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TO: Sally G. Thomas, Director, Phoenix Multifamily Housing Hub, 9EHML

Margarita Maisonet, Director, Departmental Enforcement Center, CV

Joan S. Hobbs

FROM: Joan S. Hobbs, Regional Inspector General for Audit, Region IX, 9DGA

SUBJECT: The Villas at Camelback Crossing Phase I, Glendale, Arizona, Used Project Funds Totaling \$1,039,034 for Ineligible or Undocumented Costs

HIGHLIGHTS

What We Audited and Why

We reviewed the books and records of the Villas at Camelback Crossing Phase I (project), a 264-unit multifamily housing project located in Glendale, Arizona. We initiated the review in response to a request from the Phoenix Multifamily Housing Hub of the U.S. Department of Housing and Urban Development (HUD) due to its concerns about the owner's use of project funds. Our objective was to determine whether the owner and its identity-of-interest management agent used project funds only for reasonable operating expenses and necessary repairs, as required by the regulatory agreement.

What We Found

The owner, Millenium Communities, Inc., and American West Communities, LLC, the project's identity-of-interest management agent, inappropriately used \$1,039,034 in project funds for nonproject (ineligible) purposes in violation of its regulatory

agreement. The ineligible uses included \$301,200 in international wire transfers to unknown entities; \$26,638 for payments on unauthorized loans; and \$180,315 for payment of project construction costs. Additional improper uses consisted of \$80,860 paid to management agent supervisory personnel and corporate officers; net payments of \$65,020 to other identity-of-interest projects; and payments of \$116,313 for unallocated payroll, health insurance, and other expenses of the identity-of-interest Camelback II project. Millenium Communities, Inc., and/or American West Communities, LLC, lacked documentation to support additional disbursements of \$165,051 for credit card expenses, legal expenses, insurance expenses, and other costs. Further, the project did not obtain required HUD approval of its management agents and inappropriately paid \$103,637 in management fees.

What We Recommend

We recommend that the director of HUD's Phoenix Multifamily Housing Hub ensure that the owner reimburses the project's operating account for inappropriate expenses and provides documentation for the unsupported payments or reimburses those amounts that cannot be supported to the project's operating account. We also recommend that the director, in conjunction with HUD's Office of Inspector General, pursue double damages remedies under the equity skimming statutes for the misuse of project funds. We also recommend that the director require the project's owner to contract with a HUD-approved independent fee management agent.

We recommend that the director of HUD's Departmental Enforcement Center take administrative actions against the nonprofit owner, American West Communities, LLC, and its principals/officers for the inappropriate use of project funds.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided the owner with a draft report on November 8, 2005, and held an exit conference on December 5, 2005. The owner stated he had concerns about some items in the report, but did not wish to provide formal verbal or written comments.

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BACKGROUND AND OBJECTIVES

The Villas at Camelback Crossing Phase I (project) is a 264-unit multifamily housing project located in Glendale, Arizona. The project's \$19.1 million mortgage is insured under section 221(d)(3) of the National Housing Act. Its regulatory agreement was executed on September 28, 2000, construction cost cutoff was January 20, 2002, and final endorsement occurred on August 13, 2002. The project's owner is Millenium Communities, Inc., a nonprofit corporation incorporated in the state of Colorado. The controlling officer (principal) of the nonprofit corporation is also the owner of the identity-of-interest management agent, American West Communities, LLC.

The project has been in default on its Federal Housing Administration-insured mortgage since September 2004. The project shares a leasing office, clubhouse, fitness center, swimming pools, and other common areas with another U.S. Department of Housing and Urban Development (HUD)-insured identity-of-interest project, the Villas at Camelback Crossing Phase II (Camelback II). We will address issues identified during our review of Camelback II in a separate audit report.

We initiated the review based on a request from HUD's Phoenix Multifamily Housing Hub due to its concerns about the owner's apparent improper use of project funds.

Our objective was to determine whether project funds were used only for reasonable operating expenses and necessary repairs as required by the regulatory agreement.

RESULTS OF AUDIT

Finding 1: The Project's Owner/Management Agent Improperly Used or Lacked Supporting Documentation for the Use of \$935,397 in Project Funds

The project owner, Millenium Communities, Inc., and American West Communities, LLC, the principal's identity-of-interest management agent, violated the terms of the project's regulatory agreement by using \$935,397 in project funds for nonproject purposes. The ineligible uses included \$301,200 in international wire transfers to unknown entities; \$26,638 for payments on unauthorized loans; and \$180,315 for payment of project construction costs. Additional improper uses consisted of \$80,860 paid to management agent supervisory personnel and corporate officers; net payments of \$65,020 to other identity-of-interest projects; and payment of \$116,313 for payroll, health insurance, and other expenses of the identity-of-interest Camelback II project. Millenium Communities, Inc., and/or American West Communities, LLC, lacked documentation to support additional disbursements of \$165,051 for credit card expenses, legal expenses, insurance expenses, and other costs. The problems occurred because the owner/management agent disregarded the project's regulatory agreement with HUD. As a result, the project's funds available for debt service were reduced, contributing to the current default on its \$19.1 million HUD-insured mortgage.

**Project Funds Totaling \$508,153
Were Used for Miscellaneous
Ineligible Expenses**

Project funds totaling more than \$508,153 were used for miscellaneous ineligible expenses as follows:

- Operating funds totaling \$490,200 were disbursed to foreign entities via international wire transfer. The project received reimbursements of \$189,000 via wire transfer, resulting in a net amount due to the project of \$301,200. The purpose of these payments is unknown, but the payments may have been made to finance business interests that the principal has in Russia.
- Ineligible payments of \$26,638 were made on a personal loan the principal obtained from Jackson State Bank to fund project off-site construction improvements (construction costs). Construction costs cannot be paid from project operating funds.

- \$180,315 in project operating funds was used to directly pay for other construction-related costs. This included \$160,000 in construction costs for the identity-of-interest Camelback II project, \$14,015 for project construction engineering costs, and \$6,300 used to pay audit costs related to the project's cost certification.

**The Owner/Management Agent
Inappropriately Disbursed
\$80,860 to Management Agent
Supervisory Personnel and
Corporate Officers**

Supervisory personnel of the identity-of-interest management agent, American West Communities, LLC (American West), received compensation from the project totaling \$48,647 of which, \$40,438 was salary costs and \$8,209 was for other expenses, including insurance and car payments. In accordance with paragraph 3.1 of HUD Handbook 4381.5, REV-2, "The Management Agent Handbook," salary and benefits, such as health insurance and car payments for management agent supervisory personnel, must be paid out of the management fee of an approved management agent, not out of project operating funds. The supervisory employee was hired by American West as its general manager to supervise the operations of the project and two other identity-of-interest projects, Camelback II, and the Villas at Augusta Ranch. The original general manager has since terminated her employment with American West, and a new manager, and apparently the sole employee of American West, has taken her place. The costs identified above are attributable to both the current and former general managers. It should also be noted that American West never received approval from HUD to manage any of the HUD-insured identity-of-interest projects (see finding 2).

The project also used \$32,213 for expenses of the nonprofit corporate officers, including \$13,711 for health insurance, \$3,975 for other personal expenses, \$7,837 for payroll, and \$6,690 in reimbursements for unsupported project costs. These payments violated Paragraph 7(i) of the project's regulatory agreement, which prohibits payment of any compensation, including wages or salaries, to any of the project's officers or directors.

**The Project's Owner/
Management Agent Disbursed
\$65,020 (net) to Identity-of-
Interest Projects**

The owner/management agent disbursed \$532,572 in project funds to other identity-of-interest projects. Of this amount, \$65,020 has not been reimbursed and remains outstanding and due to the project. The funds were disbursed to two HUD-insured projects as well as one non-HUD-insured project located in San Antonio, Texas. The noninsured San Antonio project, The Waters, received \$30,853 and still owes the project \$16,853. One HUD-insured project, Camelback II, received \$237,367 from the project and still owes \$48,167. The other HUD-insured project, the Villas at Augusta Ranch, received \$264,352 but has fully reimbursed the project for the ineligible disbursements.¹ Payments made to these projects were not reasonable operating expenses and, accordingly, violated the terms of the regulatory agreement. The owner previously informed HUD that these types of disbursements were intercompany loans between projects that were repaid within 30 days and that he would no longer loan funds between projects in this manner. However, such disbursements continue to occur, including a \$12,000 disbursement made to the Camelback II project during April 2005.

**The Owner/Management Agent
Used \$116,313 for Another
Identity-of-Interest Project's
Expenses**

The owner/management agent did not properly allocate \$116,313 in shared on-site employee costs to the identity-of-interest Camelback II project. The two projects essentially function as one 504-unit project and share a leasing office, clubhouse, fitness center, swimming pools, and all on-site personnel. We were informed that revenue and expenses of the project were kept separate and that any project costs that cannot be assigned to a specific unit are split between the two projects at a predetermined ratio (52 percent to the project and 48 percent to Camelback II) based on the total number of units in the two projects. However, we determined that the owner/management agent did not allocate on-site

¹ The project owes the Villas at Augusta Ranch \$16,040, as the Villas at Augusta Ranch advanced \$280,392 to the project, of which only \$264,352 was reimbursed by the project.

employee salary and health insurance payments between the two projects. This resulted in the nonprofit entity, Millenium Communities, Inc., paying for \$110,262 in payroll expenses, \$4,058 in health insurance expenses, and \$1,993 in other expenses on behalf of the identity-of-interest for-profit entity, Camelback Crossings II Limited Partnership.

More Than \$165,051 in Other Costs Were Not Supported

Documentation was not available to support \$165,051 in other costs paid by the project. These unsupported costs included credit card expenses, apparent nonproject legal expenses, insurance expenses, and computer-related expenses.

The owner/management agent failed to provide adequate supporting documentation to demonstrate that these disbursements were for reasonable operating expenses or necessary repairs, and, accordingly, they are considered ineligible costs unless appropriate supporting documentation can be provided.

Conclusion

In conclusion, the owner/management agent used \$935,397 in project funds for ineligible and unsupported expenses. Despite knowledge of HUD requirements, the owner/management agent continues to misuse project assets in violation of its regulatory agreement with HUD. The improper use of project funds has significantly contributed to the owner's default on its \$19.1 million HUD-insured mortgage. Further, the improper use of project funds makes the principal(s) subject to criminal and civil money penalties, including the equity skimming statutes set out in Title 12, *United States Code*, sections 1715z-19 and 1715-4a.

Recommendations

We recommend that the director, Phoenix Multifamily Housing Hub, require the nonprofit owner and/or identity-of-interest management agent to

1A. Repay the project operating account the \$770,346 used for ineligible expenses.

1B. Provide support for the \$165,051 in undocumented expenses detailed above or repay the funds to the project's operating account.

1C. Implement procedures and controls to ensure project funds are used only for reasonable project expenses and necessary repairs as required by the regulatory agreement.

1D. Pursue double damages remedies against the project owner, the identity-of-interest management agent and their principal(s) under the applicable equity skimming statutes, in conjunction with the Office of Inspector General.

We also recommend that the director of HUD's Departmental Enforcement Center

1E. Take appropriate administrative sanctions against the principal(s) of the project owner, the identity-of-interest management agent and other entities involved in the project's operations.

1F. Impose civil money penalties against Millenium Communities, Inc., and its principals.

Finding 2: The Project's Owner Contracted with Management Agents without HUD Approval and Paid \$103,637 in Ineligible Management Fees

The project owner, through its principal officer, contracted with an independent fee management agent and with its identity-of-interest management agent, American West Communities, LLC (American West), without obtaining required HUD approval. During our audit period, these unapproved agents were paid \$103,637 in management fees in violation of the regulatory agreement. The owner also did not ensure that these management agents complied with the project's regulatory agreement with HUD. In addition to the numerous unauthorized disbursements detailed in finding 1, the project, through its management agents, failed to satisfy other requirements of the regulatory agreement, including accounting, reporting, and tenant security deposit requirements. The owner's disregard for the regulatory agreement and failure to contract with a HUD-approved management agent has put the \$19.1 million mortgage at risk.

The Owner Failed to Contract with a HUD-Approved Management Agent

The project initially (January 2002) contracted with a HUD-approved fee management agent. However, due to a disagreement between the owner and the management agent, the management agent ended its relationship with the project in October 2002. The owner then contracted with another independent fee management agent. HUD was not informed of the change in management, and the unapproved management agent was paid \$33,530 in ineligible management fees. The owner also had a disagreement with this management agent and elected to provide management services through its principal's identity-of-interest entity, American West, beginning in July 2003.

Although American West is currently acting as the management agent for the project, it has never received HUD approval to do so as required by paragraph 7(j) of the project's regulatory agreement. The project owner, through its principal officer, attempted to obtain HUD approval for American West to manage the property on several occasions. However, HUD denied these requests and informed the owner that the project would have to contract with an independent fee management agent. HUD explained that American West did not have the successful management experience necessary to manage the project. HUD also advised the owner that since American West did not have an Arizona broker's license, Arizona state law prohibited it from collecting a management fee. The owner was also informed of

HUD requirements that prohibit payment of any management fee until HUD approval of a management agent is obtained.

During the final loan closing process for the identity-of-interest Camelback II project, HUD advised the owner's principal that final closing could not take place until both projects (the project and Camelback II) contracted with a HUD-approved management agent. Since the principal wanted to proceed with final closing of the Camelback II project, a HUD-approved management agent was selected in August 2004. However, the principal limited the role of this HUD-approved management agent to processing payroll and insurance and creating a portion of the project's monthly financial statements. The identity-of-interest management agent, American West, never relinquished its property management duties, including access to and control of the project's bank accounts, and within two months of final closing of Camelback II, the management agreement with the HUD-approved management agent was terminated. American West resumed its full control over the project and continues to manage its operations. American West was paid \$98,107 in ineligible management fees, of which \$28,000 was reimbursed, leaving a balance due to the project of \$70,107.

The Owner Did Not Manage the Project in Compliance with the Regulatory Agreement

The owner did not ensure that American West managed the project in accordance with HUD requirements, resulting in improper use of project funds, failure to provide required accounting reports to HUD, and not properly funding tenant security deposits as follows:

- The owner disbursed more than \$770,346 in project funds for ineligible purposes and failed to properly document an additional \$165,051 in project expenditures (see finding 1).
- The owner did not ensure that American West provided monthly project accounting reports requested by HUD, which were necessary to enable HUD to monitor the project's operations (the furnishing of such reports is provided for in paragraph 10(f) of the regulatory agreement). The owner and American West complied with HUD's initial request for these reports and provided the reports for the period January 2003 through August 2004. However, when HUD questioned various disbursements identified in the reports at the end of August, the owner and American West stopped submitting the reports to HUD. As a result of the owner's and American West's failure to provide these reports, HUD has been unable to properly monitor the project's operations for more than a year. The services of an approved and qualified management agent would help

- to ensure that monthly accounting reports are prepared correctly and submitted to HUD in a timely manner.
- The owner/management agent failed to submit the 2004 annual financial statement audit in a timely manner. Audited financial statements are usually due on March 31 of each year for projects with a fiscal year based on the calendar year, such as the project. However, all HUD-insured multifamily projects were given an extension in filing this year to April 30 due to technical issues with HUD's system. The project did not select a firm to conduct the financial statement audit until March 30, 2005. The project submitted the audited financial statements electronically to HUD on September 13, 2005 (more than four months after the extended deadline). We attribute the untimely filing of the financial statement audits to the owner/management agent's disregard for HUD requirements and lack of experience in operating and managing HUD-insured projects.
- The owner failed to ensure that American West established and maintained a separate tenant security deposit account until March 2005. Before the March 2005 opening of this security deposit account, the owner/management agent disregarded HUD requirements and commingled tenant security deposits with project operating funds. In many instances, the project operating bank account did not have a large enough balance to cover the corresponding security deposit liability. The owner's/management agent's disregard of the requirement for maintaining a separate, fully funded tenant security deposit account placed the project at unnecessary risk.

Conclusion

In summary, the project failed to contract with a HUD-approved management agent as required by its regulatory agreement. This lack of an independent, experienced, HUD-approved management agent contributed to the project's misuse of project assets and its failure to follow other terms of the regulatory agreement.

Recommendations

We recommend that the director, Phoenix Multifamily Housing Hub, require

2A. The project's owner to transfer operating control of the project to a HUD-approved independent fee management agent.

2B. The project's owner and/or American West to return to the project the \$103,637 in ineligible management fees paid to unapproved management agents.

SCOPE AND METHODOLOGY

We performed the review at HUD's Phoenix field office, American West's office in Scottsdale, Arizona, and the project from February through August 2005. To accomplish our objective, we interviewed appropriate personnel and management from HUD, employees of the project, and management representatives of Millenium Communities, Inc., and American West.

To determine whether the owner/management agent used project funds only for reasonable operating expenses and necessary repairs as required by the regulatory agreement, we reviewed

- The owner's regulatory agreement with HUD,
- HUD's files and correspondence related to the project,
- HUD's Real Estate Management System and Financial Assessment Subsystem information related to the project,
- The project's financial records, and
- The project's monthly accounting reports submitted to HUD.

We also reviewed Title 12, *United States Code*, sections 1715 and 1735; Title 31, *United States Code*, section 3801; 24 CFR [*Code of Federal Regulations*] parts 24 and 207; and HUD Handbooks 2000.06, REV-3; 4350.1, REV-1; 4370.2, REV-1; and 4381.5, REV-2.

The review covered the period January 2002 through May 31, 2005. This period was adjusted as necessary. We performed our review in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

Internal control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

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

- Validity and reliability of data – Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.
- Compliance with laws and regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.
- Safeguarding resources – Policies and procedures that management implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Significant Weaknesses

Based on our review, we believe the following item is a significant weakness:

- The owner and its identify-of-interest management agent lacked effective procedures and controls over the use of project funds and to ensure compliance with laws and regulations (see findings 1 and 2).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

Recommendation number	Ineligible 1/	Unsupported 2/
1A	\$770,346	
1B		\$165,051
2B	\$103,637	

1/ 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.

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of audit. Unsupported costs require a 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.

Appendix B

CRITERIA

Regulatory Agreement

Important provisions of Millenium Communities, Inc.'s regulatory agreement include the following:

- Paragraph 7(b) mandates that the owner may not, without the prior written approval of the commissioner, assign, transfer, dispose of, or encumber any personal property of the project, including rents, or pay out any funds except for reasonable operating expenses and necessary repairs.
- Paragraph 7(f) requires that any fund collected as security deposits shall be kept separate and apart from all other funds of the project in a trust account the amount of which shall at all times equal or exceed the aggregate of all outstanding obligations under said account.
- Paragraph 7(i) prohibits the project owners from paying “any compensation, including wages or salaries, or incur any obligations to themselves, or any officers, directors, stockholders, trustees, partners, beneficiaries under a trust, or to any of their nominees” without first obtaining HUD’s written approval.
- Paragraph 7(j) states that the owner may not, without the prior written approval of the commissioner, enter into any contract or contracts for supervisory or managerial services.
- Paragraph 10(e) requires that the owners, within 60 days following the end of each fiscal year, furnish the commissioner with a complete annual financial report, based upon an examination of the books and records of mortgagor, prepared in accordance with the requirements of the commissioner, certified to by an officer or responsible owner, and when required by the commissioner, prepared and certified by a certified public accountant or other person acceptable to the commissioner.
- Paragraph 10(f) requires that at the request of the commissioner, his agents, employees, or attorneys, the owners shall furnish monthly occupancy reports and shall give specific answers to questions upon which information is desired from time to time relative to the income, assets, liabilities, contracts, operation, and condition of the property and the status of the insured mortgage.
- Paragraph 10(g) stipulates that all rents and other receipts of the project shall be deposited in the name of the project in a bank and that such funds shall be withdrawn only in accordance with the provisions of this agreement for expenses of the project. Any

- owner receiving funds of the project shall immediately deposit such funds in the project bank account and, failing to do so in violation of this agreement, shall hold such funds in trust.
- Paragraph 18 stipulates that the project owner, Millenium Communities, Inc, remains liable under this agreement “a) for funds or property of the project coming into their hands which, by the provisions hereof, they are not entitled to retain; and b) for their own acts and deeds, or acts and deeds of others which they have authorized, in violation of the provisions hereof.”

Applicable Handbook Requirements

HUD Handbook 4370.2, REV-1, CHG-1, “Financial Operations and Accounting Procedures for Insured Multifamily Projects,” paragraph 2-10, section A, states that distributions to owners are not permitted on nonprofit projects. If improper distributions are made, the owner is subject to criminal and/or civil penalties.

HUD Handbook 4381.5, REV-2, “The Management Agent Handbook,” chapter 3, “Allowable Management Fees from Project Funds,” paragraph 3.1, states that “management fees may be paid only to the person or entity approved by HUD to manage the project. Management agents must cover the costs of supervising and overseeing project operations out of the fee they receive.”

Equity Skimming and Civil Remedies Statutes

Title 12, *United States Code*, section 1715z-4a, “Double Damages Remedy for Unauthorized Use of Multifamily Project Assets and Income,” allows the U.S. attorney general to recover double the value of any project assets or income that was used in violation of the regulatory agreement or any applicable regulation, plus all cost relating to the action, including but not limited to reasonable attorney and auditing fees.

Title 12, *United States Code*, section 1715z-19, “Equity Skimming Penalty,” authorizes a fine of not more than \$500,000 and/or imprisonment of not more than five years for owners, agents, or managers that willfully use or authorize the use of any part of the rents, assets, proceeds, income, or other funds derived from the property for any purpose other than to meet reasonable and necessary expenses in a period during which the mortgage note is in default or the project is in a non-surplus-cash position as defined by the regulatory agreement.

Title 12, *United States Code*, section 1735f-15, “Civil Money Penalties Against Multifamily Mortgagors,” allows the secretary of housing and urban development to impose a civil money penalty of up to \$25,000 per violation against a borrower with five or more living units and a HUD-insured mortgage. A penalty may be imposed for any knowing and material violation of the regulatory agreement by the borrower, such as paying out any funds for expenses that were not reasonable and necessary project operating expenses or making distributions to owners while the project is in a non-surplus-cash position.

Title 31, *United States Code*, section 3801, “Program Fraud Civil Remedies Act of 1986,” provides federal agencies, which are the victims of false, fictitious, and fraudulent claims and statements, with an administrative remedy to recompense such agencies for losses resulting from such claims and statements; to permit administrative proceedings to be brought against persons who make, present, or submit such claims and statements; and to deter the making, presenting, and submitting of such claims and statements in the future.