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No. 98-AT-247-1805

June 3, 1998

MEMORANDUM FOR: Kenneth C. Williams, Deputy Assistant Secretary for Grant Programs, DG

FROM: Nancy H. Cooper
District Inspector General for Audit-Southeast/Caribbean, 4AGA

SUBJECT: HUD Section 108 Loan Guarantee B-94-DC-01-0001
Good Samaritan Hospital
Selma, Alabama

We have conducted a survey of the above Section 108 Loan Guarantee and related project administered by the State of Alabama Department of Economic and Community Affairs (ADECA). Our survey was in response to concerns expressed to me by the ADECA General Counsel.

The objectives of our survey were to evaluate the merits of the facts and concerns expressed in the General Counsel's letter, including: (1) project activities and budget amounts significantly changed without required approvals, (2) project collateral security seriously compromised, (3) excessive funds spent on soft costs, such as project management; and (4) cash flow insufficient to meet loan payments.

Our survey was conducted between August 1997 and January 1998. The survey included: (1) reviewing ADECA's audit report on the loan and project, and related audit working papers, (2) reviewing borrower (City of Selma) records, (3) inspecting the project, and (4) discussing the project and loan status with the borrower, the obligor (Lighthouse of Dallas County, Inc.), and the HUD Director of Community Planning and Development (CPD) for the Alabama State Office.

BACKGROUND

The Section 108 Loan Guarantee Program was established under Title 1 of the Housing and Community Development Act of 1974, as revised, codified at 24 CFR 570.700. The purposes for loan guarantees include: (1) financing acquisition or rehabilitation of real property owned by an eligible public entity, (2) housing rehabilitation, and (3) economic development. All CDBG activities, including loan guarantees, must meet a national objective specified at 24 CFR 570.208.

HUD, ADECA, and the borrower entered into a Section 108 Contract for Loan Guarantee (Contract) in January 1995 guaranteeing a loan of \$2,200,000. The primary security for the loan is future grants or entitlements for which the State or the borrower may become eligible. For this loan, HUD had the borrower obtain as additional security guarantees from the obligor and personal guarantors (Drs. Samuel Lett and Charles Lett). The borrower assigned these guarantees to HUD. The obligor was to provide \$1,201,700 in equity for a total project cost of \$3,401,700. The borrower also received a \$330,000 Economic Development Initiative grant from HUD to provide additional collateral for the loan.

The project experienced financial and other difficulties, and on October 31, 1997, ADECA notified HUD that it believed it best to declare the loan in default as soon as possible. Funds were not available to meet the February 1, 1998, loan payment, so HUD made the payment and charged it against the State's 1997 Community Development Block Grant (CDBG) allocation.

The proposed project included renovation of three buildings formerly known as the Good Samaritan Hospital, consisting of unoccupied four-story and two-story buildings, and a one-story building occupied by the personal guarantor. Proposed work with the Section 108 loan included securing and stabilizing the site (clean up, lighting, re-roofing, window replacement, sidewalks, parking), and rehabilitating the first floors of the four-story and one-story buildings. Other remodeling was planned in the future. The application referred to the project as a new medical clinic. After renovation, annual income was estimated at \$342,000, sufficient to meet annual loan payments estimated at \$200,000 to \$240,000.

SUMMARY

The project had not met a national objective of the CDBG Program, in part because the obligor changed the intended purpose and physical configuration of the project without HUD, State or borrower approval. As a result, loan security was reduced, as well as potential rental income to make loan payments. The project is unfinished and the objectives cited in the application were not met. We believe all project costs totaling \$2,200,000 are ineligible because of the change in the project and the failure to meet an objective of the CDBG Program.

In addition, the ADECA audit questioned costs totaling \$290,062 for different reasons, such as lack of documentation. We reviewed ADECA's audit report and audit work papers, and agree with their conclusions. If the issues discussed in Finding 1 are resolved, the cost questions raised in ADECA's audit need to be addressed.

Neither the State nor the borrower complied with the following requirements of the Section 108 Contract:

- To submit to HUD monthly statements showing the balance, withdrawals, deposits, obligations and assignments of loan funds
- To provide to the custodian an appraisal of the market value of the property
- To demonstrate to HUD that the value of the property combined with the net worth of the personal guarantors exceeded 125 percent of the note, and that the ratio of net operating income of the obligor to the annual debt service on the note was at least 1.1:1.

As a result, HUD was not forewarned of the likelihood the obligor had insufficient income and net worth to keep the loan current and make the required private investment.

The deficiencies justify declaring the loan in default, to maintain the integrity of the program and protect HUD and the public's interests.

* * * *

Details of these issues are set out in Attachment 1 and in the ADECA audit report in Attachment 2. We provided a draft of our report to the Deputy Assistant Secretary for Grant Programs on February 17, 1998, soliciting comments and input into recommended corrective actions. The Deputy Assistant Secretary provided comments and suggested recommendations on March 9, 1998. We considered all comments and revised the report as considered appropriate. Their recommendations are reflected in the final report.

We also discussed the findings with ADECA staff at an exit conference on March 2, 1998. ADECA provided us written comments on April 10, 1998, which we also considered in preparing the final report. ADECA provided several comments concerning differences between their audit and ours, and their role in the project. They did not disagree in any significant manner with the substance of the issues stated in the findings.

ADECA's comments are summarized following each finding and are attached in their entirety as Attachment 4. Our final report consolidates into Finding 1, draft Findings 1, 2 and that portion of 3 related to costs questioned because of changes to project scope. These revisions should be considered when reviewing ADECA's comments in Attachment 4.

Within 60 days, please furnish us, for each recommendation in Attachment 1, a status report on: (1) the corrective actions taken; (2) the proposed corrective actions and the date to be completed; or (3) why actions are considered unnecessary. Also, please furnish us copies of any correspondence or directives issued as a result of this review.

We provided a copy of the report to ADECA.

Should you or your staff have any questions, please contact Rudy E. McBee, Assistant District Inspector General for Audit, at (423) 545-4368.

Attachments:

- 1 - Results of Review
- 2 - ADECA Audit Report
- 3 - Schedule of Ineligible and Unsupported Costs
- 4 - ADECA Comments
- 5 - Distribution

RESULTS OF REVIEW

FINDING 1 - CDBG PROGRAM OBJECTIVE WAS NOT MET

The project had not met a national objective of the CDBG Program, nor is it likely to, as it is unfinished and in fiscal default. This occurred in part because the obligor changed the intended purpose and physical configuration of the project without HUD, State or borrower approval. As a result, security for the loan and the potential income stream for repaying the loan was lessened, contributing to the default. Accordingly, we consider all costs totaling \$2,200,000 ineligible.

Program Objective Was To Create Jobs

Projects involving loan guarantees must meet the same requirements as any other CDBG funded activity, including meeting one of the national objectives of the CDBG Program (24 CFR 570.703, 570.200(a)). The national objective claimed was to create 20 new jobs, 19 of them for low and moderate income persons, with a spin-off benefit of eliminating slum and blight. The obligor had not created any new jobs at the time of our site visit and it is doubtful they will. Even if new jobs are eventually created if the project is finished, which is unlikely, the cost of the jobs of approximately \$110,000 each would be prohibitive. We also agree with comments the State made when evaluating the application, that benefit from eliminating slum and blight is minimal.

Actual benefits appeared primarily to be renovated office space for the owners. All new tenants in the facility previously had offices in the Selma area. There is little evidence the project will generate additional economic development.

Purpose and Configuration of Project Was Changed

The application described the project as a new medical clinic with diagnostic center, medical lab, pharmacy, and doctors' offices. The project included an equity contribution by the obligor of \$1,201,700 to be provided primarily through the value of the three existing buildings, estimated at \$976,600. The obligor was also to furnish equipment for the diagnostic center, providing CAT scan, sonogram, mammogram, ultrasonic and other x-ray capabilities.

After the application was approved, the obligor decided to demolish two of the buildings and renovate the third as an office building with doctors as tenants, which was what the building was to start with. As a result, the obligor in effect reduced the property improvements securing the loan and the square footage available for rent by about a third. The change in use was supposedly because of the high cost of insurance for a clinic. The obligor owners, as doctors, should have known about such costs prior to submitting the application.

The obligor demolished the one- and two-story buildings, leaving only the four-story building for renovation and rental. The obligor did not obtain approval from the borrower, State, or HUD to tear down the two buildings. The Mortgage and Security Agreement prohibits demolishing or altering the property except as approved by the borrower, and the contract describes as a default any failure to comply with conditions in the mortgage. The obligor told ADECA and the

borrower the buildings were torn down because of the high cost of asbestos removal and renovation of the two buildings, and to provide more parking. We were told the buildings were torn down to provide for parking and that asbestos was secondary. The obligor could not support the claim of severe asbestos contamination.

Changes Led to Financial Default

The \$342,000 income stream estimated in the application was more than sufficient to meet projected loan payments of \$200,000 to \$240,000 per year. However, the income was based on renovation and rental of all the buildings. When the obligor demolished the two buildings and reduced potential rental space, it forced a higher and less competitive rent structure for the remaining building. In short, higher rents were necessary to provide the same income stream. Also, the change eliminated the possibility of surplus income, which could have been used to secure additional financing for the other planned renovations.

According to the obligor, space under lease at September 2, 1997, was generating an annual income stream of about \$110,820. Funds were not available to meet the February 1, 1998, loan payment. To make prior loan payments, the obligor used the Economic Development Initiative grant to supplement rental income, but all grant funds have been used. HUD made the payment and charged it against ADECA's 1997 CDBG allocation. ADECA later reimbursed HUD directly, as it preferred not to have the payment charged against its allocation. Even if all space was renovated and leased, the income stream would be inadequate. The obligor estimated an additional \$550,000 is needed to renovate the remaining space.

All Costs Ineligible

An ADECA audit through May 31, 1997, questioned all project costs examined (\$1,273,945) because the unauthorized change in the scope of the project prevented the objective of the application being met, and caused the loan to be in default. The borrower subsequently drew down and disbursed all \$2,200,000 of the loan funds, and we consider all costs ineligible for the same reasons.

Summary

In summary, demolition of the two buildings constituted a default under the Contract, and adversely affected the economic viability of the project. Failure to make a loan payment also constitutes a default. The objectives of the project and the CDBG Program have not been met. The Section 108 loan should be declared in default in accordance with the Contract.

ADECA Comments

ADECA's director stated that whether the project met or was likely to meet CDBG Program objectives was outside the scope of ADECA's audit responsibilities. He added that the change of scope and inability to repay the loan was addressed in the ADECA audit report. The director stated that costs questioned in the ADECA audit report only covered the period ended May 31,

1997, and our audit should include additional costs incurred subsequent to their audit (our draft report questioned the same figure as questioned in the ADECA audit of \$1,273,945).

OIG Evaluation of Auditee Comments

We intend no criticism of ADECA's audit staff for not reviewing compliance with CDBG Program requirements. ADECA program staff raised the possibility of not meeting a CDBG national objective in reviewing the project; however, since ADECA approved the loan, it must have concluded the concern was unfounded. The Director is correct that our draft should have questioned all costs incurred, and we revised the final report to do so. Actually, most project costs had been incurred as of the date of ADECA's audit (\$2,106,330); however, their audit only questioned costs they tested (\$1,273,945).

Recommendations

We recommend that you:

- 1A. Declare the Section 108 loan in default pursuant to the cited provisions of the Contract.
- 1B. Declare all project costs totaling \$2,200,000 ineligible unless the borrower can demonstrate that the project met a CDBG national objective.
- 1C. Make demands on the security pledged by ADECA and/or the borrower to pay the loan, or repay HUD if HUD pays the loan, as applicable, in accordance with the Contract.

FINDING 2 - ELIGIBILITY OF VARIOUS COSTS WAS UNSUPPORTED

The ADECA audit report questioned various costs for different reasons, such as lack of documentation, in its Findings 5-8. We did not re-audit the costs, but we reviewed ADECA's audit report and audit work papers, and we agree with their conclusions. If the issues discussed in Finding 1 in our report are resolved, the cost questions raised in the ADECA audit need to be addressed.

We will not repeat the various reasons ADECA questioned costs, as we are attaching their audit report as Attachment 2. The more significant amounts questioned were:

- Costs incurred prior to release of funds, many without documentation, \$59,463
- Duplicate legal services, \$33,590
- Costs not included in approved budget, \$125,809
- Costs lacking adequate documentation, mostly paid to obligor owner, \$52,868

The costs questioned totaled \$290,062, but some were questioned more than once for different reasons, causing some duplication. The Schedule of Questioned Costs in ADECA's audit summarizes the costs. Many lacked original vendor invoices or billings, reportedly because they were not retained or were lost. The borrower inappropriately relied on the obligor's consultant (a former director of CPD for the HUD Alabama State Office) to review the eligibility of the costs before they were submitted for payment. As a result, the costs were not independently reviewed until the ADECA audit. Funds expended for questionable purposes could have been used to further renovate the building.

If costs questioned in Finding 1 are determined to be eligible, the borrower should be afforded the opportunity to provide documentation or other information to resolve the questions raised in this finding and ADECA's audit.

ADECA Comments

ADECA's director stated that we did not specifically reference the Schedule of Questioned Costs in their audit, and therefore did not make clear that some costs were questioned more than once. He also said our draft duplicated \$18,332 of costs in stating an example of undocumented costs.

OIG Evaluation of Auditee Comments

We revised our finding to reference ADECA's Schedule of Questioned Costs and clarify that the schedule questions some costs more than once. We also revised the report to eliminate the \$18,332 duplication.

Recommendation

- 2A. If all project costs are determined ineligible in connection with Finding 1, no action is necessary on this Finding. If not, we recommend that you provide the borrower the opportunity to document the eligibility of the \$290,062¹ in costs questioned herein. For any costs determined ineligible, we recommend you require ADECA and/or the borrower to reimburse the program an equivalent amount from non-Federal funds.

¹ The \$290,062 is included in the \$2,200,000 in ineligible costs addressed in recommendation 1B. In addition, the \$290,062 itself includes some duplication, as some costs were questioned more than once.

FINDING 3 - REPORTING REQUIREMENTS WERE NOT MET

Neither ADECA nor the borrower provided certain information to HUD as required by the contract. As a result, HUD was not forewarned of the likelihood the obligor or personal guarantors had insufficient income, net worth and other assets to meet loan obligations. These noncompliances are grounds for HUD to declare the loan in default.

The borrower did not submit to HUD monthly statements: (1) showing the balance in the Guaranteed Loan Funds Account and withdrawals from such account during the preceding month, and a statement identifying the obligations and their assignments; (2) showing the balance of funds in the Loan Repayment Account and the deposits and withdrawals of all funds in such account during the preceding month; and (3) identifying the obligations and their assignments in the Loan Repayment Investment Account. These statements are required by paragraph 1(b) and 6(b) of the Contract, and failure to submit them constitutes a default under paragraph 11(a). ADECA had an oversight duty to see that such statements were submitted. In not submitting the statements, the borrower denied HUD advance notice of the inability of the obligor to meet future loan payments.

The Contract required the obligor to provide \$1,201,700 in non-public funds as an equity contribution, including \$976,600 representing the appraised value of the buildings. The borrower, or ADECA acting for the borrower, did not provide to the custodian an appraisal specifying an estimate of the market value of the improved property as required (paragraph 5(c)(iii)(I) of the Contract, as amended). The appraisal is important because the Contract requires that the appraised value of the property, combined with the personal guarantor's net worth, exceeds 125 percent of the loan note.

The borrower is required to, but did not, demonstrate to HUD on an annual basis that the appraised value and net worth exceeded 125 percent of the note (paragraph 5(c)(iv)(A) of the Contract). The borrower did not submit to HUD annually, financial statements prepared by a Certified Public Accountant (CPA) indicating assets, liabilities and net worth of the personal guarantors (paragraph 5(c)(iv)(B) of the Contract). Also the borrower is required to, but did not, demonstrate to HUD on an annual basis from financial statements prepared by a CPA, that the ratio of net operating income of the obligor to the annual debt service on the note was at least 1.1:1 (paragraph 5(c)(v) of the Contract).

The borrower again concealed information from HUD that may have disclosed that the personal guarantor or the obligor could not meet Contract requirements. Failure to meet either the 125 percent appraised value and net worth requirement, or the 1.1:1 operating income ratio requirement, are defaults under the Contract (paragraphs 5(c)(iv)(A), (v)(C)). Had the information been disclosed, the potential loss from a loan default could have been minimized. The ADECA audit concluded, and we agree, that obligor rental income is insufficient to meet future loan payments. According to the borrower, the personal guarantors are considering filing bankruptcy.

The effect of the borrower's non-compliance could have been lessened had ADECA provided more aggressive and timely oversight. Both ADECA and the borrower acted in an irresponsible manner relative to their Contract obligations. Because the required documents and reports were not sent to the custodian and to HUD, HUD should declare the loan in default.

ADECA Comments

ADECA's director stated it is not their responsibility to ensure documentation is forwarded to HUD, and lack of its submission would probably have made no difference regarding competition of the project. He stated ADECA submitted its pledge on the project and the loan was executed well before special conditions such as the appraisal were required by Contract amendment, indicating HUD urgently wanted to fund the project. He said HUD dealt directly with the borrower and did not consult with ADECA or provide ADECA copies of correspondence between HUD and the borrower.

He said ADECA monitoring was more timely than our review, which ADECA requested April 29, 1997, adding that ADECA had written HUD twice for guidance on declaring the project in default, and both letters went unanswered. However, he agreed that more aggressive monitoring should be conducted on Section 108 loans. He also said that HUD needs to establish written guidelines to loan recipients, and reports, statements and other documentation required to be sent to HUD should have to be submitted to ADECA for review. He asserted that ADECA's options are limited once a project is funded - that ADECA is essentially out of the picture until a loan goes into default.

The director said he never expected the \$2.2 million loan would complete the project, but he believes significantly less work was completed than should have been. He said significant funds were spent on architects, consultants and attorneys hired to develop and administer the project, and it was not ADECA's responsibility to oversee the professionals or to approve amounts expended on such work. He said our report does not recognize the fact that several individuals made a lot of money from the project, yet bad decisions were made and incompetent jobs were performed. He said our report was silent on whether the activities were or were not inappropriate or fraudulent under criminal law.

OIG Evaluation of Auditee Comments

ADECA is in error regarding its responsibilities. It is principally responsible under Section 108 regulations for ensuring that the borrower complies with all requirements governing use of the loan funds (24 CFR 570.710). In addition, since failure to comply with the requirements constitutes a default under the Contract, and under a default ADECA funds are pledged as security, prudence alone dictates an active ADECA role in enforcing Contract provisions. Submission of the documents and reports is primarily related to whether the loan is adequately secured, rather than whether the project is completed, and loan security is now very important. The Contract and its amendment were signed by ADECA, and the guarantees were fully

disclosed therein. ADECA had access to all correspondence between HUD and the borrower through monitoring. We disagree that additional written guidelines are needed for monitoring the Section 108 Program. The regulations are clear regarding ADECA's responsibility, and given its exposure, it is in its interests to develop its own monitoring guidelines.

We concluded that funds expended for renovation supported the work completed and renovation was of good quality. Funds spent on soft costs appeared reasonable for a project this size. The State Attorney General's Office and Federal Bureau of Investigation are reviewing ADECA's allegations of impropriety, and will advise ADECA of the results in due time. However, making bad decisions or being incompetent is not inherently a crime.

Recommendation

- 3A. We recommend that you declare the Section 108 loan in default pursuant to the cited provisions of the Contract.

SCHEDULE OF INELIGIBLE AND UNSUPPORTED COSTS

<u>Finding/Recommendation</u>	<u>Ineligible²</u>	<u>Unsupported³</u>
1B	\$ 2,200,000	
2A		\$ 290,062

² Ineligible amounts violate law, contract, HUD or local agency policies or regulations.

³ Unsupported amounts do not obviously violate law, contract, or HUD or local agency policies or regulations, but warrant being contested for various reasons such as lack of satisfactory documentation or HUD approval.

Auditee Comments

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