



U.S. Department of Housing and Urban Development
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April 22, 2003

2003-FW-0803

MEMORANDUM FOR: Raynold Richardson
Director, Multifamily Housing Program Center, 6EHM

FROM: D. Michael Beard
Regional Inspector General for Audit, 6AGA

SUBJECT: Equity skimming from HUD supported "Projects:"
Haverstock I (Project No. 114-11002),
Haverstock II (Project No. 114-35217),
Haverstock III (Project No. 114-35240), and
Coolwood Oaks (Project No. 114-35275)
Houston, Texas

INTRODUCTION

At your request and to fulfill an escrow and payment agreement requirement, we attempted to conduct an audit of the above projects. Our objective was to determine if the owner, Mr. Zieben, complied with HUD regulations, the Regulatory Agreements, and the Compliance Agreement when he made: (1) transfers of funds between the projects and (2) payments from the projects to identity-of-interest companies. We did not conduct a full audit because the projects and identity-of-interest companies did not provide complete financial books and records.

METHODOLOGY AND SCOPE

To accomplish our objective, we interviewed the management agent's employees, employees of the identity-of-interest companies, HUD personnel, project management and employees, vendors, contractors, and the new project owner's management staff. We obtained and reviewed the available financial records for the projects and the identity-of-interest companies. In addition, we obtained and reviewed HUD multifamily files for the projects. We also made on-site visits to the projects, several vendors, and other Zieben holdings.

We did not conduct a full audit because the projects and identity-of-interest companies did not provide complete books and records. Specifically, the projects and companies did not

provide audited financial statements. The projects and the identity-of-interest companies did not have bids or specifications for the repair work performed. In addition, neither the management agent nor the projects had bids on file for landscaping and air conditioning contracts. The identity-of-interest companies did not have a job-costing system or other system of accounting which tied labor and materials to specific purchase orders or jobs. Additionally, the identity-of-interest companies did not provide complete daily labor reports for the entire audit period. Further, the companies did not establish or maintain a materials inventory system.

The audit covered the period January 1, 1998, through April 30, 2000. We expanded the scope of our audit as necessary. Audit work was performed at the offices of HJZ, Inc. and the various projects located in Houston, Texas. Based on comments provided at a meeting with Mr. Zieben's attorneys in July 2002, we performed additional audit work in July, August, and September 2002. We conducted our audit in accordance with generally accepted government auditing standards.

BACKGROUND

Haverstock I, Haverstock II, Haverstock III, (collectively referred to as "Haverstock") and Coolwood Oaks Apartments (Coolwood) were multifamily apartment complexes owned by Herbert J. Zieben until April 2000. The projects were located in Houston, Texas. Mr. Zieben operated the projects under Regulatory Agreements for Multifamily Housing Projects with HUD. Each project had a Section 8 Housing Assistance Payment Agreement with HUD. Haverstock II was in default during the entire audit period. Coolwood was in a non-surplus cash position for 1997 and 1998. Haverstock III was in a non-surplus cash position in 1997.

HJZ, Inc., a corporation wholly owned by Mr. Zieben, was the management agent for Haverstock and Coolwood. Two identity-of-interest companies performed the majority of the repairs and landscaping at the projects: Prudential Construction & Mechanical Services, Inc. (Prudential) and First Class Maintenance & Supply Company (First Class). Mr. Zieben owned Prudential. Mr. Zieben's wife, Carol J. (Posey) Zieben, owned First Class. Another identity-of-interest company owned by Mr. Zieben, Douglas Utility Company, provided water and sewer services to Haverstock.

Management agent previously pled guilty to equity skimming

HJZ, Inc. and Herbert J. Zieben Interest, Inc. pled guilty to criminal equity skimming and signed an Agreed Judgment on March 6, 1998. The global criminal and civil judgment totaled over \$1.4 million. A Plea Agreement memorialized and finalized the criminal and/or civil fraud, civil fraud penalties, and/or double damages claims between HUD and Mr. Zieben, including his agents, heirs, and assignees. The Agreed Judgment required Mr. Zieben to apply all surplus cash derived from the projects to the outstanding settlement amount. Mr. Zieben also entered into a Compliance Agreement with specific requirements for Mr. Zieben and HJZ, Inc. to prevent further diversion of funds.

In early 2000, Mr. Zieben entered into an agreement to sell Haverstock and Coolwood. Initially, the sale was scheduled to close in early March 2000. The closing finally occurred in late April 2000. Mr. Zieben paid the outstanding balance still owed under the Agreed Judgment with proceeds from the sale. At closing, an Escrow and Payment Agreement was executed between Mr. Zieben, Commonwealth (the purchaser), and HUD. Part of the agreement called for an escrow deposit of \$1,950,000 to serve as liquidated settlement of payments made by Mr. Zieben from project funds to his related identity-of-interest entities. The agreement did not preclude criminal or civil proceedings against Mr. Zieben or his related entities for equity skimming.

Criteria

In consideration for government mortgage insurance, Mr. Zieben agreed to, among other things, restrictions on the use of project funds and assets. HUD regulations set forth certain restrictions on the use of project funds. In the case of Haverstock and Coolwood, the primary controlling documents were each project's Regulatory Agreement, the Agreed Judgment, the Compliance Agreement, and *The Management Agent Handbook*.¹

Provisions in the Regulatory Agreement specified that expenditures must be reasonable and necessary to the project and limited the circumstances and manner under which the owner could take cash out of the project. The owner could contract with a professional management agent to operate and maintain the project. Nevertheless, the owner remained responsible for proper management of the project and compliance with the Regulatory Agreement. The use of project assets or income, by either the owner or agent, for other than reasonable operating expenses and necessary repairs or for payments of unauthorized distributions to the owner constituted a violation of the Regulatory Agreement. In addition, if the owner or agent improperly diverted the project's income or assets by either paying for unnecessary or unreasonable expenses or making unauthorized distributions, they were subject to criminal prosecution² or civil double damages.³ Such diversions or unauthorized distributions were equity skimming.

The Agreed Judgment further restricted Mr. Zieben's ability to take cash out of the projects. It required Mr. Zieben to use all distributions from the projects to pay any outstanding balance he owed under the Agreed Judgment.

The Compliance Agreement contained additional provisions that Mr. Zieben was required to meet. Mr. Zieben agreed to provide quarterly financial statements to HUD for each project. In addition, Mr. Zieben was required to sign each financial statement and certify "...that he has read each statement, that he has personal knowledge of the information contained therein, and that all expenditure of project funds or use of project assets is in compliance with the respective Project

¹ HUD Handbook 4381.5, REV-2, issued on September 15, 1997.

² Section 1715z-19, Title 12, United States Code, "Equity Skimming Penalty."

³ Section 1715z-4a, Title 12, United States Code, "Double Damages Remedy for Unauthorized Use of Multifamily Housing Projects Assets and Income."

Regulatory Agreements and this Compliance Agreement.” Mr. Zieben also agreed to make all records of the projects and any affiliated company that received project funds available for HUD inspection.

The Management Agent Handbook included contracting requirements for owners and management agents. The Handbook required Mr. Zieben or HJZ, Inc. to solicit written cost estimates from at least three contractors or suppliers for any contract, ongoing supply, or service which was expected to exceed \$10,000 per year. In addition, the Handbook required verbal or written cost estimates for any contract, ongoing supply, or service estimated to cost less than \$5,000 in order to assure that the project was obtaining services, supplies, and purchases at the lowest possible cost. Finally, the Handbook required Mr. Zieben to document all bids, including keeping a record of verbal bids, and keep the records for 3 years after the completion of the work.

RESULTS OF REVIEW

We concluded that Mr. Zieben improperly transferred \$230,000 out of Haverstock I, \$190,000 out of Haverstock II, and \$25,000 out of Coolwood. In addition, we found that Mr. Zieben improperly withdrew funds from the projects by having his identity-of-interest companies bill the projects inflated amounts for materials and labor. Due to the lack of records, we could not determine the exact amount he overcharged the projects. However, the projects overpaid at least \$304,087 for materials and up to \$983,265 for labor. Mr. Zieben used the unauthorized distributions and improper billings to inappropriately enrich himself and his other business ventures.

Mr. Zieben made unauthorized distributions

Mr. Zieben made unauthorized distributions from the projects totaling \$445,000. Together, the Regulatory Agreements and the Agreed Judgment prohibited Mr. Zieben from making any distributions from the projects, including surplus cash. Further, each project’s Regulatory Agreement prohibited Mr. Zieben or HJZ, Inc. from using project revenue to engage in any other business or activity not related and essential to the operation of the project. Simply stated, a project should not be in the business of lending project funds to other projects. Mr. Zieben should have used his own funds to keep the projects operating. Yet, Mr. Zieben avoided having to invest his own personal funds in two projects by transferring funds to them from another project.

The following table shows the transfers from November 1998 to July 1999 that Mr. Zieben lacked HUD approval to make. Mr. Zieben inappropriately recorded the transfers in Haverstock II’s and Coolwood’s financial statements. He either did not fully disclose the amount transferred and inappropriately classified the transfer as an owner contribution or did not disclose the transfer occurred.

Transfer of Funds from Haverstock I			Repayments to Haverstock I		
Date	Amount	Payee	Date	Amount	Payee
11/2/98	\$ 80,000	Haverstock II	9/10/99	\$ 25,000	Coolwood Oaks
3/22/99	100,000	Haverstock II	12/10/98	40,000	Haverstock II
7/7/99	50,000	Haverstock II	7/7/99	150,000	Haverstock II
Total	\$230,000		Total	\$215,000	

Each transfer by Haverstock I in 1998 and 1999 was an unauthorized distribution. Haverstock I did not have sufficient surplus cash to make distributions in 1998 because the project only had \$764 in surplus cash available at the end of 1997. In 1999, Haverstock I had surplus cash available. Under normal circumstances, Mr. Zieben would have been allowed to withdraw the surplus cash and then provide those funds as owner contributions to fund the operations of the other two projects. However, the Agreed Judgment required Mr. Zieben to use all distributions from surplus cash to pay the outstanding balance owed under the Agreed Judgment. Thus, Haverstock I did not have any surplus cash available to withdraw in 1999.

Both Haverstock II and Coolwood made unauthorized distributions to repay Haverstock I. Coolwood did not have surplus cash available when it repaid Haverstock I in 1999. Haverstock II, with its mortgage in default the entire time, was never in a surplus cash position. The Regulatory Agreements prohibited transfers. Further, if Mr. Zieben had deposited his own funds into Haverstock and Coolwood instead of making the transfers, the Regulatory Agreements would have prevented him from withdrawing those funds. As a result, HUD should seek recovery of the amounts transferred when the projects did not have surplus cash.

Identity-of-interest companies billed the projects \$2,396,122

Haverstock and Coolwood paid Prudential and First Class almost \$2.4 million from January 1998 to April 2000 for repairs, landscaping services, and air conditioning (A/C) services.

Revenue Generated from Haverstock and Coolwood			
Period Ending	Prudential Revenue	First Class Revenue	Totals
4/30/00	\$ 126,130	\$ 24,857	\$ 150,987
12/31/99	695,462	143,695	839,157
12/31/98	1,131,720	274,258	1,405,978
Totals	\$1,953,312	\$442,810	\$2,396,122

The companies existed primarily to perform work at the projects, other Zieben ventures, and Mr. Zieben's residence. Prudential and First Class generated \$2,657,169 in total revenue for the entire period. Thus, Haverstock and Coolwood generated over 90 percent of the identity-of-interest companies' total revenue.

Mr. Zieben did not maintain the projects

Even though the projects paid almost \$2.4 million for repairs, landscaping, and air conditioning services, Mr. Zieben did not maintain the projects. At the time of the PASS Physical Inspection in January 1999, all the projects failed.⁴ The scores on the day of inspection were as follows:

Project	PASS Physical Inspection Performance Score
Haverstock I	48
Haverstock II	56
Haverstock III	44
Coolwood Oaks	56

In addition, the new owners spent over \$2.1 million after the sale to improve the physical condition of Haverstock. The new owners performed major repairs in all areas including roofing, siding, air conditioning, kitchen cabinets and countertops, flooring, painting, and appliances.

Identity-of-interest companies inflated materials cost by an estimated \$304,087

Prudential and First Class overbilled Haverstock and Coolwood an estimated \$304,087 in inflated materials costs. The Regulatory Agreements stated, “Payment for services, supplies, or materials shall not exceed the amount ordinarily paid for such services, supplies or materials furnished.” Prudential and First Class did not have bids to show that the materials they sold to the projects did not exceed the amount normally paid. Testing showed Prudential and First Class consistently added a mark-up amount to all materials sold to the projects. However, the projects also bought the same or similar materials like appliances, air conditioning components, carpeting, and lumber directly from the same vendors and did not pay a mark-up. Thus, the amount of mark-up that the companies charged the projects was improper.

To determine how much the projects were improperly billed, we reviewed 100 percent of the Prudential and First Class invoices paid by Haverstock and Coolwood from March 1998 to April 2000. We attempted to match their sales of materials to Haverstock and Coolwood to the actual vendor invoices. For large dollar items like appliances and air conditioning components, we successfully matched most of Prudential’s and First Class’ sale cost of an item to its purchase cost. Thus, we determined mark-up on 98 percent of these items. For repair materials purchases like carpeting, lumber, and roofing materials, where the companies kept stock on hand but did not have a materials inventory system, we could not match each item sold to a vendor invoice. As a result, we determined the mark-up on carpeting by determining the average material cost of third-party vendors who provided carpeting. We used that average to estimate the amount of mark-up that the companies charged to the projects. To determine the mark-up on the other materials, we tested 111 items on 47 invoices. Our testing resulted in an average mark-up

⁴ The PASS scoring system is a 100-point system. Any score less than 60 is considered failing per HUD Notice 99-44, issued on February 24, 1999.

amount of almost 47 percent that we used to estimate the total amount overbilled for all other materials purchases. The following table summarizes the results of our testing and the total amount of mark-up we are questioning:

Item	Markup Range		Average Markup	Total ⁵
	From	To		
Appliances	46%	65%	57%	\$ 36,986
A/C Components	49%	109%	67%	54,284
Carpet	33%	40%	37%	34,402
Other Materials	24%	178%	47%	178,415
Total				\$304,087

Identity-of-interest companies inflated labor costs by an estimated \$983,265

In violation of the Regulatory Agreements, Prudential and First Class overcharged the projects an estimated \$983,265 in inflated labor costs. The Regulatory Agreements required services to be for the project. Further, the amount charged should not have exceeded the amount ordinarily paid for such services. To prevent excessive charges, HUD required Mr. Zieben or HJZ, Inc. to obtain, at a minimum, verbal bids for any contract or service. No bids existed. In addition, the companies lacked supporting information for their labor costs. They provided only 5 out of 24 months worth of daily labor logs even though we repeatedly asked for them. As a result, we performed analytical testing on the available records to determine the amount Mr. Zieben overcharged the projects.

Prudential and First Class charged Haverstock and Coolwood for inflated amounts of labor to subsidize the labor being performed at Mr. Zieben’s other properties. Prudential and First Class obtained 90 percent of their revenue from Haverstock and Coolwood. Yet, according to the available daily labor logs, their employees worked at the projects only 60 percent of the time. For the other 40 percent of the time, their employees worked at Mr. Zieben’s residence and other business ventures owned by Mr. Zieben like Douglas Utilities, Village Green Mobile Home Park, and Westbury Village Apartments. Although the business ventures did make an occasional payment to Prudential or First Class, bank records show that Mr. Zieben never paid for the services performed at his residence. As a result, we question approximately \$490,936 of the \$1,486,798 in labor paid to Prudential and First Class by Haverstock and Coolwood.

Additional testing and analytical procedures support the contention that Prudential and First Class inflated the amount of labor and the amount charged for labor. For example, comparison of Prudential invoices for carpet installation reflected that they charged 85 percent more for installation than third-party vendors. Prudential charged \$2.13 per square yard to install carpet in a vacant apartment. However, a third-party vendor⁶ charged only \$1.15 for the same installation. Further analysis on the total amount of labor charged in 1998 showed Prudential and First Class did not have sufficient staff working on the projects to support all of the hours billed

⁵ Total amount includes the Texas State sales tax (8.25 percent) charged on the amount of the mark-up.

⁶ A third-party vendor provided carpet and installation for the projects.

to the projects. In other words, it appears that the companies inflated the number of labor hours to complete a job. At our request, a HUD Construction Analyst reviewed several company invoices. The HUD staffer stated the amount of labor charged was very excessive on those invoices.

Prudential and First Class also billed the projects an inflated hourly rate for labor. Although they only paid their employees an average of \$8.09 per hour, Prudential and First Class billed the projects \$16 an hour for most of the labor performed.⁷ Since complete records did not exist detailing how many hours of labor the projects paid, Mr. Zieben may have improperly billed up to \$492,330 to the projects.

Mr. Zieben used the unauthorized distributions and improper billings to inappropriately enrich himself and his other businesses

Mr. Zieben used the unauthorized distributions and improper billings from the projects to inappropriately enrich himself and his other business ventures. Mr. Zieben received a total of \$273,500 in consulting fees from Prudential. He avoided having to invest \$230,000 of his own funds to keep Haverstock II and Coolwood operating. He had \$1,050 in goods delivered to his personal residence. He also had labor performed at his residence free of charge. Finally, he had repair work involving labor and materials performed at his other business ventures paid for by Haverstock and Coolwood.

Since our audit work identified equity skimming, the Office of Inspector General will be seeking recovery action. However, HUD should continue to hold the \$1.95 million in escrow until recovery actions are complete.

Auditee Comments

The auditee's attorneys faxed written comments to our office on April 17, 2002, which are attached in their entirety at Appendix A. We held an exit conference with the auditee and his attorneys on April 29, 2002, in Houston, Texas. In addition, we met with Mr. Zieben's attorneys and financial investigator on July 1, 2002. In general, the auditee's attorneys believed the memorandum was inconsistent with the "spirit of the escrow agreement." They also believed the audit memorandum contained inaccurate, misleading, and even unnecessary information.

Mr. Zieben's attorneys stated the recommendation in the memorandum was contrary to the intended outcome of the audit, according to the Escrow Agreement. According to the Escrow Agreement, the exact amount of the liquidated settlement was to be determined by means of an audit. However, the audit memorandum recommended that HUD continue to hold the \$1.95 million in escrow pending the outcome of additional work.

⁷ Prudential did charge \$22 an hour for technicians and \$48 an hour for welders. However, testing showed that less than 10 percent of the labor reviewed that had an hourly rate was at these wage rates.

Mr. Zieben's attorneys disagreed that Mr. Zieben and his identity-of-interest companies did not provide complete financial records for the audit. In addition, they believed the issue of transfers between properties was moot and irrelevant since the funds were paid back. Their response also indicated that HUD approved the transfer of funds from Haverstock I. Further, at the July meeting, they provided letters showing HUD approved \$80,000 in transfers of funds between the projects and was aware of another \$145,000. In addition, they did not believe that the memorandum should have contained a discussion of the Regulatory Agreement, Agreed Judgment, Compliance Agreement, or the Management Agent Handbook because, in their opinion, such information was outside the scope of what was agreed to in the Escrow Agreement. They stated our discussion of the properties' condition was misleading and incorrect. In regards to inflated materials and labor costs, Mr. Zieben's attorneys found the information somewhat misleading and disputed the information. However, they decided to reserve comment until a final audit was issued.

OIG Evaluation of Auditee Comments

We do not agree that the audit memorandum was inconsistent with the "spirit of the escrow agreement." To the contrary, the escrow agreement provided for "an unlimited audit." The escrow agreement contained no constraints or guidelines for the audit to follow nor did it contain specific audit objectives or timeframes for the audit. The escrow agreement was designed to set forth the terms and conditions governing the collection, safeguarding, and ultimate payment of the funds subject to the agreement. It was not designed to hinder or limit the audit in any way. Since recovery actions are not complete at this time, there was no dollar figure available to include in this memorandum.

We also do not agree that the audit memorandum contained inaccurate, misleading, or unnecessary information. As the specific examples in the audit memorandum demonstrated, we were not provided with complete financial records for the audit. While our overall objective was to determine what amount, if any, HUD was to be paid from the \$1.95 million in escrow, in order to make that determination we had to refer to the Regulatory Agreements, the Agreed Judgment, the Compliance Agreement, and the Management Agent Handbook. The Regulatory Agreements and the Management Agent Handbook contained specific guidelines and regulations owners and management agents for HUD insured and Section 8 assisted properties were to follow. In addition, the Agreed Judgment and the Compliance Agreement contained explicit guidelines for Mr. Zieben to follow in managing his HUD properties. In fact, the Compliance Agreement contained the following language:

"Whereas the parties Herbert J. Zieben and H.J.Z., Inc. in consideration of HUD not exercising its rights to terminate their authority to manage the Projects pursuant to the respective Regulations, Agreements, and Certification, enter into this compliance agreement to provide sufficient guarantees to the United States Government that civil or criminal violations will not occur."

In other words, in order to keep his position as management agent for these properties, Mr. Zieben guaranteed to the United States Government that violations of the Regulations and any other agreements would not occur. It is also important to note that this Compliance Agreement was entered into due to previous criminal equity skimming from these same properties.⁸

Contrary to their assertion, the transfers between the properties were relevant, since the Regulatory Agreements prohibited them. Since the attorneys provided documentation of HUD approval or silence on some transfers, we modified the report and deleted those transactions. For the remaining transactions, Mr. Zieben should have invested his own money instead of taking money from Haverstock I and transferring it to Haverstock II and Coolwood. Furthermore, the repayments to Haverstock I only made the financial situation of Haverstock II and Coolwood even more precarious. Neither Haverstock II nor Coolwood had sufficient funds to operate, much less improperly repay the loans.

A discussion of the condition of the properties was necessary due to the amount of money paid to identity-of-interest companies for repairs, landscaping services, and air conditioning services during the period of the audit.⁹ However, in spite of the amount of money paid out for repairs and maintenance, the properties each failed inspections performed in 1999.¹⁰ In addition, subsequent to the sale, the new owners spent over \$2.1 million to improve the physical condition of Haverstock. The work performed by the new owners was not just cosmetic. The inspection scores received by the properties in 2000 evidence this. In particular, Coolwood received a score of 91 and Haverstock III received a score of 84.

Since Mr. Zieben's attorneys did not rebut our findings on labor and material costs, our original conclusions still stand. We also made formatting modification to the report between the draft and final report to comply with new OIG reporting standards.

RECOMMENDATION

We recommend HUD:

1. Continue to hold the \$1.95 million in escrow until OIG's recovery actions are complete.

⁸ Per the Agreed Judgment in which Mr. Zieben pled guilty to criminal equity skimming.

⁹ January 1998 to April 2000.

¹⁰ Eighty-three percent of the first 3,722 privately owned complexes inspected under HUD's Physical Assessment Sub System (PASS) were in good or excellent condition as of February 25, 1999. Only 17 percent scored below the passing mark of 60.

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April 17, 2002

Via Fax 817.978.9316 and CMRRR

U.S. Department of Housing and Urban Development
Office of Inspector General
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RE: Escrow and Payment Agreement (the "Escrow Agreement") dated April 25, 2000 by and between Herbert J. Zieben and H.J.Z., Inc. (Mr. Zieben and H.J.Z., Inc. shall sometimes be collectively referred to as "HJZ") and Commonwealth Texas (Haverstock and Coolwood), LLC ("Commonwealth") and the United States Department of Housing and Urban Development ("HUD")

Dear Mr. Beard:

As you know, the undersigned attorney and law firm represent HJZ. The purpose of this letter is to respond to your letter dated March 28, 2002 which enclosed your draft audit memorandum.

There are a number of misleading statements, false innuendos and errors in the draft memorandum. In the final audit you prepare, we request that you consider the following:

1. In the first and second paragraphs of page 1, you have correctly identified that you are conducting the audit as a result of the Escrow Agreement; however, the objective of your audit was to determine what portion of the escrowed funds (\$1,950,000) are to be distributed to HUD to go back to the properties or to Zieben. As the Escrow Agreement indicates, the escrowed funds related to HUD's claim that an undetermined amount, capped at no greater than \$1,950,000, is owed by Zieben to HUD as a liquidated settlement for payments made by Zieben from project funds to related entities. Your objective in the audit should not have been anything other than what the Escrow Agreement provides, since the escrowed funds were deposited for the sole purpose of determining HUD's claim with respect to the amounts Zieben allegedly overpaid to related entities. We object to the statements made in the first and second paragraphs that are contrary and inconsistent with what is contemplated by the Escrow Agreement.

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We also object to your statement that you did not conduct a full audit because the project and identity of interest companies did not provide complete financial books and records. As we indicated in our prior letter to HUD, on or about June 19, 2000, HUD began its audit. HUD continued with its audit through the summer and fall of 2000. HUD's audit process included several meetings with HJZ's staff to ask questions and request documentation. In fact, several times, HJZ's staff would fax or mail copies of documents which had been previously provided. Beginning in October 2000, HUD's senior auditor advised HJZ's staff that she had not found anything that was very serious and that a meeting with Zieben would soon be requested to finalize the audit. Despite numerous calls by HJZ's staff to follow up, HUD failed to finish its audit or even schedule a meeting with Zieben as represented. During this audit process, as your audit memorandum suggests, you were provided with all books and records that were requested. It is neither accurate nor justifiable to indicate in your memorandum that you were somehow not provided with whatever books and records HUD deemed necessary. We object to this statement and implication and request that the final audit reflect a fair and accurate description of the cooperation which Zieben and HJZ's staff has provided.

2. In the second two paragraphs on page 1, you have discussed the alleged improper transfer of funds between projects. As I have provided below, we object to any characterization that the transfer of funds between properties was improper. Transfers were done either with the oral or written permission of HUD and only when necessary to support the project to which the funds were transferred. Additionally, as you have pointed out in your audit memorandum, all funds were repaid, rendering this issue moot and irrelevant to the discussion of whether and to what extent the escrowed funds should be paid back to the properties or released to Zieben. With respect to your conclusion that the projects overpaid for materials and labor, we have expressed our comments below.

3. With respect to the recommendation contained in the last paragraph on page 1, we submit that this is *not* the type of recommendation which is contemplated or which was agreed to in good faith by the parties to the Escrow Agreement. As the Escrow Agreement provides, the exact amount of the liquidated settlement is to be determined by means of an audit performed by the staff of the Office of Inspector General. The Escrow Agreement is designed to set forth the terms and conditions that will govern the collection, safeguarding *and ultimate payment* of the funds subject to the Escrow Agreement. Although the time for the audit process to reach completion was not strictly set forth, the Escrow Agreement provides that all parties will be committed to exercise *prompt due diligence* in performing respective required tasks under the Escrow Agreement. At no time was it contemplated that HUD could delay its audit by simply recommending that other investigations be concluded. In the event the final audit does not reach some conclusion, HUD would be in violation of the terms and spirit of the Escrow Agreement.

4. In the "Background" section on page 2, we object to the statements that Haverstock II was in default during the entire audit period, that Coolwood was in a non-surplus cash position for 1997 and 1998 and that Haverstock III was in a non-surplus cash position in 1997. It is unfair and unjustified to attribute these matters to Zieben in light of Zieben's history of infusion of funds into the properties and HUD's involvement over the years with the financing of the properties. However, none of these allegations are relevant to the purpose or intent of the audit to determine

how much, if any, of the escrowed funds should be distributed to the properties or released to Zieben.

5. In the second section (the last two paragraphs) on page 2, it appears that your memorandum is inconsistent with the spirit of the Escrow Agreement. Contrary to the implications contained in your memorandum, the Escrow Agreement provides that HUD had 3 categories of claims against the properties. In addition to the issue regarding the escrowed funds, HUD claimed to be owed the balance of any existing mortgages and the unpaid sum of a certain Judgment against Zieben. The Agreement expressly provides that, of the 3 categories of funds owed HUD, the outstanding mortgage balance and the balance of the Judgment *were* taken care of at the closing of the sale of the properties. It was certainly not the agreement of the parties nor consistent with the spirit of the Escrow Agreement for HUD to include in its audit with respect to HUD's third claim (the claim relating to the escrowed amounts) for HUD to use the Judgment which was resolved at the closing of the sale of the properties against Zieben. It is also incorrect for the memorandum to state that the Escrow Agreement did not preclude criminal or civil proceedings against Zieben for allegations directly relating to this third claim.

6. In the first section (the first 4 paragraphs) on page 3, we object to the statement that your objective in the audit was anything other than as contemplated and stated in the Escrow Agreement. As the Escrow Agreement states, the purpose of the audit was to determine the exact amount of the alleged liquidated settlement with respect to the escrowed amount. We have also previously objected to any statement implying that Zieben, HJZ or any related entities failed to provide complete books and records. As we indicated, HUD spent several months at HJZ's office reviewing books and records. All books and records of these companies were made available for HUD's inspection. The implication that complete books and records were not provided is false, misleading and unjustifiable.

7. In the "Criteria" section on pages 3 and 4, the discussion of the Regulatory Agreement the Agreed Judgment, the Compliance Agreement and *The Management Agent Handbook* is unnecessary. While we understand that the Escrow Agreement contemplated an audit from HUD with respect to what amounts, if any, were paid to related entities in excess of what would have been paid to third party vendors, the recital of provisions of a Regulatory Agreement and the threat of criminal prosecution and civil damages is outside the scope of what the parties agreed HUD's audit would involve. Further, as noted below, Zieben has not taken cash out of any project without authorization and without repaying amounts transferred.

The discussion regarding the Compliance Agreement and financial reports is not only unnecessary, but unwarranted. Over the years, HJZ and Zieben provided all required financial statements and reports to HUD and addressed questions as they were raised. These issues also appear to be irrelevant in light of the fact that there were no issues of this nature cited by HUD in the Escrow Agreement.

Similarly, the discussion of *The Management Agent Handbook* is irrelevant and unnecessary. The parties have agreed in the Escrow Agreement that the amount, if any, that has been overpaid to related entities will constitute the liquidated settlement discussed in the Escrow

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Agreement. When Zieben signed the Escrow Agreement, it was his understanding that the issue of whether or not bids were taken was part of the negotiation which led to the Escrow Agreement and the agreement to escrow virtually all amounts paid to related entities over a 28 month period.

8. The allegations of unauthorized distributions on pages 4 and 5 are inaccurate, create a false impression that there was wrongdoing and, on its face, appears to be a non-issue. Through a series of correspondence and conversations, HUD representatives *did authorize* HJZ and Zieben to transfer the funds from, and to repay the funds to, Haverstock I. Your statement that the transfers were unauthorized is simply incorrect. First, the transfer of funds was necessitated by HUD's repeated delay in funding the rents under the applicable HAP contracts for residents of the property. Additionally, since HUD's requirement prevented Zieben from ever receiving repayments of personal loans to the properties, there was no other vehicle by which Zieben could take surplus cash from one property to pay expenses of a property that did not receive HUD funds in a timely fashion. The property needed these funds to meet payroll obligations for the on-site staff and to fund other necessary expenses to operate the property. Although authorization was provided with respect to each transaction you have identified, based upon the chart you provided, it appears that this is a non-issue due to the fact that all funds that were transferred were repaid. It is curious why, if these amounts were repaid, you have recommended that HUD seek recovery of the amount transferred.

9. With respect to the section regarding the amounts billed by Prudential and First Class, HJZ and Zieben are evaluating the information you provided to determine its accuracy. However, the statements regarding the reasons these companies existed, the work performed at other properties, the company's total revenues and the percentage of each company's revenues generated by Haverstock and Coolwood is not relevant to the purpose of HUD's audit, as provided in the Escrow Agreement. Once again, pursuant to the Escrow Agreement, HUD was to perform an audit to determine what amounts, if any, were in excess of what should have been paid for the services received from Prudential and First Class. This can only be accomplished by an audit that identifies what amount was paid and whether or not the amount was reasonable for the work provided. If Zieben had these companies or their employees perform any work at his residence for which he personally paid, it should not relate to the issue of whether the amount paid was reasonable for the work provided. Similarly, the percentage of revenues generated by Haverstock and Coolwood is not relevant to the issue of whether amounts paid by Haverstock and Coolwood to Prudential and First Class were reasonable in light of the work performed.

10. The discussion of maintenancce of the projects on page 6, is misleading. We object to any characterization that the properties were not properly maintained. To the contrary, reports from mortgage lenders and from HUD during this period never indicated that the properties were poorly maintained. It is my understanding that HUD developed a new scoring system with its inspection for the year 1999. Since this was the first time this point system was used, it was unclear to our client whether it either "passed" or "failed" HUD's inspection. At any rate, the memorandum is incorrect with respect to a number of facts and implications. Our client did not receive HUD's report of its physical inspection until April 1999. Our client then proceeded to work promptly and diligently to correct the items listed by HUD that needed to be addressed. Our client's response to HUD's inspection is unjustifiably omitted from your discussion. The

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implication made with respect to the new owner's performance of major repairs is also misleading. In fact, the new owner's have advised our client that, when the properties were purchased, they were not in a state of disrepair. Although the new owner may have spent funds to improve the properties, the amount of money spent on a per unit basis by the new owner was not considered to be the amount of funds needed for "major repairs" as your memorandum suggests.

11. The allegations of inflated materials costs on pages 6 and 7 is also somewhat misleading. Although, as indicated, our client is evaluating the information you provided, it is my understanding that a large number of payments made by the properties in the early part of 1998 were actually to pay for invoices generated and work performed in 1997. I should note that it was not our client's understanding that the mark-up was as you have stated; however, we will address that in response to HUD's final audit and conclusion of what amount, if any, of the escrowed funds should be paid to the properties.

12. With respect to the allegations of inflated labor costs on pages 7 and 8, while we dispute the allegations regarding inflated labor costs, we reserve comments until we review the information contained in HUD's final audit. However, as indicated above, the reference to the issues contained in this section are not relevant to the ultimate purpose of the audit, to determine what amount, if any, was charged in excess of what would be reasonable for the work performed by Prudential and First Class.

13. In the last section on page 8, the accusations against Zieben are untrue. As indicated above, there were no unauthorized distributions to Zieben from the properties. The transfers of funds from one project to another were authorized by HUD and in no way enriched Zieben. Any consulting fees or any other fees or expenses paid by Prudential and First Class are not material to the issue of whether, and to what extent, excessive amounts were paid to Prudential and First Class. The allegation that Zieben did not make personal loans to the projects, that HUD would have prohibited the projects from repaying, does not support an allegation of wrongdoing. It makes little to no sense for any business person to make personal loans to a project that could not be repaid. The allegations that Zieben had repair work performed at his other business ventures or his personal residence paid for by Haverstock and Coolwood is simply untrue and not supported by any evidence. With respect to your recommendation contained in the last paragraph of page 8 and on page 9, we request that this recommendation be revised in the final audit to be consistent with the Escrow Agreement.

As indicated above, HJZ and Zieben are in the process of evaluating the information provided in your memorandum and will respond accordingly once we receive HUD's audit as contemplated in the Escrow Agreement. In this regard, you have indicated in your cover letter that you have solicited comments to your audit memorandum and that comments should be returned by April 18, 2002. We would expect that HUD will meet its obligations under the Escrow Agreement and exercise prompt due diligence in performing its final audit for our client's review. Pursuant to the Agreement, once HUD submits its audit to Zieben, if differences exist that cannot be resolved, the amount in controversy will be paid into the registry of the appropriate court until a judicial determination is made. While we hope that any differences can

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be resolved short of litigation, we would, at least, expect HUD to comply with its obligations under the Escrow Agreement and make a determination with respect to the escrowed funds and tender to Zieben, with its final audit, the amount which it not in controversy.

Nothing contained herein shall constitute an election or waiver of any rights or remedies HJZ or Zieben have; it is their intention to preserve all rights and remedies. Additionally, any delay or postponement in taking any action shall not constitute a waiver of their right to take such action at any time.

In light of the time frame you have set forth in your solicitation of comments to your draft memorandum and the length of time that HUD has had to meet its obligations under the Escrow Agreement, we would expect that HUD will submit its final audit to Zieben no later than April 30, 2002. If you do not contemplate having a final audit by this time, please let me know on or before April 30, 2002 when a final audit will be forthcoming.

If you have any questions regarding the comments contained in this letter, please feel free to contact me.

Very truly yours,

HOOVER SLOVACEK LLP

Howard M. Bookstaff



HMB:dm/

cc: Mr. Raynold Richardson
Mr. Kent Schaefer

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