FINDINGS AND RECOMMENDATIONS

Finding 1. Partners Made Unauthorized Distributions Of Project Funds.

From 1992 through 1994, BC paid \$305,551 in unauthorized distributions while having no surplus cash. The distributions were payments for construction costs (\$33,203), for non-project legal fees (\$107,477), for or to affiliated entities or persons (\$164,871). These amounts are discussed below and listed in Attachment 2. Distributions in excess of surplus cash violate the project's contract with the mortgagee for HUD's benefit, and other applicable HUD requirements. Improper distributions subject the partners to criminal and/or civil penalties; they contributed to defaults in mortgage payments.

Criteria

Paragraph B.3.b. of the owners' contract (regulatory agreement) with ACR, for the mortgage co-insured by HUD, states in part that the owners may use project funds only to pay reasonable expenses necessary to the proper operation and maintenance of the project, distributions of surplus cash if permitted by paragraph B.4.a. of the regulatory agreement, and owner advances if such repayments are authorized by the Secretary's administrative procedures and approved by the mortgagee.

According to paragraph B.4.a. of the regulatory agreement, distributions may be paid only from surplus cash which existed as of the end of a semi-annual or annual fiscal period. Distributions may be paid only after the end of the fiscal period in which the surplus cash is generated.

An improper distribution is any withdrawal or taking of cash or any assets of the project other than for the payment of reasonable expenses necessary to the operation and maintenance of the project. If the owner takes distributions when the project is not in a surplus cash position, the owner is subject to criminal and/or civil penalties. Surplus cash generated at the end of the project fiscal year is not to be distributed until the next fiscal period. (HUD Handbook 4370.2 REV-1, Financial Operations and Accounting Procedures for Insured Multifamily Project, Chapter 2, paragraph 2-10)

Owner advances for reasonable and necessary operating expenses may be repaid from surplus cash at the end of the annual or semi-annual period. (HUD Handbook 4370.2 REV-1, Chapter 2, paragraph 2-11). Repayment without specific advance approval of advances when the project is not in a surplus cash position is prohibited and may subject the owners to criminal and civil penalties.

Summary of Unauthorized Distributions

<u>Year</u>	<u>Surplus Cash at the end of Prior Year</u>	<u>Unauthorized Distributions</u>
1992	\$ (196,374)	\$ 33,203 (1)
1993	(119,135)	123,870 (2)(3)
1994	(156,969)	<u>148,478</u> (2)(3)
Total Unauthorized Distributions		<u>\$ 305,551</u>

(1) Year 1992

These unauthorized distributions are, as detailed in Attachment 2, amounts paid for construction costs with project funds. These amounts were charged as building improvements. The managing GP told us these payments were related to project construction cost paid after final endorsement (June 12, 1991) with no amounts escrowed for their payment.

Section B.3.b. of the regulatory agreement provides that project funds may not be used to liquidate liabilities related to the construction of the project unless the mortgagee authorizes such use. We found no mortgagee authorization for these construction costs to be paid with project operating funds.

No surplus cash was available as of the end of the prior year to pay these costs. In fact, there was negative surplus cash of (\$196,374).

(2) Legal Fees for 1993 and 1994

The owners made distributions while having no surplus cash as of the end of either prior year. Unauthorized distributions during 1993 and 1994 included \$45,559 and \$61,918, respectively, (detailed in Attachment 2) for non-project legal fees. Based on our review of the invoices and information, as provided by the managing GP, these amounts were primarily for partnership related and not project matters. The audited financial statements reported some as partnership legal expenses, and other charges were not supported as being project related.

(3) Other Unauthorized Distributions in 1993 and 1994

In addition, unauthorized distributions of project funds during 1993 and 1994 included \$78,311 and \$86,560 paid to or for affiliated entities. These amounts are listed in Attachment 2.

Mortgagor's Positions -The managing GP (Mr. Lewis) asserted that the owners made advances to the partnership in excess of distributions.* These advances were commingled with project funds in the same bank account.

The GP also pointed out that as of November 14, 1994 a separate bank account was established to account for partnership transactions separate from project transactions.

Delinquent Mortgage Payments - While the improper distributions were being made, BC mortgage and escrow payments were delinquent (i.e., not received after the 16th day of the month in which they are due). During most of 1993 and 1994 payments were generally received by the mortgagee during the last few days of the month in which they were due or the first few days of the following month.

During the months of August 1994 to April 1995, BC was in default (i.e., payments received more than 30 days after its due date) by one or more of its mortgage and escrow payments. The default was cured April 13, 1995; however at March 8, 1996, BC was again delinquent (for three monthly payments).

Owners Subject to Civil Action for Double Damages - Among purposes of requiring a contract (regulatory agreement) with owners of multifamily insured housing are to help protect the security for the mortgage lien, and the financial viability of the insured project. Violations of the regulatory agreement by misuse of project funds are a basis for civil legal action against owners to recoup double damages for the unauthorized use of project assets and income (12 U.S.C. 1715z-4a).

Auditee/GP Comments (Summary)

Some assumptions made by the auditors were incorrect. The checking account from which the reportedly unauthorized distributions were made was not and never had been a project operating account. Project funds were deposited into this real estate escrow account of the management company, Brookstone Ltd. The account was, and up until November 1994 had been, a partnership account. Also, during the period of 1990 through November 1994 (when BC opened its own checking account), deposits of GP funds into this account were made of over \$559,000; far in excess

* OIG Note

We did not audit the amount or timing of such advances to the partnership because such advances to the partnership usually would have been made for the purpose of funding critical cash flow needs; as indicated also by the mortgage default during most of 1993 and 1994, and again during 1996.

of the reported \$305,551 in unauthorized distributions. At no time were these funds ever considered to be part of the project. Therefore, any distributions of these funds could not be considered as unauthorized distributions of project assets. The Limited Partnership also funded \$193,818 to this account in August 1992.

The GP did allow the management company to use funds in the account to subsidize short falls in the cash flow of the project, and to pay project expenses directly from this real estate escrow account. Both practices were discontinued in November 1994.

According to the auditee, the two primary factors contributing to the mortgage delinquency problem were: (1) the impact of the 1986 changes in the tax law; and, (2) the projected increase in the median income of Richland County which never materialized. The auditee challenged the \$33,202 in unauthorized distributions made in 1992 for construction related costs because during 1992 the construction lender released \$195,880 in completion assurance funds to the project, which should be considered.

GP Closing Comments - As of June 30, 1995, the project has achieved a point that would indicate a surplus cash position of \$1. These matters could be cured "from the records" by:

- The recognition that the accounting method was improper, but the funds were never co-mingled in any of the project owned accounts and therefore were never part of project funds.
- The replacement of the funds that ACR removed from escrow accounts, and the replacement of funds improperly taken, and finally the refunding of late fees charged by ACR if the money authorized by the general partner had gone to mortgage payments instead of to ACR's account.
- And finally, doing a cash surplus report as of June 30, 1995, borrowing the funds, making a deposit and then withdrawing the funds to pay the loan off.

OIG Evaluation and Conclusion

Actual circumstances differ from the auditee's views. Although the auditee contends that the real estate escrow account was never part of the project, its audited financial statements up until November, 1994, presented this account as a project asset, which was used in the computation of surplus cash. In actual practice this account was a project operating account, and was so used and reported. Also, the GP's Response to our draft findings included as its last page (page 18 herein) a sample statement for this bank account entitled: Brookstone Ltd of Columbia; DBA Bentley Court II.

Concerning the \$33,202 in unauthorized distributions for construction costs made in 1992, and the contention that these payments were made from the release of the completion assurance fund by the construction lender, the GP admitted that these funds should have been deposited into the partnership account and not the project account. When funds are deposited into the project account, they become subject to the surplus cash rules for subsequent distributions. The surplus cash position of the project at the end of 1992 was a negative (\$119,135) which in our opinion confirms that all deposits were for project-cash needs. The GP also contended that they advanced other funds to the project to cover cash flow shortfalls. Such advances, without the prior approval of HUD, can only be repaid from surplus cash.

Pertaining to the auditee's rebuttal that as of June 30, 1995, the project has achieved a \$1 cash surplus position, this assertion has not been verified to our knowledge by an independent public accountant. Even if correct, only any amount confirmed (the \$1) as surplus cash can be distributed. The available evidence however indicates that surplus project cash does not exist. At the start of 1994, surplus cash was a negative (\$156,969).

We emphasize also the mortgagor's retention of residual project cash while three monthly payments, as of March 8, 1996, were delinquent. The disputes between the GP and ACR are beyond the scope of our limited review.

The surplus cash rules limit the repayment of owner advances until the project generates surplus cash, so as to protect both the project's cash flow needs and the likelihood of the insured mortgage's repayment. Thus, any advances placed in the project account by the owners became project funds restricted by the surplus cash rules.

Recommendations

We recommend that you:

- 1A. Notify the owners within 10-working days that they must repay \$305,551 to the project account to restore the identified unauthorized distributions made during 1992 through 1994, and any additional distributions of these types for 1995 to date* (as determined in part by analysis of the overdue 1995 audited financial statements).

* OIG Note

The process of identifying any diverted project funds during 1995 and 1996 to date should not delay either management actions on the known \$305,551 of improper distributions or sanctions' consideration.

- 1B. If the owners fail to repay within 30 days of the above notice, pursue administrative sanctions and/or referral to Counsel (program enforcement) for consideration of litigation.

- 1C. Take actions with the mortgagee to protect HUD's interests in the delinquent insured mortgage (such as: By either having the GP bring the mortgage fully current by May 17, 1996; or replace the management agent affiliate of the GP, and initiate through HUD Counsel litigation to obtain all BC assets including the residual project cash generated recently by the mortgagor while monthly mortgage payments were not made).

Finding 2. Reserve for Replacement (RR) Escrow Was Underfunded

The regulatory agreement requires monthly deposits of \$3,237 (rounded) to the RR escrow account commencing on the date amortization of the mortgage began. All requests for withdrawals from the RR account must be in writing. As of 7/31/95, there was a shortfall of \$74,455 in the RR escrow account, and no request for withdrawal:

Required RR deposits:

5/1/91 to 7/31/95	
51 mo. X \$3,236.92	\$ 165,083
Less actual RR balance at 7/31/95	<u>-90,628</u>
Amount Underfunded	<u>\$ 74,455</u>

As a result of BC's failure to make its August 1994 mortgage and escrow payment within 30 days of its due date, the mortgagee ACR transferred from the RR escrow \$75,538 during September for the August payment of principal, interest, and insurance escrow. ACR did not notify HUD of this withdrawal from RR for up to one month's debt service and mortgage escrows (as required under Handbook 4566.2.)

The managing GP believes that BC can justify the reduced RR escrow balance because the project has incurred and paid for qualified capital expenditures approximating \$75,000. At August 2, 1995, he had not submitted to ACR the required documentation to claim these amounts.

Based on our discussions with ACR, they believe that BC had incurred qualified capital expenditures, and they had not pursued full funding of the RR escrow account. ACR recognized that BC should provide documentation supporting the capital expenditures. On June 21, 1995 ACR wrote BC requesting that documentation.

Auditee Comments

The auditee did not specifically address this finding in its comments.

Recommendation

- 2A We recommend that you have the general partners fully fund the RR account, or submit the required documentation (supporting qualified expenditures) to claim credit for a reduced escrow balance.

BENTLEY COURT

Summary of Unauthorized Distributions

For the Year Ended 12/31/92

Building Improvements

<u>Date</u>	<u>Payee</u>	<u>Check No. (1)</u>	<u>BC G/L Acct.#</u>	<u>Amount</u>	
08/19/92	Dixie Heating & Cooling	380	1200	\$ 11,203	Health Club Electrical Work less A/C Repairs
					Total Check Amount \$12,897 Less \$1,694
08/19/92	James C. Stancel	381	1200	10,000	Note Payment for James C. Stancel
08/27/92	Jim Griggs	392	1200	<u>12,003</u>	Note Payment for James C. Stancel
	Total for 1992			<u>\$ 33,203</u>	

For the Year Ended 12/31/93

Non-Project Legal Expenses

<u>Date</u>	<u>Payee</u>	<u>Check No. (1)</u>	<u>BC G/L Acct.#</u>	<u>Amount</u>	
01/28/93	Ralph C. Robinson	471	6910	\$ 5,000	Non-Project Legal Fees
03/01/93	Ralph C. Robinson	3006	6910	7,559	Non-Project Legal Fees Total Check Amount \$8,000 less \$441 for Project
04/05/93	Ralph C. Robinson	508	6910	3,500	Non-Project Legal Fees
05/03/93	Ralph C. Robinson	528	6910	3,500	Non-Project Legal Fees
06/03/93	Ralph C. Robinson	3136	6910	3,500	Non-Project Legal Fees
07/13/93	Ralph C. Robinson	3199	6910	3,500	Non-Project Legal Fees
08/10/93	Ralph C. Robinson	3273	6910	3,500	Non-Project Legal Fees
10/04/93	Ralph C. Robinson	3363	6910	3,500	Non-Project Legal Fees
10/06/93	Ralph C. Robinson	3365	6910	1,500	Non-Project Legal Fees
10/28/93	Ralph C. Robinson	3408	6910	3,500	Non-Project Legal Fees
12/01/93	Ralph C. Robinson	3458	6910	3,500	Non-Project Legal Fees
12/30/93	Ralph C. Robinson	3489	6910	<u>3,500</u>	Non-Project Legal Fees
	Sub-total			<u>\$ 45,559</u>	

Payments to or for Affiliated Entities or Persons

<u>Date</u>	<u>Payee</u>	<u>Check No. (1)</u>	<u>BC G/L Acct.#</u>	<u>Amount</u>	
04/01/93	Canal Court II, Ltd.	508	2434	\$ 7,000	Cash transfer by GP to Canal Court II, LP
04/02/93	Canal Court II, Ltd.	510	2434	16,000	Cash transfer by GP to Canal Court II, LP
06/09/93	First Union National Bank	542	(2)	11,647	Pay IRS Trust Portion of Payroll Taxes for Bentley Construction Co. Inc.
06/11/93	First Union National Bank	544	2434	7,826	Purchase Cashier's Check to repay portion of Personal Loan made to Charlotte S. Lewis
	- Continued -				

- (1) Three-digit numbered check s were drawn on the project account at First Union National Bank. Four digit checks were drawn on the Management Agent account at First Union National Bank and reimbursed by the project account.
- (2) General Ledger (G/L) Account number could not be determined from accounting records provided; however the canceled check was payable to an affiliated company.

BENTLEY COURT

Summary of Unauthorized Distributions

For the Year Ended 12/31/93

Payments to or for Affiliated Entities or Persons

- Continued -

<u>Date</u>	<u>Payee</u>	<u>Check No. (1)</u>	<u>BC G/L Acct.#</u>	<u>Amount</u>	<u>Reason</u>
07/20/93	Orangeburg National Bank	571	2434	\$ 1,000	Repay Portion of Loan made to Charlotte Lewis
07/27/93	BDL Partnership	578	2434	5,323	Monthly Reimbursement of Construction Loan provided to BDL '89, Inc.
07/30/93	Richland County Treasurer	581	2434	28,515	Pay Real Property Taxes for Canal Court II, L
08/09/93	Orangeburg National Bank	590	2434	<u>1,000</u>	Repay Portion of Loan made to Charlotte Lewis
Sub-total				<u>\$ 78,311</u>	
Total for 1993				<u>\$ 123,870</u>	

For the Year Ended 12/31/94

Non-Project Legal Expenses

<u>Date</u>	<u>Payee</u>	<u>Check No. (1)</u>	<u>BC G/L Acct.#</u>	<u>Amount</u>	<u>Reason</u>
02/23/94	Ralph C. Robinson	3570	6910	\$ 3,500	Non-Project Legal Fees
03/01/94	Ralph C. Robinson	3586	6910	3,500	Non-Project Legal Fees
03/28/94	Powell, Goldstein	699	6910	7,168	Non-Project Legal Fees
03/31/94	Ralph C. Robinson	3634	6910	3,500	Non-Project Legal Fees
05/02/94	Ralph C. Robinson	3697	6910	3,500	Non-Project Legal Fees
05/31/94	Ralph C. Robinson	3728	6910	3,500	Non-Project Legal Fees
06/27/94	Ralph C. Robinson	3784	6910	3,500	Non-Project Legal Fees
07/22/94	Ralph C. Robinson	3836	6910	3,500	Non-Project Legal Fees
07/28/94	Ralph C. Robinson	3847	6910	3,500	Non-Project Legal Fees
08/31/94	Ralph C. Robinson	3918	6910	3,500	Non-Project Legal Fees
09/08/94	Ralph C. Robinson	3926	6910	9,750	Non-Project Legal Fees
11/01/94	Ralph C. Robinson	4035	6910	3,500	Non-Project Legal Fees
12/06/94	Ralph C. Robinson	4072	6910	7,000	Non-Project Legal Fees
12/15/94	Ralph C. Robinson	4094	6910	<u>3,000</u>	Non-Project Legal Fees
Sub-total				<u>\$ 61,918</u>	

Payments to or for Affiliated Entities or Persons

<u>Date</u>	<u>Payee</u>	<u>Check No. (1)</u>	<u>BC G/L Acct.#</u>	<u>Amount</u>	<u>Reason</u>
03/16/94	Canal Court II	Draft Trans	2440 Canal Court II (GP)	5,000	
03/21/94	Canal Court II	Draft Trans	2440 Canal Court II (GP)	5,000	
07/07/94	Brookstone, Ltd of Columbia	748	2430	15,000	Transfer to Brookstone, Ltd. (MA)
07/08/94	Primesouth, Inc.	749	2434	5,500	Repayment on Letter of Credit Fee
07/12/94	Primesouth, Inc.	751	2434	2,200	Repayment on Letter of Credit Fee

- Continued -

- (1) Three-digit numbered checks were drawn on the project account at First Union National Bank. Four digit checks were drawn on the Management Agent account at First Union National Bank and reimbursed by the project account. Bank drafts were drawn on the project account.

BENTLEY COURT

Payments to or for Affiliated Entities or Persons

- Continued -

<u>Date</u>	<u>Payee</u>	<u>Check No. (1)</u>	<u>BC G/L Acct.#</u>	<u>Amount</u>	<u>Reason</u>
09/19/94	Primesouth	797	2434	\$ 1,100	Repayment on Letter of Credit Fee
09/26/94	First Union National Bank	3967	2434	4,235	Repayment on Commercial Loan Invoice
09/28/94	Prime South Construction	3969	2428	25,000	Repayment on Letter of Credit Fee
10/03/94	Hungiville, J.R.	3979	2428	12,000	Repayment on Loan from General Partner
11/16/94	Prime South Construction	4051	2430	<u>10,000</u>	Repayment on Letter of Credit Fee
	Sub-total			<u>\$ 86,560</u>	
	Total for 1994			<u>\$ 148,478</u>	

<u>Summary</u>	<u>Building Improvements</u>	<u>Non-Project Legal Fees</u>	<u>To or For Affiliated Entities or Persons</u>	<u>Total</u>
1992	\$ 33,203			\$ 33,203
1993		\$ 45,559	\$ 78,311	123,870
1994		<u>61,918</u>	<u>86,560</u>	<u>148,478</u>
	<u>\$ 33,203</u>	<u>\$ 107,477</u>	<u>\$ 164,871</u>	<u>\$ 305,551</u>

- (1) Three-digit numbered checks were drawn on the project account at First Union National Bank. Four digit checks were drawn on the Management Agent account at First Union National Bank and reimbursed by the project account.

SCHEDULE OF INELIGIBLE COSTS

<u>Recommendation</u>	<u>Ineligible Costs</u> ¹
1A	\$ 305,551

¹ Ineligible amounts obviously violate law, contract, HUD or local agency policies or regulations.

DISTRIBUTION

Secretary's Representative, 4AS
Assistant General Counsel, 4AC/4ACE
Special Agent in Charge, 4AGI
Field Comptroller, 4AF
Director, Accounting Division, 4AFF
South Carolina State Coordinator, 4ES
Director, Multifamily Housing Division, 4EHM (2)
Associate Director, US GAO, 820 1st St. NE Union Plaza, Bldg 2,
Suite 150, Washington, DC.
Chief Financial Officer, F (Room 10166) (2)
Office of Internal Control and Audit Resolution, FOI (Room 10176)
Housing-FHA Comptroller, HF ATTN: Audit Liaison Officer (Room 5132)
Associate General Counsel, Office of Assisted Housing and Community
Development, CD (Room 8162)
Assistant to the Deputy Secretary for Field Management, SDF (Room 7106)
Bentley Court II (Mr. E. Lewis, GP)

We did not audit the amount or timing of such advances to the partnership because any such advances to the partnership usually would have been made for only one purpose: to fund critical cash flow needs. The surplus cash rules limit the repayment of owner advances until the project generates surplus cash, so as to protect the project's cash flow needs and thereby the insured mortgage's repayment. Thus, any advances placed in the project account by the owners became project funds restricted by the surplus cash rules.