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Audit Case Number	97-SF-212-1003

TO: Janet L. Browder, Director, Multifamily Housing Division, California State Office
9AHM

FROM: Glenn S. Warner, District Inspector General for Audit, 9AGA

SUBJECT: Huron Plaza and Sunridge Apartments
Multifamily Mortgage Operations
Huron and Fresno, California

INTRODUCTION

We reviewed financial activities of the multifamily projects known as Huron Plaza and Sunridge Apartments (project numbers 121-3572 and 121-35768) located in Huron and Fresno, California, respectively, in response to a March 7, 1995 request from the Asset Management Branch of HUD's California State Office. The purpose of our review was to determine whether improper asset use contributed to the projects' financial and physical problems.

SUMMARY

We found that owner/agent misuse of project assets contributed to Huron Plaza's physical problems and Sunridge's continued loan delinquency and subsequent default. Huron assets of \$407,136 and Sunridge assets of \$98,468 were used in violation of the regulatory agreements. The violations included diverted laundry income and direct distributions to owners; payment of excessive, unsupported, or non-project charges by service contractors and others; and excessive management fees. These acts contributed to the insufficiency of funds to maintain Huron and to keep Sunridge's mortgage current. This occurred because the general partners disregarded the regulatory agreements. Further, one of the project's general partners, who was also general partner of the management agent, neglected his responsibilities.

We also noted other deficiencies with the projects' management, including non-compliance with Section 8 requirements; inadequate separation of accounting, disbursement, and procurement functions; and absence of a required fidelity bond. As a result, HUD paid excessive subsidies, and there was exposure to unnecessary financial risks. These problems occurred because the agent neglected its responsibilities and disregarded both HUD requirements and good business practices.

We are recommending that HUD (1) require the owner to have needed repairs at Huron Plaza completed, (2) obtain appropriate compensation from the owner, (3) instruct the owner and current agent that distributions from Huron to the owner will not be permitted unless there is surplus cash and HUD advises that the project's physical condition is satisfactory, (4) bar responsible parties from taking part in HUD programs, and (5) conduct an occupancy review at Huron Plaza to determine if Section 8 certifications are adequately supported and rents properly calculated during R&R's management period.

We have provided a copy of this report to Mr. Jack Riley, representing the project owners and the former management agent; the current management agent Consolidated Property Masters, Inc.; and the owners' public accountant Louis Young CPA Inc.

Within 60 days, please furnish us a status report on the corrective action taken, the proposed corrective action and the date to be completed, or why action is not considered necessary for the recommendations.

If you have any questions, please contact senior auditor Mark Pierce at 415-436-8101.

BACKGROUND

The objective of HUD's mortgage insurance programs for multifamily housing is to assist in the construction, rehabilitation or preservation of rental cooperative housing. In consideration for the insurance, the owner agrees to various controls over the housing's operations. These requirements are contained or referenced in a contract known as a regulatory agreement. Some requirements include limits on use of project assets, proper project upkeep, and maintenance of accounting records.

HURON PLAZA. In 1981 HUD's Federal Housing Administration (FHA) initially endorsed a \$2.6 million mortgage loan for Huron Plaza under Section 221(d)(4) of the *National Housing Act*. The development contains 64 housing units and is located in Huron, California. The owner has a contract with HUD for subsidizing rents, under the Section 8 program, of all qualified low-income residents. The contract requires the owner to maintain the units and related facilities to provide decent, safe and sanitary housing.

Huron Plaza, a California limited partnership, owns the development. Two individuals, Jack Riley and Jerry Campbell, are the general partners. Hutton Subsidized Housing Partners II, a Delaware limited partnership, and Hutton Subsidized Housing Services, Inc. are the limited partners.

The project's physical condition was considered satisfactory until 1993 when problems were noted with landscaping, exterior paint, patio fences, driveways and parking lots, carports, carpets and dishwashers. From 1993 to 1995 the development received "below average" ratings from the mortgagee and an "unsatisfactory" rating from HUD. The March 1995 HUD inspection estimated \$269,800 for needed repairs and replacements.

SUNRIDGE. FHA also initially endorsed a \$4.56 million mortgage loan for Sunridge Apartment under Section 221(d)(4) in 1983. The development contains 120 housing units and is located in Fresno, California. Tenants paid market rents. A California limited partnership, Sunridge Associates, owned the development. The partnership had four general partners, including Jack Riley. It also had five limited partners, with Hutton Subsidized Housing Partners II having the largest (89.9%) interest.

The mortgagee assigned the loan to HUD in 1988 due to delinquent mortgage payments. A HUD analysis concluded that the development was unable to generate sufficient income due to a weak rental market. HUD sold the loan's note on October 31, 1995 when the unpaid balance was \$4.53 million and the delinquency was \$796,000. The note went for \$3.366 million, 74% of the unpaid balance.

R&R MANAGEMENT. R&R Management received fees to oversee the two properties for the period covered by our review. R&R was an identity-of-interest entity because Jack Riley (a general partner for both developments) and Jerry Campbell (a general partner for Huron) were partners for R&R. On July 1, 1996 R&R turned management of Huron Plaza over to an independent, HUD approved agent, Consolidated Property Masters, Inc.

OBJECTIVE AND METHODOLOGY

The purpose of our review was to determine whether any improper use of project assets contributed to the projects' financial and physical problems. The review generally covered the period January 1, 1991 through May 31, 1996.

We conducted the review in accordance with generally accepted government auditing standards. The primary methodologies for this work included:

- Analysis of audited financial statements of the projects and discussions with the public accountant who performed the audits.
- Interviews of multifamily asset management staff at the HUD California state Fresno area offices, and review of documents located there concerning the projects.
- Interviews of the management agent and select contractors.
- Consideration of the projects' internal control structure and assessment of risk exposure to determine review procedures. Our consideration included systems for receipts purchasing, and disbursements. We did not evaluate control effectiveness because of the limited nature of the review and the weak control environment.
- Examination of project accounting records and supporting documentation for selected financial activities and transactions.
- A visit to Huron Plaza to observe its physical condition.

This report reflects our consideration of auditee comments. We obtained comments on our written, preliminary conclusions from Jack Riley, representing the owners and R&R Management. Written comments, dated March 31, 1997, from Mr. Riley are included in Appendix to this report. We also discussed the audit conclusions in person with Mr. Riley on April 22, 1997.

RESULTS OF REVIEW

FINDING 1 - IMPROPER USE OF ASSETS CONTRIBUTED TO THE PROJECTS' FINANCIAL DEFAULT AND DEFERRED MAINTENANCE.

Huron assets of \$407,136 and Sunridge assets of \$98,468 were used in violation of the regulatory agreements. The violations included diverted laundry income and direct distributions to owners; payment of excessive, unsupported, or non-project charges by service contractors and others; and excessive management fees. These acts contributed to the insufficiency of funds to maintain Huron and to keep Sunridge's mortgage current. This occurred because general partners Jerry Campbell and Jack Riley disregarded the regulatory agreements. Further, Riley neglected his responsibilities as management agent.

LIMITS ON USE OF PROJECT FUNDS. In consideration for the insurance endorsement of the projects' mortgage loans, the owners agreed to be bound by regulatory agreements with HUD. The agreements say the owners will not, without HUD approval:

- Pay out any project funds for other than the insured loan and for reasonable operating expenses and necessary repairs, except from surplus cash,
- Receive any distributions of project assets unless from surplus cash. A distribution is the withdrawal of any project assets for all but necessary and reasonable expenses to operate and maintain the project, or
- Make or receive any distributions unless in full compliance with all HUD requirements for proper maintenance of the project.

For the period covered by our review, *distributions were prohibited*. Sunridge had surplus cash deficiencies and its mortgage loan was in fiscal default. Huron had surplus cash deficiencies or substantial maintenance defects.

As of Dec. 31	SUNRIDGE Surplus Cash Deficiency	HURON PLAZA Surplus Cash Deficiency & Physical Condition	
1991	\$273,700	\$22,791	Satisfactory
1992	\$473,017	\$9,201	Satisfactory
1993	\$603,069	\$1,412	Below Average
1994	\$798,932	\$7,456	Below Average
1995	\$878,312	-\$5,816 (a surplus)	Unsatisfactory; repair needs estimated at \$269,800

DIVERTED LAUNDRY INCOME AND DIRECT DISTRIBUTIONS TO OWNERS (HURON ONLY)

The owner took \$199,821 from Huron by diverting the project's laundry income and withdrawing money directly from the operating and security deposit accounts. The owner also contributed or repaid some monies, partially mitigating these distributions. At the beginning of the period under review, the general partners owed the project \$32,172. At the end of 1995, after taking out an additional \$167,649 and putting \$170,800 back, they still owed the project \$29,021.

	Laundry Income to Campbell	Distributions to Campbell	Distributions To Riley	Less Owner Contributions	Cumulative Totals

* HUD publications help define reasonable operating expenses and necessary repairs, principally in handbook 4381.5 REV-2, *The Management Agent Handbook* (and its predecessor 4381.5 REV-1) and handbook 4370.2 REV-1, *Financial Operations and Accounting Procedures for Insured Multifamily Projects*. Further, under statute (12 USC §1715z-4a) ". . . a use of assets or income in violation of the regulatory agreement or any applicable regulation shall include use for which the documentation in the books and accounts does not establish that the use was made for a reasonable operating expense or necessary repair of the projects and has not been maintained in accordance with the requirements of the [HUD] Secretary and in reasonable condition for proper audit."

Prior Years	\$32,172				\$32,172
1991	6,842				\$39,014
1992	6,832				\$45,864
1993	8,051	\$50,000	\$19,000	\$40,000	\$82,897
1994	10,629	44,965		60,800	\$77,691
1995	1,330	20,000		70,000	\$29,021
Totals	\$65,856	\$114,965	\$19,000	\$170,800	

LAUNDRY INCOME. The regulatory agreement requires that all receipts of the project be deposited in the name of the project in a bank. Nevertheless, Campbell received the laundry income directly from the vendor and did not remit to the project. The public accountant performing audits of the annual financial statements reported this impropriety as early as 1991 (the earliest financial statements we reviewed), yet Campbell continued to take the income through February 1995 (after which the vendor started sending the money directly to the project.) According to the 1991 financial statements, Campbell owed the project \$32,172 from prior years. We found that he took an additional \$33,684 through 1995.

In 1995 Riley claimed that since 1986 the public accountant had overstated the amount of laundry income Campbell owed the project. Riley provided us a photocopy of the front of a 1986 \$11,000 check from Campbell to the project. The existence of the check, however, does not show its purpose. Also, Campbell tended to take money soon after putting it in. (For example, Campbell had paid back \$40,000 in laundry income on December 29, 1994, but took it out again on January 3, 1995.) Thus, we have no assurance that this did not happen with the \$11,000 payment.

DIRECT DISTRIBUTIONS. Between 1993 and 1995, the general partners took \$133,965 directly from Huron's operating and tenant security deposit accounts.

- During 1993 Riley distributed \$50,000 to Campbell from the operating account and took \$19,000 for himself, mostly from restricted tenant security deposits. The security deposit liability remained under-funded until September 1994, except for a two week period starting December 29, 1993 when Riley moved operating funds to prepare for the annual audit.

During 1993 the project received \$84,727 from HUD for retroactive Section 8 rent earned between May 1982 and May 1991, which the owner withdrew even though HUD had notified Riley that the retroactive rent money must become part of project funds subject to all restrictions HUD places on distributions. When we asked for an explanation, Riley said that there would have been surplus cash available in 1988 through 1991, if the project had received the rents when earned. Nevertheless, since the project did not have surplus cash as of the end of the last semiannual period, the owner's action violated the regulatory agreement.

- During 1994, Campbell took \$44,000 from the operating account with no explanation. In addition, he took \$965 that he claimed was reimbursement for money spent on the project's behalf. The support, however, consisted of an invoice for a stove ordered by and delivered to Campbell's wife, and several illegible photocopies of cash register receipts. Since neither Campbell nor his wife were involved directly in the management of the project, and nothing indicated that purchases were for the project, we concluded that the purchases were personal.

- During 1995, Campbell took \$20,000 from the operating account. The check voucher said "repayment of owner contribution forehab." However, improper distributions to Campbell exceeded his "contributions" by over \$58,000 before this distribution. Thus, the \$20,000 payment was improper.

OWNER ADVANCES. Between December 1993 and March 1995, Campbell made some deposits that partially mitigated the effects of the distributions. The pattern, however, was erratic and did not show a commitment to comply with regulations or restore the project to satisfactory physical condition. As mentioned earlier, at the end of 1994 he deposited \$40,000 to return part of the laundry income, but he withdrew the money several days later. On January 3, 1995 he also took \$4,000, which he returned to the project on January 12. In September 1994, Riley returned \$14,000 of the \$19,000 he had taken from the project, restoring the security deposit account to an acceptable level. While Campbell continued to take money out and put money in, the partners still owed the project \$29,021 as of the end of our audit period.

IMPROPER CHARGES FOR SERVICE CONTRACTS

Inadequate management practices led to \$19,640 of unnecessary (\$12,722 for Huron, \$6,918 for Sunridge) and \$334,620 of unsupported payments (\$305,699 for Huron, \$28,921) to service vendors for both Huron and Sunridge. Riley did not obtain multiple bids or cost estimates before awarding service contracts, which included bookkeeping, landscaping, pest control, Section 8 tenant screening and certifications, and maintenance. There were significant disbursements without benefit of written contracts, but even when the contracts were in writing, the scope of work was ambiguous. Once contracts were in place, Riley did not require the contractors to submit documents supporting extra charges to the projects, whether the charges were for labor or reimbursements for materials. The following are examples of the most significant transactions with which we took exception.

MANCORN. Three related companies, M.A.N. Power Management, MANCORN Management, and MANCORN Diversified received a total of \$177,748 for service contracts with the two projects. (We refer to all as MANCORN.) Of that amount, \$98,349 were not adequately supported and \$14,625 were unreasonable or unnecessary. The services, provided between 1994 and the first half of 1996, included landscaping, pest control, maintenance, Section 8 screening and certifications, and bookkeeping. Only the Section 8 work and the bookkeeping appeared reasonable in cost. We noted irregularities with all others.

The management agent is expected to obtain bids to assure that goods and services are procured at reasonable prices. However, during the time the agent contracted with MANCORN, the agent delegated this responsibility to MANCORN. Michael Nolan, who owned MANCORN, claimed that he had obtained bids to show that his company's fees were reasonable. As a result, Nolan's interest in obtaining the contracts for his company created a conflict of interest that unnecessarily increased project costs. Sometimes Nolan represented MANCORN as the lowest bidder and prepared invoices that gave the appearance that MANCORN did the work, when he actually subcontracted out to other companies for less than MANCORN'S fees. The following are examples of irregularities with MANCORN'S contracts.

- Jose Lozano had been providing monthly landscaping services for Sunridge since December 1991. From February through October 1995, MANCORN received \$1,675 per month for landscaping, although there was no written contract. We found that Lozano continued to do the work. During this period, however, MANCORN paid Lozano \$950 per month, keeping \$725 (a 79% markup) for itself. Nolan said the markup was justified because Lozano did not do a good job without Nolan's supervision. This was

not proper because it was the agent's job to supervise contractors. In addition, the project was paying for an on-site employee responsible for maintenance supervision.

- MANCORP provided landscaping services to Huron for \$500 to \$750 per month from January 1995 through May 1996. While the amount did not appear excessive, it was not evident what services MANCORP actually provided. HUD's March 1995 inspection report said the lawns needed to be replanted and bare spots eliminated. In May 1996, the landscaping still appeared neglected. Huron's lawns were brown and patchy, with many bare spots. Neighboring low-income properties had lush lawns. Since MANCORP's efforts were not evident or not documented, we concluded that costs were not supported.
- MANCORP took over monthly pest control at Huron in the last quarter of 1994 and at Sunridge in January 1995. Although there were no written agreements for pest control, Nolan provided us bid documents to show MANCORP was selected competitively. Apart from Nolan obtaining the bids himself, we found that the work was actually done by one of the companies that had submitted a bid. Actually, that company provided services for less than the bid and less than MANCORP charged the project. Nolan said he obtained the services at a below-market rate because the subcontractor was a friend and would have charged R&R more. The subcontractor told us this was not true and that he did not know Nolan was charging the project extra. Nolan's added charges for pest control came to \$1,860 for both contracts at a rate that varied from a 10 to a 57% markup.
- Huron's maintenance contract with MANCORP stated that MANCORP would provide all maintenance and repairs not requiring a licensed professional for a cost of \$2,150 per month. Except for the cost of one on-site employee, we concluded that most of the cost was for management and supervision, which were the agent's responsibilities. Available records showed only that the contract paid for the on-site maintenance employee's salary. MANCORP's payroll records showed that he paid the maintenance employee amounts varying from \$300 to \$1,100 per month. The maintenance employee lived on-site and worked full-time at Huron. While compensation for the employee was a necessary project expense, the agent did not show that the project gained from contracting out instead of employing the maintenance worker directly, or that MANCORP provided anything more than supervision: an agent responsibility already compensated for in the R&R management fee.
- Nolan claimed that MANCORP's labor-only proposal to replace Huron's patio fences for \$4,950 was less expensive than labor-and-materials bids from two other companies. Since he did not quote a cost for materials, a comparison could not be readily made. MANCORP received \$4,910 for the job that was done by another company for \$86 less.
- Nolan said that he tried unsuccessfully to find another company willing to repair and refinish kitchen and bathroom cabinets at Huron. MANCORP's invoices showed that MANCORP repaired and refinished cabinets in all 64 units for which MANCORP charged the project \$7,700. Actually, work was done by another company for a total cost of \$6,300 with repairs done on only some units as others did not require any work.
- MANCORP charged Huron \$1,953 for replacing doors on the water heater closets. Nolan told R&R that he tried to obtain bids from other companies, but could not find one willing to do the work. Nevertheless, he hired another company to do the work for \$543 less than he charged the project.

SIERRA PACIFIC. Sierra Pacific received more than \$216,000 from Huron and Sunridge for maintenance, landscaping, repairs and other items from 1991 through 1994. Only \$5,664 was supported and for an eligible purpose: work to reduce property taxes for both projects. Sierra Pacific charged Huron \$5,015 for work done by other vendors, who had already been paid directly by the project. All other payments to Sierra Pacific (\$91,565 for Huron, \$13,952 for Sunridge) were unsupported. Riley did not show any evidence of written contracts with Sierra Pacific or that he obtained bids from other companies.

Sierra Pacific invoices submitted to R&R did not provide sufficient information to evaluate whether charges were reasonable. For 1991 and 1992 there were no invoices available for review. Among the unsupported payments was one for \$208,504. The check notation said it was for refrigerators. In 1993, the only payment Sunridge made to Sierra Pacific was for property tax reduction, but Huron paid the company over \$76,000. Most invoices said only "Grounds Maintenance," or "Maintenance Contract," but \$2,000 was for other inadequately unsupported items including tree removal and pruning, air conditioner repair and maintenance, carpet replacement, retroactive Section 8 calculations, plumbing, and unexplained "unscheduled labor." In 1994, Sierra Pacific was no longer providing either project with regular services. Still, Huron paid \$1,800 for temporary management, paperwork, and a chain-saw, and Sunridge paid \$92 for collection services, all unsupported.

Based on the billing irregularities we observed from MANCORN and the events described below, it appears likely that much of this work was done by other companies and Sierra Pacific received excessive payments.

Two of Huron's payments to Sierra Pacific were supported in the agency file by HUD letters approving reserve-for-replacement releases in like amounts. While R&R's files did not show what goods or services were obtained, HUD's records on the releases did.

- Huron check #2101 was to Sierra Pacific for \$6,848. Sierra Pacific's invoice only stated the charge was for "Maintenance contract." The reserve for replacement letter was attached as support. The HUD file showed that the reserve release approval was based on four vendor invoices from companies other than Sierra Pacific. We confirmed that two of those invoices, totaling \$1,667 were paid directly by the project. Thus, the payment to Sierra Pacific for these invoices duplicated that already made directly to the vendors. The remainder of Sierra Pacific's charge was unsupported because the records did not show that Sierra Pacific had paid the other two invoices.
- Huron check #2191 was to Sierra Pacific for \$3,348.00. The invoice said "Maintenance contract." Again, the HUD file showed that HUD approved the reserve release based on four vendor invoices and a cash register receipt from companies other than Sierra Pacific. Huron had paid all the vendors directly for the goods and services. The payment to Sierra Pacific was ineligible and constituted double payment by the project. One \$1,443 invoice should not have been included in this draw-down since it had already been included in another reimbursement (the \$6,848 discussed above). The project paid this same invoice three times: once directly to the vendor and twice to Sierra Pacific.

OTHER SERVICE CONTRACTS. In 1991 and 1992, Huron and Sunridge each appeared to have two concurrent grounds contracts. Both projects contracted with Sierra Pacific, yet at the same time Huron paid Frank's Maintenance \$13,910 for grounds work, maintenance and cleaning and Sunridge paid Jose Lozano \$13,444 for grounds work. Without written contracts and other evidence showing the need for multiple contracts, we asked Riley to explain. He did not respond, so we consider the additional payments to be unsupported.

OTHER IMPROPER CHARGES

Other unsupported charges of \$30,088 (\$18,966 for Huron, \$11,122 for Sunridge) and unnecessary costs of \$26,344 (\$10,438 for Huron, \$15,906 for Sunridge) included expenses that should have been paid by the owner or agent, reimbursements of expenses paid by the agent, payments for collection efforts by the owner of Sierra Pacific, and petty cash disbursements for restaurant food and gas for non-project employees. The following are examples:

- In 1992 and 1993 Sunridge and Huron paid Ed Psych Services \$4,715 and \$2,05 respectively for management advice. The consultant was Riley's father. Since management expertise was already compensated by the agent's fee, these costs were to be borne by the agent and were not necessary for the projects.
- The State of California imposes a tax of \$800 per year on all limited partnerships doing business in the state. Each year, (1991 through 1996 for Huron and 1991 through 1995 for Sunridge) the tax was paid from the projects' operating funds. Since the tax does not relate to income, holdings, or type of business the partnership is engaged in, it is a cost of the owners and not the projects.
- R&R took reimbursements for postage, telephone, automobile, office supplies and insurance expenses. With one exception, a truck lease, Riley did not provide any support showing how the amounts were determined or what they were for. The agent's telephone costs, even if made to or on behalf of the project, are not to be borne by the project. Costs for office supplies, postage and printing may have been eligible, if there were records showing actual costs and relationships to the projects. Employee health insurance would have been eligible if it covered only on-site employees and it was supported. Thus, without records to assure that these other costs were project and not agent expenses, we considered them to be unsupported.
- Riley provided us with a copy of the lease on a truck that he said was used to deliver supplies to all properties managed by R&R. The truck was leased to Riley's father (who had no apparent connection with the properties) and the agreement specified that the vehicle was for personal and not commercial use. Riley could not show that the truck was used for the projects. Considering the circumstances, we concluded that all the auto and related insurance costs were unnecessary.
- In 1991 Riley used Sunridge operating funds for campaign contributions totaling \$500.

UNREASONABLE MANAGEMENT FEES

R&R received excessive management fees of \$65,891 (including \$8,900 received before 1991 from Huron (\$30,290) and Sunridge (\$35,601)). Further, the agent did not properly notify HUD of fee increases and did not obtain required approval for fee increases at Sunridge.

REQUIREMENTS GOVERNING FEES. HUD handbooks 4381.5 REV-1, *Management Documents, Agents and Fees*, and 4381.5 REV-2, *The Management Agent Handbook*, which superseded REV-1 on December 1994, provide guidance with respect to allowable management fees. Relative to the circumstances of the Huron and Sunridge projects, the pertinent requirements governing the fees are the following.

- Fees, like other expenses, are subject to regulatory agreement requirements that they be reasonable, that is, not exceed what is ordinarily paid for such services. In assessing reasonableness, they are to provide sufficient compensation to attract quality

management but are not to exceed the amount HUD determines agents and owners would ordinarily negotiate considering the project's environment. While fees are to be stated as a percentage of income, the determination of reasonableness is based on the equivalent monthly per-unit amount (PUPM).

- The fees for projects such as Huron and Sunridge do not usually require up-front approval by HUD. Nevertheless, the initial agreement for Huron was subject to pre approval because it was the first HUD project managed by the agent. Further, fee increases for Sunridge also required approval because its mortgage loan was in default.

R&R started managing Huron in December 1985; however, the only management certification in HUD records was one dated December 1, 1986. This certification stated that the management fee was 7.8%. This was equivalent to \$37.79 PUPM, exceeding the maximum guideline of \$3 effective through June 1991. Neither HUD nor agent records show that HUD approved this or any other certification.

R&R subsequently submitted a December 15, 1989 management certification for Sunridge showing a fee of 5.78% (equivalent to \$28.72 PUPM). In this case, the fee rate was within HUD's guidelines that allowed up to \$30 PUPM at that time.

EXCESSIVE FEES. The actual management fees paid were at rates generally higher than the management certifications submitted to HUD. At Huron, for instance, the rate was 7.91% in 1991, 9.43% in 1994, and 10.49% applied to a retroactive Section 8 rent adjustment made in 1993. At Sunridge, examples are 7.27% in 1991 and 10.09% in 1994. (Besides its "normal" fee averaging 8.02% at Sunridge in 1994, R&R received special incentive fees of \$10,835 and a fee \$4,563 to prepare a cash-flow projection.) The agent told us that fees were raised based on management contracts that were submitted to HUD. However, neither HUD nor agent records indicated that new agreements were submitted or that required pre-approval of the Sunridge increases was either requested or received.

Both Huron and Sunridge paid management fees that significantly exceeded the maximum fee levels developed by the HUD office having jurisdiction over the projects. We noted that the fees paid exceeded the limits most years.

We discussed this matter with the cognizant HUD asset management branch. We were advised that it was probable that the branch would have approved any fee increase that was consistent with established guidelines. Thus, under these circumstances, we decided that any fees claimed in excess of the greater of (1) the HUD maximum or (2) the rates specified in the management certifications submitted to HUD, were unreasonable. Further supporting our conclusion that rates exceeding HUD maximums are unreasonable is the owner's negotiation of a 7.5% fee with a new agent for Huron in mid-1996. This rate is slightly below HUD's current maximum of 7.6% (\$50 PUPM).

Huron. For Huron, the 7.8% rate shown in the management certification exceeded HUD's maximums for all years. (The maximum rate increased from \$32 PUPM in early 1991 to \$50 PUPM, equivalent to 7.76%, in mid-1996.) Therefore, we take exception with \$21,391 of the fee in excess of the 7.8% rate. (The actual rates shown for Huron and Sunridge are the averages for the year. Actual rates for each month varied.)

Huron Plaza and Sunridge Apartments

Year	Actual		Allowed		Excess
	Amount	Rate	Amount	Rate	
1991	\$34,711	7.91%	\$34,224	7.8%	\$487
1992	39,950	8.78%	35,472	7.8%	4,478
1993	50,544	9.06%	43,507	7.8%	7,037
1994	46,242	9.43%	38,261	7.8%	7,981
1995	40,591	8.08%	39,184	7.8%	1,407
Total	\$212,038		\$190,648		\$21,390

Besides the above excessive fees for the period 1991 through 1995, the audited financial statements revealed that R&R owed Huron \$8,900 for excessive fees taken before 1991. Thus, total excess fees for Huron were \$30,290.

Sunridge. For Sunridge, the fees exceeded HUD limits in 1991, 1992 and 1994 by \$35,601. (The maximum HUD rates for Sunridge were lower than for Huron because of different factors used in determining those rates.)

Year	Actual		Allowed		Excess
	Amount	Rate	Amount	Rate	
1991	\$49,660	7.27%	\$41,491	6.07%	\$8,169
1992	48,784	7.29%	43,739	6.54%	5,045
1993	43,320	6.13%	43,320	6.13%	0
1994	75,008	10.09%	52,621	7.08%	22,387
1995	36,989	7.41%	36,989	7.41%	0
Total	\$253,761		\$218,160		\$35,601

Appendices A and B itemize the misuse of assets by project.

EFFECTS

The asset misuse contributed to deferred maintenance at Huron Plaza and to the continued loan delinquency and subsequent default at Sunridge.

HURON PLAZA. While the surplus cash deficiencies at Huron were minor and a small surplus was achieved in 1995, the agent had put off making needed repairs and replacements. This caused tenants to suffer from deteriorating living conditions. Also, the mortgagee and HUD experienced higher business risks because the value of the property, which is the security for the insured loan, erodes when its physical condition is neglected.

After several years of "satisfactory" inspection reports (from May 1989 through June 1993), the mortgagee rated Huron's physical condition as "below average" in October 1993. The mortgagee repeated that rating in 1994 and 1995 although management had assured the inspector that the necessary work was imminent. Further, a March 1995 HUD inspection concluded that conditions were "unsatisfactory" (the lowest possible rating).

When HUD inspected the property in March 1995, long-standing repair needs had not been addressed, such as painting the exterior and interior, repaving the parking area, and repairing or replacing fences, landscaping, carports, and floor coverings. Replacement of sinks, countertops, and closet doors was also needed. In addition, HUD believed that the all stoves and dishwashers needed to be replaced. HUD estimated the total cost of this work at \$269,800.

When we visited the project in April 1996, a substantial amount of work had been completed. The parking lot had been repaved, the building exteriors had been painted, the patio fences had been replaced, and kitchen cabinets had been repaired or refinished.

Still, much work remained. The carports still needed repairs, and the lawns remained neglected. Further, our observations of seven units confirmed interior problems. Several apartments still had the original carpets that were stained and threadbare. We saw units with mildewed bathroom needing to be repainted and one with a hole in an interior wall. We also saw a unit with chipped kitchen and bathroom counters needing replacement.

SUNRIDGE. This project went into default in April 1988, and the mortgagee filed an assignment to HUD the following October. At the time an independent agent managed the project. R&R took over management the following year. Although R&R was not responsible for the initial default which Riley and HUD attributed to a soft rental market and substandard management, we concluded that R&R's subsequent misuse of assets contributed to the continued default. The total delinquency grew from \$44,895 in April 1988 to \$796,674 in October 1995.

HUD sold the note in October 1995 for \$3,366,000, which was 74% of the \$4,530,506 unpaid principal balance. This represents a loss of nearly \$1.2 million to HUD's insurance fund.

CAUSE OF THESE ACTS

The violations of the regulatory agreements occurred generally because of disregard of HUD requirements. Jack Riley told us that he was not knowledgeable of HUD requirements and indicated that he relied on HUD to notify him of noncompliance. Further, Riley neglected his responsibilities as management agent and relied on subcontractors to make management decisions without adequate oversight.

OWNER/AGENT COMMENTS AND INSPECTOR GENERAL EVALUATION

Jack Riley said that any violations of HUD's requirements were not intentional. He had no previous experience with HUD programs or in property management. He had relied on contractors and employees to properly perform their duties and for his public accountant and HUD to notify him if and when he was not complying. The contractor charges appeared reasonable to him, but he was unaware of any duplicate payments or improper markups. Mr. Riley said he would make further attempts to obtain documentation to support the reasonableness and necessity of some of the excepted transactions such as the truck his father leased, payments to Sierra Pacific, and the extent laundry income had been taken from and returned to the project.

Mr. Riley said that his partner returned the balance of the laundry income to Huron in 1997A (footnote to the 1996 audited financial statements states that \$2202 were returned in March 1997, but the issue remains on whether \$11,000 had also been repaid in 1986.)

* This estimate includes \$20,000 for purchase of playground equipment. Since Huron never had such equipment, its absence cannot be considered to be deferred maintenance.

Mr. Riley acknowledged that he may be liable for paying compensation to HUD for Sunridge, if HUD so determines. In regards to Huron Plaza, Mr. Riley said that the project is now financially healthy (the financial statements show a \$28,586 surplus cash balance as of December 31, 1996) and except for minor landscaping work, the project's deferred maintenance has been remedied.

At our request, HUD made a physical inspection of Huron on April 1, 1997. The inspection noted substantial improvement in the property's condition. Nevertheless, estimated repairs still needed totaled \$91,000, consisting primarily of replacement of carpeting and flooring (\$35,000) replacements of dishwashers (\$6,700) and purchase of play equipment (\$20,000). HUD sent the inspection results to the owner on April 23, 1997, after we obtained owner's comments on the audit.

The owners are responsible to assure that the projects are operated in accordance with the contractual agreements with HUD. Thus, in our opinion, compensation should be obtained from the project owners to mitigate the insurance loss, recompense the government for audit costs discourage future violations of regulatory agreements, and make reparations for the substandard living conditions at Huron. Also, HUD needs to assure that the physical condition of Huron is brought up to standard. Further, other administrative action is necessary to protect HUD's interests.

RECOMMENDATIONS

We recommend that HUD:

- 1A. Require the owner to have necessary repairs at Huron Plaza completed in a timely manner. Closely monitor the progress of the repair work.
- 1B. For Huron, obtain compensation from the owner and decide what portion may be returned to the project and what conditions or restrictions will be imposed for use of those funds, to cure the project's physical needs.
- 1C. Instruct the owner and current agent that distributions from Huron to the owner will not be permitted unless there is surplus cash and HUD advises that the project's physical condition is satisfactory.
- 1D. For Sunridge, obtain compensation from the owner.
- 1E. Debar Jack Riley, Jerry Campbell and Michael Nolan to preclude their taking part in HUD programs. In anticipation of debarment, limited denials of participation should be issued.

FINDING 2 - OTHER DEFICIENCIES WITH PROJECT MANAGEMENT WERE NOTED.

The purpose of our review was to determine if asset misuse contributed to the projects' physical or financial problems. During the review, however, we noted other management deficiencies: non-compliance with Section 8 requirements; inadequate separation of accounting, disbursement, and procurement functions; and absence of a required fidelity bond. As a result, HUD paid excessive subsidies, and there was exposure to unnecessary financial risks. These problems occurred because the agent neglected its responsibilities and disregarded both HUD requirements and good business practices.

ADMINISTRATION OF SECTION 8. Under Section 8 of the *United States Housing Act of 1937*, HUD contracted with the owner of Huron to subsidize housing costs of low-income families. The

program requires families to pay 30 percent of their income for housing. The subsidy from HUD, known as a housing assistance payment, makes up the difference between the tenants' rent payments and a "contract rent" set by HUD. The contract requires the owner to assure the families are eligible and pay their share of housing costs. The requirements are contained principally in Chapter VIII, Title 24 of the *Code of Federal Regulations* and in HUD handbook 4350.03, *Occupancy Requirements of Subsidized Multifamily Housing Programs*.

While reviewing accounting records, we saw that the project collected Section 8 subsidy for the resident manager's unit, but did not collect the corresponding tenant rent. The agent had contracted with Michael Nolan, the owner of MANCORP, to manage the Section 8 process. Nolan explained that the tenant portion of the manager's rent was considered part of her salary. This was not proper because Section 8 regulations require tenants to pay 30 percent of their adjusted incomes for rent. Further, the subsidy calculation should have included income from all sources; but Nolan did not include the income represented by the unsubsidized portion of the contract rent, which varied from \$290 per month in August 1995 to \$449 per month in February 1996.

Other income of the resident manager's family was also understated, further increasing the amount of excess HUD subsidy. Nolan was responsible for verifying tenant income and determining subsidy and tenant rent amounts. Nolan knew the salary of the manager's husband since he worked for Nolan's company MANCORP as Huron's maintenance worker. Nevertheless MANCORP's payroll records revealed that the maintenance worker's salary exceeded the amount reported for Section 8 subsidy for all but the first month of his employment. From October 1995 through May 1996, his income exceeded the amount reported by an average 45% or \$366 per month.

Mr. Riley acknowledged that he may be liable for repaying any excess Section 8 billings, if HUD so determines.

SEPARATION OF DUTIES. Good business practices dictate the segregation of certain duties to prevent or minimize employee errors and misconduct. Ideally, the same individual should not make up bank deposits, authorize disbursements and maintain accounting records. In contrast, the agent gave Nolan full responsibility for purchasing, approving payments, writing and signing checks (using the agent's signature stamp), and recording disbursements in the accounting records, even when Nolan's company MANCORP was a major recipient of project funds. He also collected, deposited, and recorded tenant rents for Huron. While ideal segregation of duties is not always possible in small companies, the agent could have compensated by retaining review and approval responsibilities, but he did not.

The agent relied on the owner of MANCORP to ensure that goods and services were obtained at the most advantageous terms. As discussed in finding 1, MANCORP used the opportunity to obtain all ongoing and most task-specific contracts for itself, even when other companies offered better terms.

FIDELITY BOND. As insurance against loss due to misconduct, HUD requires the owner or agent to obtain a fidelity bond in an amount at least equal to potential collections for two months. Coverage is required for all principals of the agent and all persons who participate directly or indirectly in management and maintenance of the project and its assets, accounts and records. This requirement, however, was not met. Although the agent obtained coverage for project and agent

* The bond requirement is mentioned in the 1992 HUD handbook 4370.2 REV-1 *Financial Operations and Accounting Procedures for Insured Multifamily Projects*, and its 1981 predecessor 4370.2. Further, the agent/owner submitted a management certification form to HUD attesting that the coverage would be maintained.

employees, neither the agent's principals nor Michael Nolan were covered. These uncovered individuals had the greatest access to project assets.

On July 1, 1996 R&R turned management of Huron Plaza over to an independent agent, Consolidated Property Masters, Inc. Thus, no further action is needed to correct these last few deficiencies. Also, we understand that Consolidated provides a rent-free unit to the resident manager and does not obtain Section 8 subsidy for the unit. However, considering the excess subsidies previously paid for the resident manager's unit and the pattern of owner/agent noncompliance, we believe that a review of R&R's administration of the Section 8 program should be done.

RECOMMENDATION

- 2A. We recommend that HUD conduct an occupancy review at Huron Plaza to determine if Section 8 certifications are adequately supported and rents properly calculated during R&R's management period. Noted excess subsidy payments should be returned by the owner/agent.

**HURON PLAZA
SUMMARY OF UNNECESSARY AND UNSUPPORTED ASSET USE**

DESCRIPTION	ITEMIZED AMOUNTS		CATEGORY TOTALS	
	Unnecessary	Unsupported	Unnecessary	Unsupported
Net Direct Distributions & Laundry Income	\$ 29,021			
DISTRIBUTIONS & LAUNDRY INCOME subtotal			\$ 29,021	
MANCORP - various contracts	7,707	\$ 96,824		
Sierra Pacific - various contracts	5,015	191,565		
Frank's Maintenance - Pest Contract		3,400		
Other Service Contracts - Frank's, Lozano etc.		13,910		
SERVICE CONTRACTS subtotal			12,722	\$305,699
Ed Psych Services - management consultation	2,350			
Franchise Tax Board - partnership tax	4,800			
Petty Cash - restaurants and gas	1,044	1,157		
R & R - reimbursements	2,146	13,671		
Corporate Collections		125		
Other - miscellaneous payments	98	4,013		
OTHER IMPROPER CHARGES subtotal			10,438	18,966
R & R - excessive management fees	30,290			
UNREASONABLE MANAGEMENT FEES subtotal			30,290	
TOTALS	\$82,471	\$324,665	\$82,471	\$324,665
GRAND TOTAL			\$407,136	

**SUNRIDGE APARTMENTS
SUMMARY OF UNNECESSARY AND UNSUPPORTED ASSET USE**

DESCRIPTION	ITEMIZED AMOUNTS		CATEGORY TOTALS	
	Unnecessary	Unsupported	Unnecessary	Unsupported
MANCORP - various contracts	\$ 6,918	\$ 1,525		
Sierra Pacific - various contracts		13,952		
Other Service Contracts - Frank's, Lozano etc.		13,444		
SERVICE CONTRACTS subtotal			\$ 6,918	\$ 28,921
Ed Psych Services - management consultation	4,715			
Franchise Tax Board - partnership tax	4,000			
R & R - reimbursements	4,147	6,960		
Corporate Collections		1,269		
Other - miscellaneous payments	3,044	2,893		
OTHER IMPROPER CHARGES subtotal			15,906	11,122
R & R - excessive management fees	35,601			
UNREASONABLE MANAGEMENT FEES subtotal			35,601	
TOTALS	\$58,425	\$40,043	\$58,425	\$40,043
GRAND TOTAL			\$98,468	

OWNER/AGENT COMMENTS

SCHEDULE OF INELIGIBLE AND UNSUPPORTED AMOUNTS

PROJECT	INELIGIBLE AMOUNTS	UNSUPPORTED AMOUNTS
Huron Plaza	\$82,471	\$324,665
Sunridge Apartments	58,425	40,043
Totals	\$140,896	\$364,708

For internal HUD purposes, audit-expected amounts are categorized as either ineligible or unsupported amounts. Ineligible amounts obviously violate law, contract, HUD or local agency policies or regulations. Unsupported amounts do not obviously violate such requirements, but warrant being contested for various reasons such as the lack of satisfactory documentation to support eligibility and HUD approval.

In the context of this report, ineligible amounts represent project assets used in a manner that obviously violates the regulatory agreements such as diverted income, excess distributions, and unreasonable and unnecessary expenditures. Unsupported amounts represent project assets where documentation was not available to show that they were used in conformity with the regulatory agreements. However, see the note on page 4 that cites law stating that inadequately documented use of project assets constitutes a violation of the regulatory agreement.

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U.S. Department of Housing and Urban Development

Office of Inspector General

Pacific/Hawaii District

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May 12, 1997

TO: DISTRIBUTION BELOW

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Multifamily Mortgage Operations
Huron and Fresno, California
Report 97-SF-212-1003**

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