Office of Inspector General
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March 28, 1996

AUDIT RELATED MEMORANDUM
96-SF-212-1805

TO: Keith Axtell, Director, Office of Housing, 9AH

FROM: David A. McCargar, Assistant District Inspector General for Audit, 9AGA

SUBJECT: Lakeridge Apartments East
Multifamily Mortgagor Operations
Reno, Nevada

INTRODUCTION

In response to a request from HUD's Nevada State and Reno Area offices, we reviewed selected aspects of the operations of Lakeridge Apartments East (project 125-35055) located in Reno, Nevada. We identified no violations of HUD requirements involving the matters raised in the request except for the delinquency on the HUD-held mortgage. However, we noted other matters requiring attention if HUD does not sell the project mortgage as planned.

The request concerned matters arising from an unusual agreement between the project owner and HUD. Under the agreement, HUD allowed the owner to convert individual apartment units to single-family properties. Some of the project's units had been converted to single-family mortgages, and a few of the converted units had been paid for in full. The request noted that HUD's monthly statements indicated the project mortgages were delinquent. Also, there was concern whether HUD had received all funds due for the paid-off units and that the owner had sold time shares on project units.

BACKGROUND

Lakeridge Apartments East is a 320-unit multifamily housing development located in Reno, Nevada. It is owned by Eastside Investment Company (the mortgagor), a limited partnership with Nathan L. Topol as general partner. The project's mortgage loan was originally for $14,348,600 at a 7½ percent interest rate with a 40-year term ending April 2021. HUD insured the mortgage under Section 221 (d)(4) of the *National Housing Act,* as amended. Project operations are governed by a regulatory agreement dated March 1, 1978. The owner defaulted on the loan, and the mortgage was subsequently assigned to HUD on February 24, 1983. There is no rental subsidy associated with the project.

Lakeridge East is part of a larger development. The Lakeridge development started in 1968. Phases 1 and 2 include 128 units with approximately 150,000 square feet. Lakeridge East, completed in March 1980, includes 320 units with 300,000 square feet. The project included tennis facilities that were later expanded. Rental office, maintenance, and payroll are centralized with costs allocated to the various elements of the total development.

HUD made several agreements with the owner after the mortgage assignment:

DEBT DEFERRAL. The first provisional workout agreement approved by HUD Headquarters was in effect from October 1, 1983 through March 31, 1986. The agreement deferred debt and reduced monthly payments. In December 1985, the mortgagor requested a two-year extension of the workout agreement. The second provisional workout agreement, effective April 1, 1986 to March 31, 1988, split the note into two separate notes of approximately $10 and $7 million. The mortgagor was obligated only to make monthly payments on $8½ million of the $10 million first note during the work-out period. Any net cash on hand from project operations at the end of the month, following payment on the $8½ million, would be applied to debt service on the remaining $1½ million balance of the first note and lastly to debt service on the second note. Under certain conditions, HUD had the right to call the second note.

TENNIS CLUB AGREEMENTS. The project included 13 tennis courts, a swimming pool, and four recreational buildings. In 1978 HUD allowed the Lakeridge Tennis Club, an identity-of-interest entity, to lease the facilities for a nominal fee. In 1983 the HUD Nevada State Office agreed to arrangements whereby the project paid a portion of the operating costs of the tennis club, and in 1984 agreed to fixed fees for each occupied unit to be paid to the lessee.

In 1986 HUD agreed to allow the owner to expand the tennis club to include a new indoor health/-fitness facility by incurring additional debt against the project and deferring payment of the HUD second note as discussed below.

1986 SUBORDINATION AGREEMENT. In the 1986-1988 second provisional workout agreement, the Office of Multifamily Housing Management at HUD's Headquarters agreed to subordinate payments due on the second note to a loan of up to $1.2 million from a private institution in the event the mortgagor elected to finance a new health/fitness facility on project premises. After March 31, 1988, the mortgagor was obligated to resume full payments on the $10 million first note, with any remaining net cash on hand from the project operations at the end of the month to be applied as follows:

- first to debt service on the private note;
- then to any accrued, unpaid interest on the first note; and
- last to debt service on the second note.

Pursuant to the subordination agreement, loan notes were executed between Eastside Investment Company (Nathan Topol, general partner) and the Fifteenth Hole Corporation (Nathan Topol, president). Both notes, totaling $1.2 million and bearing 10 percent annual interest, are payable on demand. A loan note for $764,452 was made January 1, 1991 and a second note for $435,458 was made June 1, 1995.

1988 UNIT RELEASE AND SALE AGREEMENT. On December 28, 1988, the Office of the Secretary agreed to allow the owner to release units from the multifamily mortgage and transfer the debt to single-family mortgages in principal amounts equal to 105 percent of the allocable HUD indebtedness. Upon sale of the units, the mortgagor was to pay off the loans and pay HUD four percent of the gross sales proceeds.

One-hundred-thirty-six units have been released from multifamily debt, creating 136 HUD-held, single-family notes. As a result, the HUD loan on the remaining multifamily units is secured by the subordinated second mortgage. The mortgagor paid off loans on eight single-family units in June 1990.

HUD agreed to sell the Lakeridge East multifamily and single-family notes in September 1995. The auction winner, who agreed to purchase the Lakeridge East notes along with the notes for 157 other projects in a bulk "non-performing note sale," has not agreed to close on the Lakeridge portion. Also, the project owner is disputing the loan auction.

PURPOSE AND METHODOLOGY

The purpose of this review was to address areas of concern identified by the Nevada State and Reno Area offices: (1) examine the handling of sales proceeds from single-family unit sales, (2) determine if project units were inappropriately sold as time shares, and (3) determine whether the multifamily mortgage was current.

The primary methodologies of this work included:

- ✓ Interviews of key Las Vegas, Reno, and Washington, D.C. HUD staff and obtaining updated information as to their experiences and concerns with Lakeridge East and review of pertinent documents in their possession.

- ✓ Discussion with the project owner's general partner.

- ✓ Discussions with the owner's public accountant and examination of project records in his possession.

- ✓ Analysis of the project's 1993 and 1994 audited financial statements and related audit workpapers.

- ✓ Contacts with the owner's lawyer and review of documents related to agreements with HUD and private loans encumbering the project.

Our review generally covered the selected project activities from January 1, 1989 to September 30, 1995.

RESULTS OF REVIEW

We found that HUD had received all money due when the eight units were paid off, and there was no indication that the owner sold time shares on HUD-held units. However, a certified public accountant concluded that the principal and interest payments on the modified, HUD-held, first mortgage were delinquent as of June 30, 1995. We identified problems with the project's accounting and financial statement presentation, a need to evaluate the reasonableness of tennis/health club charges and management fee, and an overstatement of accrued interest. HUD's planned sale of the multifamily mortgage note, if it closes, would eliminate the need to deal with these issues.

PROCEEDS FROM SINGLE-FAMILY UNIT SALES

On December 28, 1988 HUD Headquarters agreed to allow the owner to release project units from the multifamily mortgage and convert them to single-family mortgages so units could be sold as condominiums. The agreement provided that "upon initial sale of a unit by mortgagor, the mortgagee shall receive at closing . . . an amount in cash equal to 4% of the gross sale proceeds."

In June 1990 Eastside paid off the loans on eight units and compensated HUD $4,400 for each of six units and $4,600 for each of the other two units. Since the sales were not arms-length (they were sales to an identity-of-interest company), the owner paid HUD four percent of appraised value instead of gross sales proceeds. HUD legal counsel believes this was proper.

Sale of Time Shares

The audit request asked if the owner was selling units as time shares, an improper use of HUD-insured units.

The owner did sell time shares, advertised as Club Lakeridge "Vacation Ownerships," on the eight units whose HUD loans were paid-off; however, we found no evidence that time shares were sold on units still having HUD multifamily or single-family mortgages.

Status of the Multifamily Mortgage Loan

The Nevada State and Reno offices were concerned about an apparent multifamily mortgage default. HUD's monthly statements indicated the first mortgage loan was delinquent.

A HUD accounting official advised us that there were problems with HUD's record keeping that introduced errors in the monthly statements. Principal amounts for the new single-family loans were not transferred from the multifamily mortgage in a timely fashion. Also, some payments were misapplied to the subordinated second mortgage. HUD counsel told us that some of these problems were caused by the owner attaching its payment to the wrong bill, and that HUD Headquarters did not receive documents on the mortgage modification in a timely fashion.

HUD engaged a certified public accountant to review the project's loan documents, payment records, correspondence from the owner's public accountant, and other documents. The accountant concluded that the loan account was delinquent in principal and interest by $162,032 as of June 30, 1995. HUD counsel advised us that the first loan had been extinguished by September 1995 by the transfer of debt to single-family loans.

Matters Requiring Attention

We noted other matters requiring attention if HUD does not sell the project note. These include commingled financial activity, the reasonableness of tennis/health club charges and management fee, and overstated interest liability.

Commingled Financial Activity

The regulatory agreement states in paragraph 9(d) that ". . . the books and accounts of the operations of the mortgaged property and of the project shall be kept in accordance with the requirements of the Secretary." HUD Handbook 4370.2 REV-1, governing financial operations and accounting procedures, states in paragraph 2-3.A that ". . . the mortgaged property, equipment, buildings, plans, offices, apparatus, devices, books, contracts, records, documents, and other papers relating thereto shall *at all times be maintained in reasonable condition* for proper audit . . ." and in paragraph 2-3.B ". . . The books of original entry must *be kept current at all times, and postings must be made at least monthly* to ledger accounts . . ." (emphasis added). Paragraph 3-3.A requires that financial reports must be related solely to the project.

As part of a larger complex, Lakeridge East shares most expenses with the tennis/health club, rental units from separate multifamily developments, and the units spun-off from Lakeridge East. There is a central rental office, one crew that does maintenance and repair, and a central payroll. These costs must be allocated to the various entities. In violation of HUD requirements, however, this allocation is done only after the year end instead of monthly. Further, the financial records and reports for Lakeridge East include both the multifamily units subject to the regulatory agreement and the single-family units that were spun-off. Thus, non-project activity (revenues, expenses, assets and liabilities) is improperly commingled in the Lakeridge East records and financial statements, and audits are hampered.

TENNIS/HEALTH CLUB CHARGES

Paragraph 9(b) of the regulatory agreement states "Payment for services, supplies, or materials shall not exceed the amount ordinarily paid for such services, supplies, or materials in the area where the services are rendered or the supplies or materials furnished."

Charges for operating the tennis/health club on project grounds significantly burden the project. In addition to loans encumbering the project for the club's capital costs, the project pays fees and reimburses club operating costs in excess of half a million dollars a year. While HUD approved the charges, we do not believe the owner provided HUD sufficient information to make fully informed decisions.

The project is encumbered with the capital costs of the club although it serves not only residents of Lakeridge East, but other residents in the development. Lakeridge East originally contained 13 tennis courts, a swimming pool, and four recreational structures in addition to the 320 housing units. Thus, the project bears the cost of capital for the tennis club in the HUD Lakeridge East mortgage. Further, the project was additionally mortgaged for a $1.2 million note for the expansion of the club facilities in the mid-1980s.

HUD has approved several agreements regarding the club. In 1978 HUD assented to a lease between Lakeridge East and an identity-of-interest entity, Lakeridge Tennis Club, permitting the lessee to rent 7½ acres of land and improvements for $7,680 a year. This amount is nominal in comparison to the costs the project incurs for the club's capital costs. The interest cost alone on the $1.2 million loan is over $120,000 a year.

In December 1983 the Nevada State Office allowed certain club expenses to be paid by the project such as 100 percent of pool and lifeguard expenses, 90 percent of gas and electricity and lease payments for club equipment, 50 percent of control center payroll, and 25 percent of cleaning payroll. For 1994 we identified $157,885 charged to the project for control center payroll, lifeguard payroll, electricity, water, and gas of the club, but there were probably more costs that we did not identify.

In May 1984 the Nevada State Office approved an agreement for the project to pay the club operator a minimum fee of $75 per month per occupied unit for use of the outdoor tennis club facilities, excluding indoor tennis, sports equipment, and other amenities. The fee was raised later to $100. For 1994 this fee totaled $361,700. Thus, the total fee and costs charged to the project were at least $519,585 in 1994 alone.

In our opinion, the owner did not provide HUD sufficient information to make fully informed decisions concerning these agreements. For example, the owner omitted the following relevant information: total costs of club operations and the proportion of costs the project covered, the costs of services and facilities not available to Lakeridge East residents, the fees charged to other users of the club, the market value of the lease, and level of club profits. While the owner might argue that the project receives a benefit from the club by being able to charge higher rents for Lakeridge East units, other units in the development receive similar benefits. The information provided was not sufficient to determine whether the agreements were fair to the project and did not impose an unnecessary financial burden. Further, the lease agreement, fee rate, and cost allocations must be considered together, not separately, in determining their reasonableness.

Further, HUD needs to consider the impact of the 1988 unit release and sale agreement. With the release of units from the multifamily mortgage, the tennis facilities become a greater proportion of the mortgaged property. Thus, a new tennis club agreement must consider the declining number of HUD-insured multifamily units and the revenues needed to service the project loans.

MANAGEMENT FEE

Lakeridge East pays a management fee of three percent of collected residential income to the general partner, Nathan Topol. The management fee was $74,250 in 1994 and $76,204 in 1993. The fee appears to only compensate the general partner, who has several business interests, for any services he performs on a part-time basis. There are no employees or facilities associated with the management agent. All management services are performed on the project premises. All staff payroll and other expenses are charged to the project on an allocated basis. Considering the weak financial condition of the project and limited services provided, we believe that HUD should evaluate the reasonableness of the fee as provided for in Figure 2-5 of Handbook 4381.5 REV-1.

OVERSTATED INTEREST LIABILITY

The first of two promissory notes, dated January 1, 1991, for the $1.2 million loan* to expand the tennis club was for the principal sum of $764,542 plus accrued and unpaid interest through that date of $267,697. The initial promissory note called for a variable interest rate, but this agreement was modified retroactively on January 1, 1994 to provide a fixed annual interest rate of 10 percent, compounded annually. Inconsistent with the revised interest rate, the revised promissory note restated cumulative interest as $723,192. Based on the stated rate and its application, cumulative interest should have been $609,368. The incorrect, restated amount in the modification approximates a 10 percent rate compounded monthly rather than annually.

The December 31, 1994 financial statements contain a similar error. The statements show accumulated interest as $871,966, $125,207 more than $746,759 it would be based on the revised promissory note using annual 10 percent interest compounded annually. The amount in the statements was based on a monthly compounding at a 10 percent rate. The public accountant agreed that the monthly compounding was in error. Thus, the reported loan liability and interest expense were overstated.

AUDITEE COMMENTS

On behalf of the owner, Richard C. Tremelling, partner of the public accountant firm of Wilson, McCall & Daoro, provided written comments to our conclusions. He agreed that the accrued interest on the private note was overstated, and said that he was willing to make changes in the accounting structure so that activities related to the multifamily note are separated.

Mr. Tremelling also stated both he and Mr. Topol believe that the tennis/health club charges and management fee are reasonable. He also stated that he believed that the issue regarding the sale of the HUD note would be resolved within 90 days. He said that the next bidder in line to the successful bidder (who has not closed on the Lakeridge East note) is the Fifteenth Hole Corporation, owned by the owners of Lakeridge East.

We believe that HUD needs to obtain sufficient information to assure that the health/tennis club charges and management fees are reasonable unless the note is sold soon.

RECOMMENDATIONS

* The second promissory note for $435,458 was executed June 1, 1995 and was not relevant to the 1994 financial statements. This note, like the 1991 note, also called for 10 percent annual interest, compounded annually.

If the HUD note is not sold shortly, we recommend that you require the owner to:

A. Keep current and separate books and accounting records for the HUD-held multifamily portion still subject to the regulatory agreement. Original books of entry should identify direct costs charged to the project and revenue earned, with monthly postings. The revenue, expenses, assets and liabilities of the units spun-off should be excluded. Joint costs should be allocated monthly. Prorations of expenses must consider the declining number of project units.

B. Provide, for your evaluation,* all relevant information regarding the tennis/health club for you to determine what club charges to the project are reasonable. Negotiate a new agreement that is equitable to the project and considers the revenues needed to service the project mortgages.

C. Provide, for your evaluation,* information on the nature and extent of services provided for the management fee and the extent of management costs absorbed by the agent. If warranted, require a revised fee rate.

D. Correctly record in the accounting records and properly present in the financial statements the accrued interest on the $1.2 million loan.

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 auditor Sadie Cooper or senior auditor Mark Pierce on 415-436-8101.

Attachments: Auditee Comments
Distribution

* Our staff is available to assist in the evaluation of information provided by the owner.

AUDITEE COMMENTS

Distribution

Office of Housing, California State Office, HUD
Chief, Multifamily Asset Management Branch, Nevada State Office, HUD
Office of Comptroller, Texas State Office, HUD
Director, Office of Multifamily Housing Preservation and Property Disposition, HUD
Director, Office of Multifamily Housing Management, HUD
Assistant General Counsel, Multifamily Mortgage Division, HUD
Assistant General Counsel, Litigation Division, HUD
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