audit report
OFFICE OF INSPECTOR GENERAL

Issue Date
February 21, 1996
Audit Case Number
96-AT-219-1002

TO: Herman S. Ranson, Director, Multifamily Division, Birmingham, Alabama State Office, 4CHM

FROM: Kathryn Kuhl-Inclan
District Inspector General for Audit-Southeast/Caribbean, 4AGA

SUBJECT: Development Fees Claimed by General Contractor
The Village at Lakeside (Lakeside Apartments)
Auburn, Alabama

In response to the Assistant General Counsel's (4AC) request, we have reviewed $564,318 in development fees included as part of the $8,088,560 construction-development costs for Lakeside Apartments. The property owners/mortgagor are Lakeside Apartments Limited Partnership; the developer is Winn Development Company of Boston.

The report presents one finding: the costs included $564,318 in ineligible development fees, which were paid to an affiliate of the mortgagor. As a result, the owners did not contribute $239,187 needed to meet the Housing Development Grant (HDG) minimum equity investment.

If you have any questions, please call me or Ted E. Drucker, Assistant District Inspector General for Audit (404-331-3369). We are providing copies of the report to the mortgagor, the general contractor, and the City of Auburn.

*   *   *   *

Within 60 days please give us, for each recommendation made in this report, a status report on: (1) the corrective action taken, (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Also, please furnish us copies of any correspondence or directives issued because of the audit.

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Executive Summary

We audited the records of Theodore N. Freeman, the general contractor (GC), at Columbus, Ga relating to $564,318 in development fees claimed as project costs. We conducted the limited review at the request of Department of Housing and Urban Development's (HUD) Assistant General Counsel (4AC) to determine the basis for these fees, and whether they were allowable costs. Mr. Freeman also is president of Freeman & Associates, Inc. (F&A); Columbus, Ga.

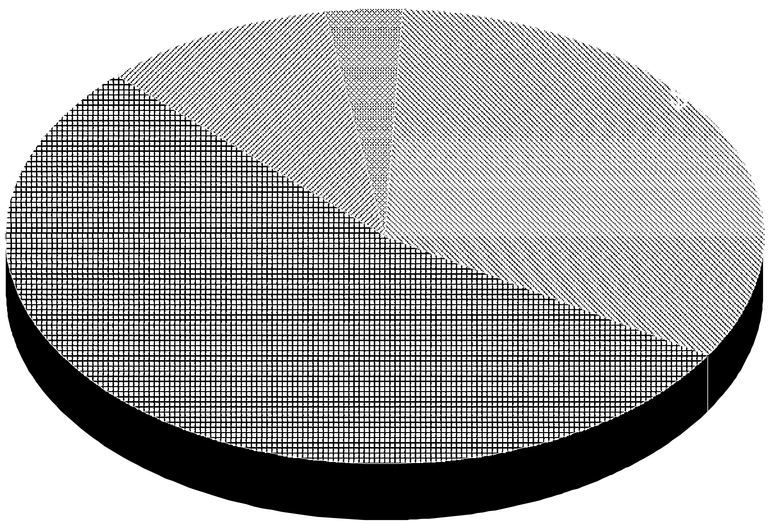
The $564,318 were ineligible costs paid to the mortgagor's identity-of-interest (IOI) affiliate, Construction Alliance, Ltd. (CA), because the fees were either for customary duties of the owner or for usual responsibilities of GCs under a construction contract. Also, the owners should contribute an additional $239,187 to meet the minimum HDG equity requirement. The GC stated that he did not know the costs violated HUD's requirements.

We are recommending that you have the mortgagor both disgorge the ineligible fees, and reduce project costs on the Lakeside entity's books and records by that amount. We also recommend that HUD encourage the City of Auburn to have the mortgagor make the additional equity-investment in the Lakeside entity.

We discussed matters presented in the finding with the GC and HUD officials during the course of the audit. On December 4, 1995, we sent the draft finding to the mortgagor and requested written comments, which were dated January 19, 1996. The Mortgagor written comments are included as Appendix D[1] mortgagor in general disagreed with us. Although our conclusions on the nature of the fees, and their ineligibility as project costs remain the same, we made some clarifications in our presentation.

The chart on the next page is based without audit on the developer's statement of development costs by financing source. The sources primarily are tax-exempt or subsidized; the related percentages (rounded) of each category are compared to the total.

[1]We added Office of Inspector General (OIG) Notes at the bottom of some pages of the auditee comments to clarify possible auditee misunderstandings on our finding presentation. The absence of such notes, however, does not imply or connote OIG agreement, as in repeated statements or matters which in our opinion were outside the crux of our finding development and conclusions.



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Abbreviations

CA	Construction Alliance, Ltd.
CFR	Code of Federal Regulations
F&A	Freeman & Associates, Inc.
FNMA	Federal National Mortgage Association
GAS	Government Auditing Standards
GC	General Contractor
HDG	Housing Development Grant
HUD	Dept. of Housing and Urban Development
IOI	Identity-of-Interest
JV	Joint Venture
OIG	Office of Inspector General

Introduction

Background

The property (Project AL 001HG403) has 200 units located in Auburn, Alabama. The property owners/mortgagor are Lakeside Apartments Limited Partnership. The Developer, Winn Development Company on April 20, 1993, stated that the following financing sources were used for development costs.

Tax-exempt bonds	$ 6,000,000
HDG	3,670,000
Tax credit sale proceeds from FNMA*	1,120,000
Additional capital (loan by Winn)	353,417
Total	$ 11,143,417

On November 20, 1987, the General Contractor (GC) agreed with Construction Alliance, Ltd. (CA) for CA to be a subcontractor for Lakeside. Arthur M. Winn is the general partner of the mortgagor and the President of CA.

The tax-exempt bond financing and HDG loan were closed on December 28, 1987. Project construction began in December 1987 and was completed in April 1989. Project rent-up commenced in September 1988.

The Housing Authority of Auburn issued the bonds which are secured by a first lien on the project. The City of Auburn obtained the HDG funds and provided them to the mortgagors as a low interest loan secured by a second lien on the project. HUD completed its HDG settlement process in September 1990.

Objectives and Scope

We performed a special-purpose audit of the GC's records plus related City and HUD records solely for $564,318 in other development fees claimed as project costs. We examined 100 percent of these fees due to HUD's concern about their eligibility. Our objectives were to determine eligibility of these fees as project costs, and if ineligible, their impact on HDG calculations.

* Federal National Mortgage Association

The examined costs are about seven percent of the $8,088,560 construction contract sum. We did not audit the project's other costs, which generally approximated HUD's estimated costs, due to the elapsed period since construction activities were completed (as of April 30, 1989), and the limited scope for our audit.

During our limited audit, we: (a) examined various records and files obtained from the GC, City of Auburn, Housing Authority of Auburn, and HUD; and, (b) interviewed various GC, HUD, and City of Auburn officials. We performed our work at the City of Auburn, and at the GC and HUD offices.

This is our initial audit of any aspect of the Auburn project. We previously audited two LaGrange, Georgia developments involving the same GC and Winn-interests (Audit Report 94-AT-219-1024, dated August 25, 1994, which continues to have an unresolved audit recommendation.)

We conducted this work between August and October 1995, mainly covering the period from project inception through its completion. Our limited audit was conducted in accordance with generally accepted government auditing standards (GAS) as qualified below (also see the report section on internal controls):

> Subsequent Events - Although we requested through Counsel that the owners provide us the Lakeside development's financial statements for periods subsequent to completion of its construction, they declined to do so. In our opinion, there was no resulting material effect on our limited audit's primary objectives.

The GC Claimed and Received Ineligible Development Fees, and Paid them to an IOI Affiliate of the Mortgagor

The GC, Theodore N. Freeman as an individual, claimed and paid development fees totaling $564,318 to the mortgagors' identity-of-interest (IOI) affiliate, CA. These fees were not eligible or needed to construct the project. Also, the owners did not contribute $239,187 needed to meet the HDG minimum equity investment.

Criteria

Generally to be allowable, costs must be necessary, and reasonable as well as related directly to the grant or contract, and conform to limitations or exclusions for costs. (Office of Management and Budget Circular A-87, Cost Principles for State and Local Governments, Section C.)

Section 2.01 of the HDG Agreement defined eligible costs for Grantee activities and non-Grantee activities to include that such costs: (1) not be incurred in connection with activities which, under 24 CFR part 850, are ineligible under the HDG program; and (2) conform, as applicable, to the requirements of OMB Circular A-87.

Developer/sponsor fees or risk allowance may not be considered in the grant amount, project costs, or owners' equity to be contributed in excess of an amount that HUD determines to be reasonable [24 Code of Federal Regulations (CFR) 850.37(d), dated June 14, 1984, and later 1986 and 1987 revisions].

Summary of work done and results

We reviewed $564,318 of development fees the GC claimed and paid to CA (Appendix A), which are not reasonable or necessary project costs. We did not audit the project's other construction costs, which generally approximated HUD's estimated costs. We accepted HUD's prior adjustment to reduce claimed legal costs by $53,777. As a result of these reductions in costs claimed for ineligible costs, the mortgagor needs to contribute an additional $239,187 to meet the HDG minimum required equity investment of $1,098,118 (See Appendix B).

Details on the ineligible costs

The mortgagor provided the City of Auburn as HDG Grantee, and ultimately HUD, with a Project Financial Settlement Statement as of April 30, 1989. This statement included the figure of $8,088,560 as the construction contract sum. Included were $564,318 for development fees paid to CA. The GC did not incur these fees for labor, materials, equipment or related services necessary and reasonable for project development.

The GC, Mr. Freeman individually, is also the President of F&A. The GC and mortgagor signed a Standard Form of Agreement Between Owner and Contractor on November 19, 1987. On November 20, 1987, the GC and CA signed a Standard Form of Agreement Between Contractor and Subcontractor. Arthur M. Winn's name appears on both agreements. He is a general partner in the Lakeside mortgagor and also the President of CA, which made CA an IOI entity.

Prior to the Lakeside project, F&A and CA formed Freeman/ Alliance Company, a Joint Venture. The parties signed a Joint Venture Agreement dated December 5, 1986, prior to the construction of Meadow Terrace Apartments in LaGrange, GA. The agreement's first amendment, at May 2, 1988, added the Greenwood Park Apartments, also in LaGrange. The GC joined with CA on the Lakeside project. However, documentation showed CA as a subcontractor, not as part of a Joint Venture. Although no Joint Venture Agreement for the Lakeside project existed, the Joint Venture bank account was used to disburse all payments except one to CA. This same account was used for construction payments for the LaGrange projects.

The mortgagor increased the GC's Lakeside total contract sum for the development fees paid to CA. F&A's 1987 Financial Statements showed the estimated total contract amount for Lakeside was $7,524,242. The owner's Application for Multifamily Housing Project of September 18, 1986 also included a builder's estimated costs of $7,524,242. This amount was increased $564,318 in the construction contract sum of $8,088,560. According to the final cost summary, the development fees totaled $564,318. Of this amount, CA received $556,811 by checks issued on the Joint Venture bank account, and F&A paid CA the remaining $7,507 from its general account.

The Joint Venture Agreement, dated December 5, 1986, stipulated in part that CA would:

> "expedite the processing of requisitions, contribute its financial experience and expertise; assure timely decision-making by Owner in connection with all special requirements of the Project, including compliance with... HoDAG administration; and generally to coordinate finishes (sic), delivery schedules and communications between Contractor, Owner and the Lenders for the Project."

Excluding an omitted reference to the Georgia Department of Transportation requirements, the contractor/subcontractor agreement for the Lakeside (Alabama) project had almost identical wording as the Joint Venture Agreement concerning what CA would do. The subcontractor was not required "to devote any specific amount of time or effort."

GC views

Mr. Freeman, representing his and his firm's interests, stated that:

- he did not believe there was anything wrong with the arrangements, including the development fees paid.

- his name individually was used on the Lakeside construction contract due to a poor previous financial year (for F&A), which caused insurance-bond difficulty.

- CA functioned as a subcontractor.

The GC's former Controller and present consultant stated that:

- The GC and CA agreed to, and CA received, a specific amount of $564,318 for the developer's fees.

- Although the developer's fees and F&A's profit were spread to the various work category items, the GC viewed each interim application for payment as an indication of completion percentage and not as a certification of specific incurred costs.

OIG conclusion

As set forth on Page 3 (See Criteria), to be allowable, HDG costs must be necessary and reasonable, as well as related directly to the project. The Lakeside Financial Settlement Statement correctly stated that one of the significant accounting policies affecting development costs is that costs are to be exclusive of kickbacks, rebates, or trade discounts. In our opinion, the GC effectively made kickbacks or rebates to CA, who thereby received a windfall.

CA's services either overlapped those allowed for organizational or other costs, or were not necessary because the GC did not incur them for project labor, materials, equipment or related services essential to produce the project. Most services provided by CA were GC responsibilities; thus, if CA performed instead, the GC should have similarly offset its contract revenues rather than increasing total costs for the fees paid to CA.

The $564,318 in fees were not bona fide project costs because they were unnecessary; they resulted in the mortgagor's affiliate receiving a windfall, and in the mortgagor not contributing $239,187 to meet the HDG required minimum equity. Footnotes 2 and 3 of Appendix B of this audit report should be considered in a final determination of the amounts of adverse effects to the HDG program.

The relationships and payments among the GC, mortgagor, and the IOI entity should not result in added project costs or benefits to the IOI parties. The reasonable and prudent standard for persons and entities in IOI relationships is: no added project costs should occur, as compared to arms-length competitive transactions. This is to lessen the inherent potential of IOI self-dealing. Both added project costs, a detriment to the mortgagor entity, and benefits to the IOI entity did occur. Neither the mortgagor nor the GC adequately disclosed these facts to HUD and to the City.

Mortgagor's comments (Summary)

Lakeside Limited Partnership, the developer disagrees with the OIG's analysis, including the interpretation of the applicable regulations, and its understanding of HUD practices and precedent on other HDG new construction projects.

<u>Criteria</u>- The OIG relies upon Office of Management and Budget Circular No. A-87, Section C ("Circular A-87") for the proposition: "[t]o be allowable, costs must be necessary, reasonable and directly related to the grant program, and conform to limitations or exclusions for cost." Later, the OIG applies this statement to mean that costs, to be eligible, must be incurred "for labor, materials, equipment or services reasonable or necessary to construct the project," or more restrictively that HDG costs must be reasonable and necessary and "directly" related. These are inaccurate interpretations of Circular A-87.

The purpose of Circular A-87 is "to provide that federally-assisted programs bear their fair share of costs recognized under [Circular A-87] principles." The principles do not express a view, one way or the other, regarding the payment of profits or other increments above costs. (Circular A-87, Section A). Section C of Circular A-87--the section cited in the Draft--provides that allowable costs must meet the following criteria: "Be necessary and reasonable for proper and efficient administration of the grant programs, be allocable thereto under these principles and...not be a general expense required to carry out the overall responsibilities of State, local or federal-recognized Indian tribal governments." Circular A-87 is not meant to dictate, prohibit, or limit the profit or amount to be paid above costs in connection with any federal project to which Circular A-87 may apply. The Circular is consistent with the Federal Regulations. Section 850.17 of Title 24 of the code of Federal Regulations provides that grant funds "may be used to provide grants or loans to defray project costs." The Section cites several nonexclusive examples of the types of costs for which grants or loans may be made and specifically includes "related soft costs."

The OIG here misapplied the general principle of Circular A-87 by failing to consider the particular facts and circumstances of the Lakeside project. A proper application would allow the amount called ineligible (amount hereafter) to be paid to CA consistent with the proper administration and goals of the HDG program, even if deemed an amount above costs traditionally incurred on a construction project. The OIG failed to acknowledge that the regulations and Circular A-87 provide that grant funds could be used for broad purposes, including soft costs. Instead, it elected to require that the costs be for "labor, materials, equipment or services" actually provided, which also were reasonable or necessary.

In the circumstances here (and in the Meadow Terrace and Greenwood Park projects mentioned by the OIG in the Draft), the General Contractor entered into a contractual relationship with CA to meet the demands of the financing entity because the General Contractor was not able to satisfy the requirements for use of the bond proceeds for construction financing. The fact was that the General Contractor had experienced financial difficulty and was unable to provide a surety bond. Without a bond, the credit enhancer would not permit the bonds to be used to finance construction, necessitating an alternative construction financing arrangement to allow the project or proceed. That arrangement was for a construction loan to be obtained from a lending institution. A principal condition of the construction loan was that it be personally guaranteed. Mr. Winn guaranteed the loan himself, putting himself at risk for any default by the General Contractor.

The payment of the amount to CA for assuming the risk of the General Contractor's default was reasonable and necessary under the circumstances and a "soft cost" that should have been considered for payment. It was a cost directly related to the project. Circular A-87 envisions payments of this kind. For example, Circular A-87, Attachment B, Section C(4) provides for the payment of various costs associated with insurance and indemnification of grantees. The amount paid to CA permitted the project to go forward. It allowed the credit enhancer to enhance the bond rating, all because Mr. Winn agreed personally to assume the risk of default by the General contractor. The arrangement, in the end, enhanced the viability of and contributed substantially to the project, promoting the "proper and efficient administration" of the Lakeside grant and enabling the project to be constructed.

The payment of the amount--even if designated simply as a payment to the Developer--is not expressly prohibited by Circular A-87 or applicable regulations. Section 850.37(d), Title 24 of the Code of Federal Regulations, which the OIG cites as its second "criteria of eligibility," anticipates that developer/sponsor fees and risk allowance are permitted on HDG projects in reasonable amounts. We note the following acknowledgment by the OIG in the audit of funds (similar in nature to the amount) paid on the meadow Terrace and Greewood Park projects. "We recognize that the regulations that accompanied the 1984 application package do not prohibit the inclusion of developer/sponsor fees or risk allowance." (Audit Report 94-AT-219-1024, dated August 25, 1994, at p. 7). Accordingly, the issue, if any, should not be the eligibility of the amount, but whether any part of it is unreasonable.

HUD Practices on other HDG new Construction - In reaching its draft findings, the OIG also has not addressed HUD's precedent and practice of allowing funds, like the amount, on other HDG new construction projects. By 1988, HUD began considering various financial issues relating to costs and financing on HDG new construction projects. In various instances, developers complained that these projects were not profitable under strictly construed HDG regulations. Specifically, developers argued that HUD should interpret existing HDG regulations in a manner that would allow the payment of a fee to developers and which would reduce the amount of hard equity required to be contributed by developers. HUD's practice was to allow a fee equal to 7% of hard costs (approximately the same percentage of total contract costs the amount represents). which HUD permitted to be waived to allow the developer to avoid a further equity contribution. That is, HUD recommended that the actual cost of the project be increased after all work was completed and all costs incurred, and that this supplemental amount be added to the actual cost which then would be waived to permit the developers to avoid having to make further contributions to the project. This mechanism, developed and approved by HUD officials, reflects the flexibility HUD actually employed to insure that developers made fair profits on HDG new construction projects. More importantly, it illustrates HUD's recognition that the payment, to developers, of amounts in excess of incurred costs were allowable in various instances without regard to whether the amount paid related to services actually performed, because the payments promoted the "proper and efficient" administration of grant funds. HUD's policies and practices provide a precedent for the allowance of the amount paid to CA.

OIG evaluation

We and the mortgagor disagree about eligibility of the $564,318 in payments to the mortgagor's IOI affiliate, CA. As set forth above under OIG conclusion, these payments did not add value --only charges -- to the Lakeside project.

The mortgagor, in our opinion, is incorrect in interpreting A-87 as "not meant to dictate, prohibit, or limit the profit or amount to be paid above costs." Actual project costs and justifiable portions of allocable charges which actually benefit the grant program are acceptable. Although the parties may contractually provide for profit, "No provision for profit or other increment above cost is intended" (as quoted from A-87 by the mortgagor in its footnote on page 3 of Appendix D). Thus a mark-up to increase actual or indirect costs is not acceptable, and the ineligible payments of $564,318 are not bona fide project costs.

Known facts indicate that the earlier GC financial problems should not affect the Lakeside development. If the GC's actual performance was less than specified by the contract, the mortgagor had contractual remedies. In any event, GC financial problems do not justify increasing total project costs, and neither do vague references to precedent. Fundamentally these payments of $564,318 fail the necessary and reasonable concept, and should not burden the Lakeside project or the taxpayers who provided its HDG funding.

Recommendations

So that costs and related consequences are accurate (not inflated), and to protect taxpayer and other stakeholder interests, we recommend that you:

1A. Have the mortgagor and/or its IOI affiliate disgorge the ineligible fees, and accordingly reduce project costs on Lakeside's books and records. (The objective is to put all parties in the same positions as if the ineligible fees were never claimed.)

1B. Encourage the City of Auburn as HDG grantee to have the additional mortgagor equity investment be paid by the mortgagor partners to the Lakeside entity. (This additional investment is owed as a result of the ineligible fees and may be increased for any additional amounts justified by HUD Program staff and supported by legal or equitable bases for disallowance at this time).

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Internal Controls

Our audit scope was limited to $564,318 in development fees claimed by the GC, and paid to CA, to construct the Auburn project. We reviewed 100 percent of these fees. Therefore, review of internal controls was not necessary to accomplish the objectives of our limited audit.

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Schedule of Ineligible Payments to Mortgagor's IOI Affiliate, Construction Alliance, Ltd.

Check Date	Amount
12/30/87	$ 7,507*
02/08/88	4,137
03/04/88	14,276
04/06/88	12,280
05/04/88	32,617
06/02/88	56,814
07/07/88	72,797
08/03/88	48,525
09/09/88	58,515
10/10/88	50,936
11/01/88	55,455
11/07/88	22,992
12/12/88	62,027
01/27/89	30,160
02/17/89	35,280
Total	$ 564,318

* Paid from F&A's General Account; all other amounts were paid from the Freeman/Alliance Company JV ban k account.

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Interim Computation of Additional Investment Requirement

COMPUTATION OF GRANT AMOUNT

Total Costs Claimed by Mortgagor			$11,479,822
Less: OIG Adjustments[1]	$564,318		
HUD Adjustments[2]	53,777		
			(618,095)
Adjusted Costs[3]			$10,861,727
Less: Non-HDG Committed Financing	$6,000,000		
Minimum required equity investment	1,098,118		
		(7,098,118)	
Tentative Eligible HDG Costs[3]			$ 3,763,609
HDG Amount Disbursed (HDG Maximum)		$ 3,670,000	

COMPUTATION OF EQUITY IN THE PROJECT

Total Adjusted Costs[3]		$10,861,727	
Add: Expenditure for Operating Deficit	$ 267,204		
Less: Operating Deficit Reserves	(600,000)		- 332,796
Total Settlement Requirements			$10,528,931
Less: Non-HDG Actual Financing	$ 6,000,000		
HDG Funds Drawn Down	3,670,000		- 9,670,000
Owner's Equity Invested			$ 858,931

ADDITIONAL EQUITY INVESTMENT REQUIRED

Required Equity Investment	$ 1,098,118
Less: Equity Currently Invested	- 858,931
Additional Equity Investment Required[3]	$ 239,187

[1]See Finding for details, and our limited scope.

[2]HUD program staff made this adjustment prior to HDG close-out for excess legal costs. Also, during September 1995, they were considering to reduce the Mortgagor's Interest Yield Costs by $205,447 ($305,447 per Owner compared to approved amount of $100,000); we did not include that adjustment in our interim computations due to the legal question of reopening the HDG close-out process for claimed costs which were disclosed.

[3]The final disposition of the HUD adjustment for interest yield costs (above Note 2) may require additional equity investment and also affect whether an excess HDG amount was paid.

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Schedule of Ineligible Costs

Recommendation	Ineligible Costs[1]
1A	$564,318[2]

[1]Ineligible amounts are clearly not allowed by law, contract, or HUD policies or regulations.

[2]Other amounts mentioned in the Recommendations are related to the ineligible development fees ($564,318) and are not scheduled to avoid double-counting.

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Auditee Comments

OIG Notes

* Our position was <u>and is</u> that the ineligible fees are not bona fide project costs.

** Our limited audit pertains only to Lakeside costs; however, as to HUD practices/precedent on other HD G projects, see our footnote on page 26 about any specific relevant information.

OIG Notes

* The sentence in the text on this page concerning profit or amounts above costs, in our opinion, is inconsistent in its restatement of the last sentence of the footnote above, and also incorrect.

** We disagree that an "amount above costs traditionally incurred" may be generally allowable, rather the usual disapproval should be applied against waste and abuse for programs using taxpayer-provided funds.

OIG Note

* Our limited facts indicate that this earlier GC "difficulty" should not affect the Lakeside or Greenwood Park projects. In any event GC problems do not justify increasing total project costs; however, the total contract amount could be apportioned if the GC actual contract performance was less than contractually specified. Every cost with a relationship to the project is not per se allowable, particularly unnecessary or unreasonable charges.

OIG Notes

* The payment of any amount must meet the necessary, reasonable, and related stipulation of A-87.

** Our basic point is that such fees or risk allowances, like other allowable costs, be necessary and reasonable. Accurate disclosure and approval, in our opinion, should occur so that reasonableness is determined in advance, instead of retroactively.

*** The essence is whether these fees in the context of total-project costs are necessary and reasonable; in our opinion the facts fully support that they are ineligible in that context.

OIG Note

* As presented on page 1 of our Audit Report (See introduction), the construction contract and related arrangements for Lakeside were prior to 1988. If there is precedent for one party unilaterally increasing costs for such fees as the GC and CA have done, the mortgagor should provide for HUD's consideration the cases and specifics on their relevance to the circumstances involving Lakeside.

OIG Note

* The Developer did not provide the requested information, as discussed in the Scope segment beginning on our report's page 2. We did not pursue that oral request, which we had presented in the general context of GAS, due to our opinion on effect, also stated on page 2 of the audit report.

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Distribution

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