

December 19, 1995  
Audit Case Number  
96-SF-212-1001

TO: Janet Browder, Director, Multifamily Housing Division, 9AH

FROM: Gary E. Albright, District Inspector General for Audit, 9AGA

SUBJECT: Walnut Ranch Apartments  
Multifamily Mortgagor Operations  
Dixon, California

### SUMMARY

We reviewed financial activities of the multifamily project known as Walnut Ranch Apartments (project number 121-35735) located in Dixon, California. We found that project funds were improperly used for many years to repay loans from third parties and the general partner. Also, the project was deprived of revenue by an unfavorable lease with the partner. These actions were mitigated by the partner's advances to the project until 1990. Since then, however, we estimate that project funds were improperly reduced by \$94,519.

### BACKGROUND

The National Housing Act authorizes HUD's mortgage insurance programs. The objective of the mortgage insurance programs for multifamily housing is to assist in the construction, rehabilitation or preservation of rental or cooperative housing. In consideration of the mortgage insurance, the owner agrees to various controls of certain aspects of 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 to those necessary and reasonable for project operations except for allowable distributions, proper project upkeep, and maintenance of accounting records. The mortgage loan of Walnut Ranch Apartments was insured under Section 221(d)(4) of the National Housing Act.

Walnut Ranch Apartments, Ltd. is a limited partnership organized to construct, own and operate the multifamily project Walnut Ranch Apartments that has 95 housing units. The partnership entered into a regulatory agreement with HUD in May 1982. FPI Management, Inc., handles project operations.

The owner defaulted on the mortgage loan in September 1993, and the mortgagee assigned the mortgage to HUD. The principal balance of the loan at default was \$3,488,116.

## PURPOSE AND METHODOLOGY OF REVIEW

The purpose of our review was to determine whether any improper use of project assets contributed to the default on the HUD-held (formerly HUD-insured) mortgage loan. The review generally covered the period July 1, 1985 to September 30, 1994.

The primary methodologies of this work included:

Analysis of audited financial statements of the project.

Consideration of the project's internal control structure and assessment of risk exposure to determine review procedures. We did not evaluate control effectiveness because of the limited nature of the review.

Interviews with the owner's general partner and knowledgeable HUD officials.

Examination of supporting documents for selected transactions.

We conducted the review in accordance with generally accepted government auditing standards.

## RESULTS OF REVIEW

Finding - Improper Acts by the Owner's General Partner Contributed to Loan Default.

Due to the general partner's disregard of HUD requirements governing the operations of Walnut Ranch Apartments, project funds were improperly used for many years to repay loans from third parties and the general partner. Also, the project was deprived of potential revenue by an unfavorable lease with the partner. These actions were mitigated by the partner's advances to the project until 1990. Since then, however, we estimate that project funds were improperly reduced by \$94,519. This reduction contributed to the owner's fiscal default on the HUD-insured loan.

Requirements of Regulatory Agreement. Paragraphs 8b and 8e of the regulatory agreement state that the owner shall not without written

HUD approval:

"Assign, transfer, dispose of, or encumber any personal property of the project, including rents, or pay out any funds except from surplus cash, except for reasonable operating expenses and necessary repairs."

"Make, or receive and retain, any distribution of assets or any income of any kind of the project except surplus cash . . ."

The regulatory agreement defines "distribution" as ". . . any withdrawal or taking of cash or any assets of the project . . . and excluding payment for reasonable expenses incident to the operation and maintenance of the project."

The project has been delinquent periodically on the insured mortgage and has never had surplus cash. As of the end of fiscal year 1994, the project had a surplus-cash deficiency of \$117,763. Also, the owner defaulted on a HUD-insured mortgage loan in September 1993, and the loan note has been assigned to HUD. Thus, any distribution would violate the regulatory agreement and be a misuse of project assets.

Further, the HUD management certification form requires reasonable efforts to be made to maximize project income.

Repayments of Partner Advances. Until recent years, the general partner advanced significant funds to the project to help meet its financial needs. Through June 1994, we identified advances totaling over \$325,000. Contrary to HUD requirements, however, the general partner was repaid for part of the advances. We identified repayments totaling \$29,690. Appendix B lists the advance and repayment amounts by year.

Prior to the January 17, 1991 change to HUD handbook Financial Operations and Accounting Procedures for Insured Multifamily Projects, owners could repay advances if prudent judgment was used, but were prohibited if the repayments would jeopardize the project's financial condition. In our opinion, the repayment of owner advances before the 1991 change violated the previous requirement because it contributed to the weak cash position of the project and under funding of the tenant security deposit obligation. The regulatory agreement requires that the liability for tenant security deposits be fully and separately funded but, except for the 1987 fiscal year, the security deposit account has been underfunded. The underfunded amount was usually in the range of \$20,000 to \$27,000. Through fiscal year 1992, the underfunded amount exceeded the cash in the operating account.

After the January 1991 change, advances were only to be repaid from surplus cash unless specific HUD approval was given. The project had no surplus cash, and the owner did not obtain HUD approval for the repayments. Thus, repayments after the change also violated the regulatory agreement.

Nevertheless, subsequent advances by the general partner exceeded the repayments, thus mitigating the negative financial effects on the project. Further, the advances mitigated the effects of repayments on third-party loans and the unfavorable lease agreement discussed below, but only through June 1990.

Repayments on Third-party Loans. Payments on loans not authorized by HUD have been made since the mid-1980's. The general partner executed a loan for \$100,000 with the First Northern Bank of Dixon to refinance an earlier loan from the bank. The refinanced loan called for 13 percent annual interest, with monthly payments of \$1,493 and a balloon payment due November 1990. This note was secured by other (non-project) real property owned by the general partner. When the balloon payment was due, a promissory note was executed with a relative of the partner. This note was for \$66,000 with annual interest of 12 percent and monthly payments of \$1,468.

We identified payments from project funds totaling \$88,101 (excluding a \$65,262 balloon payment financed with the subsequent loan) for the bank loan and \$49,916 for the relative's loan. Payments after June 1990 (when partner advances stopped mitigating the effects) totaled \$55,889: \$5,974 to First Northern and \$49,916 on the relative's loan. We noted no payments on these loans after February 1994.

The owner did not obtain HUD approval of loans from third parties. Further, HUD told the owner in August 1987 that the payments violated the regulatory agreement. Also, in response to a finding in the 1987 financial statements, the general partner acknowledged that HUD had not authorized the payments, and the partner stated that such payments would no longer be made from project funds. Nevertheless, the general partner continued to use project funds for loan payments in disregard of her promise and the regulatory agreement.

Unfavorable Lease Agreement with General Partner. The general partner executed a lease between herself and the project for use and operation of the project's laundry facilities. The lease has been in effect since September 1982. The lease provides for the project to furnish the space and utilities in exchange for \$750 a year (The partner usually reduced the advance balance by \$750 a year instead of making the payment to the

project). The partner provided no documentation to support the reasonableness of the lease with the project.

The lease agreement between the project and owner was not fair to the project. The agreement deprived the project of revenues and enriched the partner. We contacted a laundry-equipment company to determine if there was a more equitable lease available. (The general partner had leased 8 washers and 8 dryers from the company.) According to the company sales representative, 99 percent of their contracts involve a lease where the company provides and maintains laundry equipment and their receipts are split, usually on the basis of 50 percent to the company and 50 percent to the party providing the space and utilities.

The partner did not provide information on the amount of gross revenues generated by the laundry equipment. Therefore, to evaluate the reasonableness of the partner's arrangement and to estimate the amount of lost revenues to the project, we compared the annual lease payments of \$750, equal to \$7.89 per unit, to three sources:

average laundry income of 14 HUD-insured projects with 90-100 units located in the San Francisco HUD office's jurisdiction. This equated to \$4,939 in annual revenues, or \$51.99 per unit.

the laundry-equipment company representative. The representative estimated revenues of \$10 per unit a month. This would be equivalent to annual revenues of \$5,700 to the project (\$10 times 50 percent, times 12 months, times 95 units).

the staff of the project's management agent. The staff estimated at least \$132 a year per unit, equal to annual revenues of \$12,540.

Based on the above, the unfavorable lease deprived the project of \$7,726 a year (an average of the above estimates) in annual revenues. This totals \$38,630 for the five years from July 1990 to June 1995.

In our opinion the third-party loan payments (\$55,889) and the unfavorable lease (\$38,630) totaling \$94,519 represented unauthorized distributions. They reduced assets available to the project and thus contributed to the owner's fiscal default on the HUD-insured loan.

Auditee Comments. We considered written comments to our conclusions from Wilson, McCall & Daora, CPAs, submitted on behalf of the project's general partner. The entire comments are displayed in Appendix A. We also considered the remarks of the general partner and her accountant (from the same CPA firm) at a conference with us on December 5, 1995.

The CPAs contended that only loan repayments made after May 1992 should be returned because that was the date of the handbook revision that required HUD approval for loan repayments. We note, however, that the requirements concerning repayments of owner advances changed in January 1991 (CHG 2 of Handbook 4370.2) which were repeated in the May 1992 version. Further, as previously discussed, earlier payments jeopardized the project's financial condition, thus violating the earlier handbook requirements.

The general partner told us she presumed she could continue making payments on the loan because of the extent of the advances made previously. As discussed earlier, however, the regulatory agreement allows such payments only under certain circumstances, which were not met.

The CPAs contended that our estimate of lost income due to the partner's lease is invalid because it does not consider such factors as the profit gained by the partner and the partner's costs operating the laundry facility. In our opinion, these factors are irrelevant because the issue is the loss of revenues due to the non-arm's-length contract.

The general partner stated that the HUD Sacramento Area Office had approved similar laundry lease arrangements for other projects. We found no evidence that the HUD California State Office, responsible for Walnut Ranch, had approved the lease. Our position is that even if the lease was reasonable in the early 1980's, the owner's responsibility was to maximize project revenues (especially considering the project's poor financial condition) and subsequently obtain a fair lease. The general partner stated that a plan would be submitted to HUD covering future laundry arrangements.

Recommendations. We recommend that you:

- A. Coordinate with our efforts to obtain compensation from the general partner for the improper distributions.
- B. Require the project's management agent to obtain an equitable lease for the laundry facilities.

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 or your staff have any questions, please contact Mark Pierce, Senior Auditor, on 436-8101.

## Appendix B

### Schedule of Loan Payments and Partner Advances and Repayments

Fiscal Year Ended June 30	Third Party Loan Payments	Advance Repayments	General Partner Advances
1986	\$10,543	\$ 2,675	\$ 58,373 (Note 1)
1987	17,919	-	77,410
1988	17,919	22,060	37,886
1989	17,919	750	122,830
1990	17,919	750	24,237
1991	16,250	1,955	110
1992	17,618	750	3,022
1993	17,618	750	500
1994	4,404	-	1,667

Note 1: This amount includes partner advances for years through 1986.