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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 II, Glendale, Arizona, Used Project Funds Totaling $1,008,215 for Ineligible or Undocumented Costs

HIGHLIGHTS

What We Audited and Why

We reviewed the books and records of the Villas at Camelback Crossing Phase II (project), a 240-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, Camelback Crossings II Limited Partnership, and American West Communities, LLC (American West), the project's general partner and identity-of-interest management agent, inappropriately used $1,008,215 in project funds for nonproject (ineligible) purposes during a period when the project did not have surplus cash available for distribution and/or was in default on its HUD-insured mortgage. The ineligible uses included $262,100 in international wire transfers to

unknown entities, $101,984 for payments on unauthorized loans, $100,000 to an unknown certificate of deposit account, and $79,389 for payment of project construction costs. Additional improper uses consisted of $151,146 paid to corporate officers and management agent supervisory personnel and net payments of $119,000 to other identity-of-interest projects. Camelback Crossings II Limited Partnership and/or American West also lacked documentation to support additional disbursements of $182,595 for credit card expenses, real estate taxes, and other costs. Further, the owner did not obtain required HUD approval for American West to serve as the project's management agent and allowed another identity-of-interest project to retain $12,001 in project revenue.

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 the ineligible disbursements 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 further 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 owner, American West, and/or 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 II (project) is a 240-unit multifamily housing project located in Glendale, Arizona. The project's $16.7 million mortgage is insured under section 221(d)(4) of the National Housing Act. Its regulatory agreement was executed on December 11, 2002, construction cost cut off date was March 29, 2004, and final endorsement occurred on September 30, 2004. The project's owner is Camelback Crossings II Limited Partnership. The partnership is composed of its general partner (which is also the identity-of-interest management agent), American West Communities, LLC (American West), holding 25 percent interest in the project, and two limited partners. One of the limited partners holds a 50 percent interest in the project, and the other, who is the sole member of the general partner, holds a 25 percent interest. The general partner/management agent has control over all project operations.

The project has been in default on its Federal Housing Administration-insured mortgage since February 2005. 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 I (Camelback I). We will address issues identified during our review of Camelback I 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 $996,214 in Project Funds

The project owner, Camelback Crossings II Limited Partnership and American West, the project's general partner and identity-of-interest management agent, violated the terms of its regulatory agreement by using $996,214 in project funds for nonproject (ineligible) purposes during a period when the project did not have surplus cash available for distribution and/or was in default on its HUD-insured mortgage. The ineligible uses included $262,100 in international wire transfers to unknown entities, $101,984 for payments and fees on unauthorized loans, $100,000 to an unknown certificate of deposit account, and $79,389 used for payment of project construction costs. Additional improper uses consisted of $151,146 paid to corporate officers and management agent supervisory personnel and net payments of $119,000 to other identity-of-interest projects. Camelback Crossings II Limited Partnership (owner) and/or American West also lacked documentation to support additional disbursements of $182,595 for credit card expenses, real estate taxes, and other costs. The problems occurred because the owner/management agent (principal) 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 $16.7 million HUD-insured mortgage.

Project Funds Totaling $543,473 Were Used for Miscellaneous Ineligible Expenses

Project funds totaling more than $543,473 were used for miscellaneous ineligible expenses as follows:

- Operating funds totaling $262,100 were disbursed to foreign entities via international wire transfer. The payments may have been made to finance business interests that the principal has in Russia.

- Ineligible payments of $76,816 were made on a personal working capital 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.

- In May 2005, project funds were used to make a principal payment of $25,000 on a $100,000 loan derived from a line of credit against the project. Finance fees related to this loan totaling $168 were also paid from project funds. The funds from this original loan/line of credit were transferred to an unidentified nonproject checking account in March 2005 and were not used for project operations.

- In March 2005, the owner transferred $100,000 to an unknown certificate of deposit account. We have been unable to obtain an explanation from the owner for this disbursement. However, it is clear that it does not represent a project operating cost.

- $79,389 in project operating funds was used to directly pay other construction-related costs. This included $65,574 paid to the construction contractor for the builder's and sponsor's profit and risk allowance, $13,050 used to pay audit costs related to the project's cost certification, and $765 for construction engineering costs. Use of operating funds to pay construction-related costs is a violation of the regulatory agreement.

The Owner Disbursed $151,146 (Net) to Principals and Management Agent Supervisory Personnel

The owner (partnership) disbursed $151,146 in project funds to its partners and identity-of-interest management agent supervisory personnel in violation of the regulatory agreement. The principal (sole member of the general partner and also a limited partner) took distributions from the project totaling $117,946. In one instance, the payment was noted as a repayment for prior owner contributions. However, the project's regulatory agreement forbids repayment of owner advances or any distributions to owners except from surplus cash. The owner has failed to repay the project for the $117,946 in unauthorized distributions. The owner disbursed to another limited partner $36,250, of which $14,500 remains unreimbursed. The project was in a non-surplus-cash position at the time of the distributions, and, accordingly, these owner distributions violated the regulatory agreement.

Supervisory personnel of the identity-of-interest management agent, American West, received compensation from the project totaling $18,700–including $17,499 in salary costs and $1,201 for employee health insurance. Salary and insurance 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 I and the Villas at Augusta Ranch. American West did not receive approval from HUD to manage any of the HUD-insured identity-of-interest projects (see finding 2).

The Owner Disbursed $119,000 (Net) to Identity-of-Interest Projects

The owner disbursed $490,400 in project funds to other projects controlled by the sole owner of the general partner (principal). Of this amount, $119,000 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 $217,000 and still owes the project $114,000. One HUD-insured project, the Villas at Augusta Ranch, received $82,200 from the project and still owes $5,000. The other HUD-insured project, Camelback I, received $191,200 but has fully reimbursed the project for these ineligible disbursements.[1] Payments made to these projects were not reasonable operating expenses and accordingly violated the terms of the regulatory agreement. The sole owner of the general partner 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 two disbursements totaling $60,000 made to The Waters project during the last month of our review period, May 2005.

More Than $182,595 in Other Costs Were Not Supported

Documentation was not available to support $182,595 in other costs paid by the project. These unsupported costs included wire transfers in October 2004 of $100,000 ($93,000 and $7,000) to an unknown entity (possibly for real estate taxes) and $82,595 in other unsupported costs including credit card expenses, nonproject legal expenses, and unsupported computer-related expenses. The owner failed to provide adequate supporting documentation to demonstrate that

[1] The project owes Camelback I $34,167 as Camelback I advanced the project $225,637, of which only $191,200 was reimbursed.

these disbursements were reasonable operating expenses or necessary repairs, and, accordingly, they are considered ineligible costs unless appropriate supporting documentation can be provided.

Conclusion

The owner used $996,214 in project funds for ineligible and unsupported expenses. Despite knowledge of HUD requirements, the owner 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 $16.7 million HUD-insured mortgage. Further, the improper use of project funds makes the owner(s) subject to criminal and civil money penalties, including the equity skimming statutes set out in Title 12, *United States Code*, §1715z-19 and §1715-4a.

Recommendations

We recommend that the director, Phoenix Multifamily Hub, require the owner/management agent to

1A. Repay the project operating account $813,619 used for ineligible expenses.

1B. Provide support for the $182,595 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's principals/partners 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 principals/partners and other entities involved in the project's operations.

1F. Impose civil money penalties against Camelback Crossings II Limited Partnership and its principals.

Finding 2: The Project's Owner Contracted with Its Identity-of-Interest Management Agent without HUD Approval

The owner contracted with its identity-of-interest management agent, American West, without obtaining HUD-required approval. American West, owned in whole by one of the project's limited partners, is both the general partner and management agent of Camelback Crossing II Limited Partnership and has in effect managed the project since its inception. During this period, the project has not been operated in conformance with the owner's regulatory agreement with HUD. In addition to the numerous unauthorized disbursements detailed in finding 1, the project, through its management agent, has failed to satisfy other requirements of the regulatory agreement, including improperly accounting for $12,001 in project income. The owner's disregard for the regulatory agreement and failure to contract with a HUD-approved management agent has put the $16.7 million mortgage at risk.

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

Although American West is acting as the management agent for the project, it has not received HUD approval to do so, as required by paragraph 6(c) of its regulatory agreement. The owner 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 project, HUD advised the owner that final closing could not take place until the project contracted with a HUD-approved management agent. Since the owner wanted to proceed with final closing of the project, a HUD-approved management agent was selected. However, the owner 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, did not relinquish its property management duties, including access to and control of the project's bank accounts. Within two months of final closing of the project, the HUD-approved management agent was terminated and American West resumed full control over the project and its operations.

Owner Did Not Operate the Project in Compliance with the Regulatory Agreement

The owner did not ensure that the project was operated in accordance with HUD requirements, resulting in improper use of project funds, failure to provide required accounting reports to HUD, not funding tenant security deposits, and lack of control over project income as follows:

- The owner disbursed $813,619 in project funds for ineligible purposes and failed to properly document an additional $182,595 in project expenditures (see finding 1).

- The owner did not provide 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 9(f) of the regulatory agreement). The owner complied with HUD's initial request for these reports and provided the reports for the period January through August 2004. However, when HUD questioned various disbursements identified in the reports at the end of August, the owner stopped submitting the reports to HUD. As a result of the owner'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 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 reporting 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 14, 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 establish and to maintain a separate tenant security deposit account until May 2005. Before the May 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.

- The owner did not ensure that $12,001 (net) in project income was properly accounted for and deposited into the project's operating bank account—$14,521 in project income was mistakenly deposited into the Camelback I bank account, and $2,520 in Camelback I income was mistakenly deposited into the project's bank account. In August 2004, the independent fee management agent determined that $12,107 in project revenue was incorrectly deposited into the Camelback I bank account but was unable to correct the errors since American West had sole control of the operating bank accounts of both projects. The independent fee management agent informed the owner of the $12,107 deposit error (other offsetting deposit errors with a net effect of $6 were identified during OIG's review). However, the owner, through American West, has not directed Camelback I to reimburse the project for the $12,001 (net) in misdirected project revenue. The services of an approved and qualified management agent would have ensured that project revenue was deposited into the appropriate bank account and that any errors were corrected in a timely manner.

Conclusion

In summary, the owner failed to contract with a HUD-approved management agent as required by the regulatory agreement or ensure that other regulatory agreement requirements were followed. Despite knowledge of these requirements, the owner/management agent continues to operate the project in violation of its regulatory agreement with HUD. Due to the owner/management agent's disregard of the regulatory agreement, operating control of the project should be transferred to a HUD-approved management agent

Recommendations

We recommend that the director, Phoenix Multifamily Hub,

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

2B. Require the owner/American West to ensure that Camelback I reimburses the project for the $12,001 mistakenly deposited into its bank account.

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 from the project, and management representatives of Camelback Crossings II Limited Partnership and American West.

To determine whether the owner and the management agent used project funds only for reasonable operating expenses and reasonable 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*, §1715 and §1735; Title 31, *United States Code*, §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 March 1, 2004, 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 identity-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	$813,619	
1B		$182,595
2B	$12,001	

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 Camelback Crossings II Limited Partnership's regulatory agreement include the following:

- **Paragraph 6** mandates that the owner may not, without the prior written approval of the secretary of housing and urban development, assign, transfer, dispose of, or encumber any personal property of the project, including rents, or pay out any funds except from surplus cash, except for reasonable operating expenses and necessary repairs, and make or receive and retain any distribution of assets or any income of any kind of the project except surplus cash.

- **Paragraph 6(c)** states that the owner may not, without the prior written approval of the secretary of housing and urban development, convey, assign, or transfer any right to manage the mortgaged property.

- **Paragraph 6(g)** states that any funds 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 obligations under said account.

- **Paragraph 9(e)** requires that the owners, within 60 days following the end of each fiscal year, furnish the secretary of housing and urban development with a complete annual financial report based upon an examination of the books and records of the borrower, prepared in accordance with the requirements of the secretary, prepared and certified to by an officer or responsible owner, and when required by the secretary, prepared and certified by a certified public accountant or other person acceptable to the secretary.

- **Paragraph 9(f)** requires that at the request of the secretary of housing and urban development, 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 income, assets, liabilities, contracts, operations, and condition of the property and the status of the insured mortgage.

- **Paragraph 13(g)** defines "distribution" as any withdrawal or taking of cash or any assets of the project, excluding payment for reasonable expenses incident to the operation and maintenance of the project.

- **Paragraph 17** stipulates that Camelback Crossings II Limited Partnership and all present or future general partners and limited partners to be liable for a) funds or property of the project coming into their hands that they are not entitled to retain and b) their own acts

- and deeds or acts and deeds of others, which they have authorized, in violation of the provisions.

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 if the owner takes distributions when the project is in default or when the project is in a non-surplus-cash position, 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: "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*, §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*, §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*, §1735f-15, "Civil Money Penalties Against Multifamily Borrowers," 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*, §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.