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

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Joan S. Hobbs

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

SUBJECT: The Villas at Augusta Ranch, Mesa, Arizona, Used Project Funds Totaling $965,316 for Ineligible or Undocumented Costs

HIGHLIGHTS

What We Audited and Why

We reviewed the books and records of the Villas at Augusta Ranch (project), a 238-unit multifamily housing project located in Mesa, 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, Tegan Communities, Inc., and American West Communities, LLC, the project's identity-of-interest management agent, inappropriately used $965,316 in project funds for nonproject (ineligible) purposes in violation of its regulatory agreement. The ineligible uses included $366,980 in wire transfers to unknown entities, $136,531 for payments on an unauthorized line of credit, and $8,593 for payment of project construction costs. Additional improper uses consisted of $78,460 paid to management agent supervisory personnel and corporate officers and net payments of $72,040 to other identity-of-interest projects. Tegan Communities, Inc., and/or American West Communities, LLC, lacked documentation to support additional disbursements of $246,277 for credit card expenses, legal expenses, and other costs. Further, the project did not obtain required HUD approval of its management agents and inappropriately paid $56,435 in management fees.

What We Recommend

Subsequent to completion of our audit, the project was sold and the HUD-insured mortgage was paid in full, canceling HUD's insurance liability on the project. Accordingly, we have not recommended repayment of the ineligible costs detailed in our report. However, we recommend that the director of HUD's Phoenix Multifamily Housing Hub, 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 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. We also recommend that the director impose civil money penalties against the nonprofit owner and its principals.

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 draft schedules of the questioned and disallowed costs on November 8, 2005, and held an exit conference on December 5, 2005. The owner stated he had concerns about some items in the schedules, but did not wish to provide formal verbal or written comments at this time.

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BACKGROUND AND OBJECTIVES

The Villas at Augusta Ranch (project) is a 238-unit multifamily housing project located in Mesa, Arizona. The project's $17.9 million mortgage is insured under section 221(d)(3) of the National Housing Act. Its regulatory agreement was executed on October 30, 2000, construction cost cutoff was February 28, 2002, and final endorsement occurred on August 13, 2002. The project's owner is Tegan Communities, Inc., a nonprofit corporation incorporated in the state of Arizona. The controlling officer (principal) of the nonprofit corporation is also the owner of the identity-of-interest management agent, American West Communities, LLC (American West). The project has been in default on its Federal Housing Administration-insured mortgage since September 2004. The principal also controls the activities of two other U.S. Department of Housing and Urban Development (HUD)-insured projects, the Villas at Camelback Crossing Phase I (Camelback I) and the Villas at Camelback Crossing Phase II (Camelback II). We will address issues identified during our review of these projects in separate audit reports.

Subsequent to the completion of our review, the project was sold and its HUD-insured mortgage paid in full. Accordingly, HUD no longer has an insurance risk related to the project

We initiated the review based on a request from HUD's Phoenix Multifamily Housing Hub for HUD 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 $908,881 in Project Funds

The project owner, Tegan Communities, Inc., and American West, the nonprofit corporation's controlling officer's (principal) identity-of-interest management agent, violated the terms of its regulatory agreement by using $908,881 in project funds for nonproject purposes.

The ineligible uses included $366,980 in wire transfers to unknown entities, $136,531 for payments on an unauthorized line of credit, and $8,593 for payment of project construction costs. Additional improper uses consisted of $78,460 paid to management agent supervisory personnel and corporate officers and net payments of $72,040 to other identity-of-interest projects. Tegan Communities, Inc., and American West also lacked documentation to support additional disbursements of $246,277 for credit card expenses, legal expenses, insurance expenses for another identity-of-interest project, and other expenses. The problems occurred because the owner/management agent disregarded the project's regulatory agreement with HUD. As a result, project funds available for debt service were reduced, contributing to the current default on its $17.9 million HUD-insured mortgage.

Project Funds Totaling $512,104 Were Used for Miscellaneous Ineligible Expenses

Project funds totaling $512,104 were used for miscellaneous ineligible expenses as follows:

- Operating funds totaling $510,000 were disbursed to unidentified entities for investment purposes. The project received reimbursements of $143,020 via wire transfer, resulting in a net amount due to the project of $366,980.

- Operating funds totaling $136,531 were used to make payments on a Bank of America line of credit in the project's name. Funds withdrawn from this line of credit were transferred to an unidentified nonproject Bank of America account, while the line of credit was repaid using project funds.

- $8,593 in project operating funds was used to directly pay for construction-related costs. This included $5,243 for project construction engineering costs and $3,350 for audit costs related to the project's cost certification. Construction costs cannot be paid from project operating funds.

The Owner/Management Agent Inappropriately Disbursed $78,460 to Management Agent Supervisory Personnel and Corporate Officers

Supervisory personnel of the identity-of-interest management agent, American West received compensation from the project totaling $71,692–$51,149 in salary costs and $20,543 for other costs including insurance expenses, vehicle expenses, and housing expenses. In accordance with paragraph 3.1 of HUD Handbook 4381.5, REV-2, "The Management Agent Handbook," salary and benefits, such as insurance, vehicle expenses, and housing expenses 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 Camelback II. The original general manager has since terminated her employment with American West, and a new manager has taken her place. The costs identified above are attributable to both the current and former general managers. American West did not receive approval from HUD to manage any of the HUD-insured identity-of-interest projects (see finding 2).

The project also made payments of $6,768 to nonprofit corporate officers. Insufficient documentation was available to identify the purpose of these payments, and they are, therefore, considered to be ineligible compensation to the corporate officers.

The Project's Owner/ Management Agent Disbursed $72,040 (Net) to Identity-of-Interest Projects

The owner/management agent disbursed $420,092 in project funds to other identity-of-interest projects. Of this amount, $72,040 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 $62,500 and still owes the project $56,000. One HUD-insured project, Camelback I, received $280,392 from the project and still owes $16,040. The other HUD-insured project, Camelback II, received $77,200 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 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 $28,000 disbursement made to The Waters during July 2005.

More Than $246,277 in Other Costs Were Not Supported

Documentation was not available to support $246,277 in other costs paid by the project. These unsupported costs included credit card expenses, apparent nonproject legal expenses, and insurance expenses of another identity-of-interest project.

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

[1] The project owes Camelback II $5,000 as Camelback II advanced the project $82,200, of which only $77,200 was reimbursed.

Conclusion

The owner/management agent used $908,881 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 significantly contributed to the owner's default on its $17.9 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

Subsequent to completion of our audit, the project was sold and the $17,710,686 balance on the HUD-insured mortgage was paid in full, canceling HUD's insurance liability on the project. Accordingly, we are not recommending repayment of the misused funds to the project, however, we are recommending:

1A. The director of HUD's Phoenix Multifamily Hub, in conjunction with HUD's Office of Inspector General, pursue double damages remedies against the project owner, the identity-of-interest management agent, and their principals under the equity skimming statutes for the $908,881 of ineligible and undocumented expenses detailed in this finding;

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

1B. 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.

1C. Impose civil money penalties against Tegan Communities, Inc., and its principals.

Finding 2: The Project's Owner Contracted with Management Agents without HUD Approval and Paid $56,435 in Ineligible Management Fees

The project owner, through its principal officer, contracted with several independent fee management agents and with its identity-of-interest management agent, American West, without obtaining required HUD approval. During our audit period, these unapproved agents were paid $56,435 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 $17.9 million mortgage at risk.

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, without obtaining HUD approval, then contracted with another independent fee management agent, Archstone Management. Archstone managed the project from November 2002 through May 2003; at that time it sold its fee management division (including its management rights for the project) to Gables Residential. In January 2004, the owner ended its relationship with Gables and elected to provide management services through its identity-of-interest entity American West. HUD was not informed of these changes in management, and Archstone and Gables were paid $30,977 and $18,958 in ineligible management fees, respectively.

Although American West is currently acting as the management agent for the project, it 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 on several occasions to obtain HUD approval for American West to manage the property. 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 all projects controlled by the principal, including Camelback I and Augusta Ranch, 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, Tucson Realty and Trust, 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 one month of final closing of Camelback II, the management agreement with Tucson Realty and Trust was terminated. American West resumed its full control over the project and continues to manage the project. American West was paid $19,500 in ineligible management fees, of which $13,000 was reimbursed to the project, leaving a balance due to the project of $6,500.

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 $662,604 in project funds for ineligible purposes and failed to properly document an additional $246,277 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 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 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's 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

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

Subsequent to completion of our audit, the project was sold and the HUD-insured mortgage was paid in full, canceling HUD's insurance liability for the project. Accordingly, we are not recommending repayment of the misused funds to the project, however, we are recommending:

2A. The director of HUD's Phoenix Multifamily Hub, in conjunction with HUD's Office of Inspector General, pursue double damages remedies against the project owner, the identity-of-interest management agent, and their principals under the equity skimming statutes for the $56,535 of ineligible expenses detailed in this finding.

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 Tegan Communities, Inc., and American West.

To determine whether the owner/manager 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 February 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 implement 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	Funds to be put to better use 1/
1A	$17,710,686

1/ Funds to be put to better use" are quantifiable savings that are anticipated to occur if an OIG recommendation is implemented, resulting in reduced expenditures at a later time for the activities in question. This includes costs not incurred, deobligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made, and other savings. In reviews involving equity skimming violations where the mortgagor pays off the mortgage, OIG may claim the remaining balance of the mortgage as funds to be put to better use since the prepayment frees up available FHA commitment authority and HUD no longer has any financial interest or potential financial interest in the property.

Appendix B

CRITERIA

Regulatory Agreement

Important provisions of Tegan 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 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 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 the 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, Tegan 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.

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 manager 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 mortgagor 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 mortgagor 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 nonsurplus 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.