



Rainbow Terrace Apartments, Cleveland, OH

Section 221(d) Multifamily Insurance Program

**Office of Audit, Region 5
Chicago, IL**

**Audit Report Number: 2018-CH-1009
September 28, 2018**





To: Daniel J. Burke, Director of Multifamily Midwest Region, 5AHMLA

From: //signed//
Kelly Anderson, Regional Inspector General for Audit, 5AGA

Subject: The Owner and Management Agent for Rainbow Terrace Apartments, Cleveland, OH, Did Not Always Operate the Project in Accordance With the Regulatory Agreement and HUD's Requirements

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of Rainbow Terrace Apartments.

HUD Handbook 2000.06, REV-4, sets specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the audit.

The Inspector General Act, Title 5 United States Code, section 8M, requires that OIG post its publicly available reports on the OIG website. Accordingly, this report will be posted at <http://www.hudoig.gov>.

If you have any questions or comments about this report, please do not hesitate to call me at 312-353-7832.



Audit Report Number: 2018-CH-1009

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The Owner and Management Agent for Rainbow Terrace Apartments, Cleveland, OH, Did Not Always Operate the Project in Accordance With the Regulatory Agreement and HUD's Requirements

Highlights

What We Audited and Why

We audited Rainbow Terrace Apartments based on our analysis of risk factors related to multifamily projects in Region 5's jurisdiction¹ and the activities included in our fiscal year 2018 annual audit plan. Our objective was to determine whether the project's owner and management agent operated the project in accordance with the regulatory agreement and the U.S. Department of Housing and Urban Development's (HUD) requirements.

What We Found

The project's owner and management agent did not always operate the project in accordance with the regulatory agreement and HUD's requirements. Specifically, the project's owner and management agent did not always provide sufficient documentation to support that project funds were used for reasonable operating expenses or necessary repairs of the project. In addition, (1) project funds were not used for reasonable expenses or necessary repairs of the project, (2) excess management fees and unsupported bookkeeping fees were charged to the project, and (3) tenants' security deposits were not maintained in the project's security deposit bank account. As a result, HUD and the owner lacked assurance that more than \$2.3 million in project funds was used for reasonable operating expenses or necessary repairs of the project. In addition, more than \$141,000 in project funds was not used appropriately.

What We Recommend

We recommend that HUD require the owner to (1) support the reasonableness of or reimburse the project from nonproject funds for disbursements from the project's operating account without sufficient documentation, (2) reimburse the project from nonproject funds for unreasonable operating expenses or unnecessary repairs of the project, (3) use the project's security deposit bank account to deposit and disburse security deposits, and (4) implement adequate procedures and controls to address the findings cited in this report.

¹ The region contains six States: Illinois, Indiana, Michigan, Minnesota, Ohio, and Wisconsin.

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Background and Objective

Rainbow Terrace Apartments is a 484-unit Section 8-assisted multifamily project located in Cleveland, OH. In December 2001, the U.S. Department of Housing and Urban Development (HUD) insured the project's mortgage of more than \$14.8 million under section 221(d)(4) of the National Housing Act and executed a regulatory agreement with the project's owner, Vesta Cleveland, Limited Liability Company. The Company entered into a management agreement with Vesta Management Corporation (Vesta Corporation), an identity-of interest entity, to manage the project in 2001.

In October 2017, the Company refinanced the project's Federal Housing Administration (FHA)-insured mortgage under a debt restructuring arrangement under HUD's Mark to Market program, resulting in a new mortgage amount of nearly \$12.8.² As part of the same arrangement, the Company executed a second FHA-insured mortgage under section 223(f) of the National Housing Act for nearly \$7 million. Therefore, as of December 31, 2017, the Company's FHA-insured mortgage payable was nearly \$20 million. The project has been in a non-surplus-cash position since at least January 2015. The records are maintained at the project located at 7310 Carson Avenue, Cleveland, OH, and Vesta Corporation's corporate office located at 175 Powder Forest Drive, Weatogue, CT.

Our objective was to determine whether the project's owner and management agent operated the project in accordance with the regulatory agreement and HUD requirements. Specifically, we wanted to determine whether (1) project funds were used only for reasonable operating expenses or necessary repairs of the project, (2) the management agent charged the project the correct management and bookkeeping fees, and (3) security deposit funds were deposited into and refunded from its security deposit bank account.

² The Mark-to-Market program preserves the affordability and availability of low-income rental multifamily properties with federally insured loans. The purpose of the program is to reduce rents to market levels by restructuring existing debt to levels supportable by these rents.

Results of Audit

Finding: The Project's Owner and Management Agent Did Not Always Operate the Project in Accordance With the Regulatory Agreement and HUD's Requirements

The project's owner and management agent did not always provide sufficient documentation to support that project funds were used for reasonable operating expenses or necessary repairs of the project. Specifically, (1) project funds were not used for reasonable expenses or necessary repairs of the project, (2) excess management fees and unsupported bookkeeping fees were charged to the project, and (3) tenants' security deposits were not maintained in the project's security deposit bank account. These weaknesses occurred because the owner and management agent lacked adequate procedures and controls for the operation of the project to ensure that project funds were properly used and security deposits were managed in accordance with the regulatory agreement and HUD's requirements. As a result, HUD and the owner lacked assurance that more than \$2.3 million in project funds was used for reasonable operating expenses or necessary repairs of the project. In addition, more than \$141,000 in project funds were not available for reasonable operating expenses or necessary repairs for the project.

The Project Lacked Sufficient Support for Nearly \$2.3 Million Disbursed From Its Operating Account

We reviewed 211 of the 1,563 check disbursements from the project's operating account totaling nearly \$2.6 million. The project's owner and management agent did not provide sufficient documentation showing that nearly \$2.3³ million associated with 127 disbursements was for reasonable project operating expenses. Of the nearly \$2.3 million, the owner and management agent did not provide sufficient documentation showing that (1) contracts associated with nearly \$1.8 million in disbursements to 11 payees were properly procured, (2) \$484,615 in disbursements was associated with a valid⁴ contract for security services and that the contracted amount matched the invoices, and (3) \$27,653 in disbursements was associated with a valid⁵ contract for cleaning services.

A representative of the project's owner stated that three bids were not obtained for the contracts associated with the 11 payees for various reasons, such as the need for specialized services, existing relationships between the vendor and the management agent, a lack of contractors in the

³ \$1,785,966 + \$484,615 + \$27,653 = \$2,298,234, or nearly \$2.3 million

⁴ The contract expired in 2006. In 2016, the owner and management agent discontinued using the security company.

⁵ The contract expired in August 2015.

area, and the proprietary status of the good purchased. However, the project owner did not provide sufficient documentation to support the rationale for not obtaining three required bids and that the costs incurred for the procured goods or services were reasonable. Paragraph 6.50(a) of HUD Handbook 4381.5, REV-2, states that when an owner or agent contracts for goods or services involving project income, an agent is expected to solicit written cost estimates from at least three contractors or suppliers for any contract, ongoing supply, or service, which is expected to exceed \$10,000 per year. In addition, Vesta Corporation's Property Management Standard Operating Procedure Manual states that a minimum of three bids must be obtained for every contract.

Further, for costs associated with 20 disbursements from the project's operating account totaling \$39,690, the supporting invoices appeared to show duplicate work for floor installation and cleaning services for the same units. According to the representative for the project's owner, the contractor who provided floor installation services would provide a credit for the questioned amounts. The credit would be used to offset costs of future work. The other contractor provided cleaning services for make-ready units. The representative for the project owner stated that some units needed more than one cleaning to be ready for the next occupant. Therefore, those costs were not duplicate. However, the representative for the owner did not provide documentation to support that the vacant units needed to be cleaned more than once, especially since one of the nine duplicate invoices for cleaning services had the same date and was for services performed at the same unit as another invoice. The remaining eight invoices were usually 1 month after the initial invoice.

In addition, for costs associated with two disbursements totaling \$7,091, the supporting invoices did not sufficiently detail the purchased services. The representative of the management agent stated that the invoices were for emergency mold mitigation and rebuild services, due to damage, and pest control. Because the invoices identified the provided service, the representative of the management agent believed that they were sufficient. However, unlike other invoices from the same contractors, the two invoices did not include specifics of the services provided or the addresses of the units that received service.

Further, costs associated with 29 disbursements from the project's operating account totaling \$46,024 were not for reasonable operating expenses or necessary repairs of the project. The disbursements included (1) travel and overtime costs for supervisory staff from other projects, (2) entertainment costs, (3) contract costs for HUD file reviews, (4) a payment error, and (5) expenses for other properties. The project was in a non-surplus-cash position when the funds were disbursed from the project's operating account. Paragraph 6(b) of the project's regulatory agreement states that without the prior written approval of HUD, the owner must not convey, 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.

The representative for the project's owner stated that the travel costs incurred by the regional manager were appropriate operating expenses because the regional manager was acting as the interim property manager at the time. However, according to figure 6-2 of HUD Handbook 4381.5, REV-2, travel expenses for the management agent's supervisory staff must be paid from

management fee funds. The representative for the owner also stated that the travel and overtime costs incurred by two maintenance leads for different projects were appropriate operating expenses because these individuals had performed front-line tasks at the project. The representative for the owner or management agent did not provide documentation showing that the maintenance leads performed front-line tasks at the project when the expenses were incurred.

Further, regarding the HUD tenant file review services, the project owner stated that project funds used to pay a contractor to perform HUD tenant files review services were allowable front-line expenses. However, according to the management agent's contract, these services were included as part of the project's monthly management fee. In addition, the representative for the project owner stated that the expenses incurred for entertainment directly related to efforts to promote community safety. However, entertainment expenses are not reasonable operating expenses of the project. Regarding the expenses for other properties, the owner's representative stated that the contractor will provide a credit for services provided at different properties.

Excess Management and Unsupported Bookkeeping Fees Were Charged to the Project

We reviewed all 24 of the project's monthly management and bookkeeping fees charged to the project from October 2015 through September 2017 totaling \$691,330. Based on the project's owner and management agent certification that was approved on January 25, 2005, the management agent was allowed to earn a residential and miscellaneous income fee of 6 percent.⁶ At the time the certification was approved, the fee generated a yield of \$39.68 per unit per month. However, as a result of the last rent increase, dated February 1, 2014, the yield had increased to \$52.02 per unit per month, which was above the approved maximum yield.⁷ The management agent charged the project \$95,174 in excess management fees to the project. The owner's representative stated that the owner was not aware of the management fees newsletter or related memorandums issued by HUD, which stated that the maximum yield was \$44 per unit per month.

In addition, the owner and management agent did not provide sufficient documentation to support that \$70,632 charged for bookkeeping fees for the project was reasonable because it was based on a \$6 per unit fee rather than the actual cost as required by paragraph 6-38(a)(2)(b) of HUD Handbook 4381.5, REV-2, which states that the management agent may not impose surcharges or administrative fees in addition to actual fees. The owner's representative stated that the cost for bookkeeping services for the project was higher than \$6 per unit per month. However, he did not provide documentation to support the actual monthly cost.

⁶ The residential and miscellaneous income fee of 6 percent has been reduced to 5.13 percent as part of the mortgage restructuring arrangement under HUD's Mark to Market program.

⁷ The management fees newsletter, effective November 2014, and a memorandum for project owners and management agents, effective March 2016, both issued by the HUD's Detroit Satellite Office, stated that the approved maximum yield was \$44 per unit per month. The Detroit Satellite Office is an office of the Chicago Regional Office and service the States of Michigan and Ohio.

The Management Agent Did Not Use the Project's Security Deposit Bank Account

The owner and management agent maintained a separate bank account for the project's security deposits. However, from October 2015 through September 2017, the project's operating account was used to deposit and refund tenants' security deposits. According to paragraph 2-12(A)(2) of HUD Handbook 4370.2, REV-1, CHG-1, and paragraph 6(g) of the project's regulatory agreement, any funds collected as security deposits must be kept separate and apart from all other project funds. The owner's representative believed that maintaining a balance that exceeded the security deposit liability was sufficient to satisfy HUD's requirements.

Conclusion

The weaknesses described above occurred because the owner and management agent lacked adequate procedures and controls for the operation of the project to ensure that operating funds were used and security deposits were managed in accordance with the regulatory agreement and HUD's requirements. As a result, HUD and the owner lacked assurance that more than \$2.3 million⁸ in project funds was used for reasonable operating expenses or necessary repairs of the project. In addition, more than \$141,000 in project funds was not used appropriately.

Recommendations

We recommend that the Director of HUD's Multifamily Midwest Region require the project owner to

- 1A. Support the reasonableness of or reimburse the project \$2,232,004 (\$1,719,736 + \$484,615 + \$27,653) from nonproject funds for the project funds disbursed without sufficient procurement or contract documentation.
- 1B. Support or reimburse the project from nonproject funds \$7,091, as appropriate, for the project funds disbursed without sufficient supporting documentation.
- 1C. Reimburse the project from nonproject funds \$46,024 for the project funds that were not used for reasonable operating expenses or necessary repairs of the project.
- 1D. Support or reimburse the project from nonproject funds \$39,690, as appropriate, for the project funds disbursed without sufficient documentation supporting that the invoices were not for duplicate work.
- 1E. Implement adequate procedures and controls to ensure that project funds are used for only reasonable operating expenses or necessary repairs when the project is in a non-surplus-cash position.

⁸ \$1,719,736 + \$484,615 + \$27,653 + \$70,632 + \$39,690 + \$7,091 = \$2,349,417 or more than \$2.3 million. Regarding the \$1,719,736 in unsupported project disbursements, the actual unsupported amount was \$1,785,966. However, the amount was reduced by parts of recommendations 1C and 1D (\$28,867 of the \$46,024 in funds not used for reasonable expenses or necessary repairs and \$37,363 of the \$39,690 in funds disbursed without sufficient documentation supporting that the invoices were not for duplicate work

- 1F. Reimburse the project \$95,174 from nonproject funds for management fees in excess of the maximum yield.
- 1G. Support or reimburse the project \$70,632 from nonproject funds, as appropriate, for the project funds disbursed to Vesta Corporation for bookkeeping fees without documentation showing that the bookkeeping fees charged were reasonable.
- 1H. Implement adequate procedures and controls, including but not limited to ensuring that the project receives HUD's communications to ensure that its management and bookkeeping fees comply with HUD's requirements.
- 1I. Implement adequate procedures and controls to ensure that its bookkeeping fees are based on actual costs.
- 1J. Use the project's security deposits bank account to deposit and disburse security deposits.

Scope and Methodology

We performed our onsite audit work between February and June 2018 at the owner and management agent's corporate office located at 175 Powder Forest Drive, Weatogue, CT, and at the project located at 7310 Carson Avenue, Cleveland, OH. The audit covered the period October 1, 2015, through September 2017.

To accomplish our audit objective, we interviewed HUD staff and the management agent's employees. In addition, we obtained and reviewed the following:

- HUD's regulations at 24 CFR (Code of Federal Regulations) Part 200; HUD Handbooks 4370.2, REV-1, CHG-1, and 4381-5, REV-2; and the HUD Detroit Satellite Office's management fees newsletter, effective November 2014, and memorandum, effective March 2016.
- The project's audited financial statements from 2014 through 2017, financial records, bank statements, regulatory agreement, management agent agreement, operating agreement, and closing files.
- The management agent's property management standard operating procedures manual.
- Data in HUD's Integrated Real Estate Management System.

We reviewed the bank statements for the project's operating account from October 2015 through September 2017. The project made the following disbursements:

- 69 disbursements (checks and transfers) to Vesta Corporation totaling nearly \$809,000;
- 1,563 checks totaling nearly \$4.1 million to payees other than Vesta Corporation;
- 203 electronic payments totaling nearly \$5.6 million, mostly for the mortgage, taxes, and utilities;
- 24 transfers into its utility reimbursement account totaling more than \$337,000; and
- 5 transfers into its escrow account totaling nearly \$273,000.

Check Disbursements Review

During the survey, we selected a nonstatistical sample of 31 disbursements of the 1,563 check disbursements from the project's operating account to payees other than Vesta Corporation to determine whether they were for reasonable and necessary project expenses. During the audit, we selected 15 more disbursements (46 disbursements total). We used a nonstatistical sample since we knew enough about population to identify items of interest that were likely to be misstated or otherwise have high risk and we were not projecting the results to the population that we did not review. Of the 46 disbursement reviewed, we had concerns with 19. We identified the payees for the 19 disbursements and reviewed all disbursements for goods or services related to the issues identified with the 19 payees from October 2015 through September 2017. Therefore, we reviewed 211 disbursements from the project's operating account to payees other than Vesta Corporation totaling nearly \$2.6 million.

Management and Bookkeeping Fees

During our survey, we selected a sample of 7 of the 69 disbursements from the project's operating account to Vesta Corporation, the owner and management agent for the project. We found issues with two of the seven disbursements, which were payments of the project's monthly management and bookkeeping fees. Therefore, for the audit, we conducted a 100 percent sampling selection method for our review of the project's monthly management and bookkeeping fees from October 2015 through September 2017 totaling \$691,330. We selected this method because the universe was small enough to review all of it. Therefore, our results will not include a projection. We completed the review to determine whether the management agent charged the project reasonable management and bookkeeping fees for the 24 months selected.

Data, Review Results, and Generally, Accepted Government Auditing Standards

We relied in part on data maintained by the management agent in its systems. Although, we did not perform a detailed assessment of the reliability of the data, we performed a minimal level of testing and found the data to be adequately reliable for our purposes.

We provided our review results and supporting schedules to the Director of HUD's Multifamily Midwest Region and the management agent's executive vice president during the audit.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective(s). We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Internal Controls

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

- effectiveness and efficiency of operations,
- reliability of financial reporting, and
- compliance with applicable laws and regulations.

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined that the following internal controls were relevant to our audit objective:

- Effectiveness and efficiency of operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.
- Reliability of financial reporting – Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.
- Compliance with applicable laws and regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Significant Deficiency

Based on our review, we believe that the following item is a significant deficiency:

- The project owner and management agent lacked adequate procedures and controls for the operation of the project to ensure that operating funds were used and security deposits were managed in accordance with the regulatory agreement and HUD's requirements (finding).

Appendixes

Appendix A

Schedule of Questioned Costs

Recommendation number	Ineligible 1/	Unsupported 2/
1A		\$ 2,232,004
1B		7,091
1C	\$ 46,024	
1D		39,690
1F	95,174	
1G		70,632
Totals	141,198	2,349,417

- 1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local policies or regulations.
- 2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.

Appendix B

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments

September 20, 2018

Via Email (krandolph@hudoig.gov)

Mr. Kornelius Randolph
Assistant Regional Inspector General for Audit
United States Department of HUD-Office of Inspector General
477 Michigan Avenue, Room 1780
Detroit, Michigan 48226

RE: Response to September 6, 2018 Discussion Draft Audit Report regarding Rainbow Terrace (Report No. 2018-CH-100X)

Dear Mr. Randolph:

Thank you for providing us with a copy of HUD OIG's draft report concerning its recently completed audit of Rainbow Terrace, dated September 6, 2018 (the "Draft Report"). We write on behalf of Vesta Corporation and Vesta Management Corporation (the management company) and Vesta-Cleveland LLC (the owner) (collectively, "Vesta") to address Vesta's concerns with the Draft Report.

We want to note from the outset that Vesta cooperated extensively with HUD OIG's audit of Rainbow Terrace, including during multiple site visits and multiple corporate office visits, in extensive correspondence and conversations with the primary assigned auditor, and by providing voluminous records to conclusively support the costs and expenses incurred at the property. We responded to every question raised during the course of the audit. We are disappointed that the Draft Report does not reflect or contain much of the information Vesta provided during this process, or any acknowledgment concerning Vesta's extensive cooperation during the audit. We also object to the inaccurate characterizations that leave the reader with

In conjunction with this letter, we are providing additional documentation relevant to issues raised in the Draft Report, as referenced herein. We are providing that information under separate cover for HUD OIG's review, and not for publication. If you intend to publish that information, please inform us first, so that we can address all necessary privacy and proprietary concerns.

Comment 1

Comment 2

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments

Comment 3

the incorrect impression that valuable services were not fully performed by third-party vendors. As an overall matter, unless specifically noted below, actual funds were spent on essential goods and services from vendors that provided value and improved conditions at Rainbow Terrace. HUD OIG has not found—and would have no basis to find—that the vendors did other than deliver the necessary services for which they were paid. We note that the initial assumption by HUD OIG at the start of the audit, as reflected in a prior interim summary, was that there were identity of interest vendors and that, for that reason, costs were not market based. We repeatedly rebutted that presumption. Vesta's ownership and management of Rainbow Terrace has resulted in significantly positive operations to this property that is home to extremely low income families. Through its ownership and management of Rainbow Terrace, Vesta provides homes to largely single-parent households in an area of Cleveland that has faced significant challenges with respect to crime.

One very key point omitted entirely from the Draft Report is that the only money in question was, for the audit time period in question, Vesta's money. This property was a for-profit owner without a limitation on distributions. Assuming, for argument's sake, that funds should be repaid as alleged in the Draft Report, in part or whole, those funds would have been paid to the owner as surplus cash for the prior, audited years in question. In a very real sense, Vesta was simply and fully committing its own resources to project operations. For this Vesta should be thanked and praised.

Comment 2

Understanding this context is crucial to evaluating Vesta's ownership and management of the property. Placing form over substance—and reality—the Draft Report recommends that HUD seek further clarification, or if not provided, reimbursement of more than \$2 million in expenses, the majority of which are attributable to security services provided to ensure tenant safety. Yet there is no dispute, nor can there be, that the services tied to the questioned expenses were provided, and that they benefited the residents. To the extent its findings are not clearly disputed by information provided by Vesta, as summarized below, HUD OIG has amassed what amounts to a series of *de minimis* administrative deficiencies.

We have organized this response to address the Draft Report's findings in the following order: (1) management fees, (2) bookkeeping fees, (3) security deposits, and (4) reasonableness of questioned expenses. In addition, we include a section discussing certain regulatory and historical context that is relevant to the Draft Report.

A. Regulatory and Historical Context

As the Draft Report discusses funds that HUD OIG asserts should be clarified further or reimbursed to the project, we believe it is important to place this recommendation in the appropriate regulatory context. Rainbow Terrace is a privately owned property that receives partial assistance from the government, including in the form of Section 8 Housing Assistance Payment (HAP) contracts and a Federal Housing Administration (FHA)-insured mortgage.

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments

Comment 3

During the audit period Rainbow Terrace had a profit-motivated mortgage and did not have a limitation on distributions. Accordingly, even if one were to take all of HUD OIG's assertions in the Draft Report as true, any "reimbursement to the project," as HUD OIG recommends, would result in funds repaid to Vesta as owner, not to the Section 8 program. Of note, Vesta has historically elected to keep its money *in* the project, as opposed to pulling it out (as a more cash-interested owner might do). Vesta's continuing investment in the property should be applauded, not questioned.

Comment 4

The Draft Report also discusses the Mark-to-Market refinancing that took place in October 2017. This occurred outside of the audit period (October 1, 2015 to September 2017, *see* Draft Rep. at 9), so it is unclear to us why it is discussed here. HUD OIG stated during the audit that the Mark-to-Market refinancing was outside of the audit period, and accordingly said it was not part of the audit. Nonetheless, as HUD OIG raises it in the Draft Report, we note that the Mark-to-Market process included a thorough review of the historical costs of the property by HUD and its third-party contractor. Upon reviewing the historical costs as part of this process, HUD and its contractor concluded that they were all reasonable, and did not identify any material deficiencies.

Comment 5

B. Management Fees (Recommendations 1F, 1H)

The Draft Report concludes that Vesta should reimburse more than \$95,000 alleged to be "management fees in excess of the maximum yield." (Draft Rep. at 8). In drawing this conclusion, HUD OIG relies on HUD newsletters and memoranda that set a maximum yield per unit per month.

This conclusion and the corresponding recommendation contradict what HUD OIG conveyed to Vesta during the audit. When HUD OIG asserted, during a discussion in May 2018, that Vesta's management fees exceeded the approved per-unit maximum for the region, Vesta asked where this maximum was published, because Vesta was not aware of it. The primary auditor responded that he had not found it published anywhere, but had discussed it with HUD. **The primary auditor also stated that, if Vesta was not aware of the maximum, HUD OIG would not find against Vesta on this point.** Upon further examination, no evidence was found or provided by HUD OIG that this per-unit maximum was communicated to Vesta or published for the public in accordance with law and HUD procedures.

Then, in July 2018, HUD OIG provided Vesta with what it said were the relevant newsletters and guidance setting forth the maximum. Vesta promptly confirmed that it was not aware of these materials until it received them in this context. Indeed, the documents do not indicate whether, when, or how they were circulated (nor, according to an internet search, do they appear to be available online). Vesta should not be required to reimburse funds attributable to management fees when it was not aware of a per-unit maximum and therefore lacked the opportunity to account for them in assessing its fees.

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments

Comment 5

We also note that HUD has been aware of Vesta's 6% management fee since Vesta's acquisition of Rainbow Terrace in 2001, and has never questioned it. Every year since 2001, Vesta has submitted its annual audit and financials to HUD, providing information as to the amount and rate of the management fee. Yet HUD never raised any questions to Vesta about the management fee. The last HUD-signed management agent certification (HUD Form 9839b) provided for the 6% management fee with no per-unit per-month maximum.

The recent Mark-to-Market refinancing also is relevant here. In connection with that closing in October 2017, Vesta agreed to reduce its management fee to 5.13%, as footnote 6 of the Draft Report notes. Neither during those discussions nor in the documents was there mention of a per-unit per-month cap on the fee, even though it is now alleged that there was such a cap.

Accordingly, we submit that HUD OIG's recommendations corresponding to management fees (Recommendations 1F and 1H) must account for the following:

- Vesta should not be required to reimburse the project for fees in excess of the maximum yield, for the reasons stated above, and HUD should not now retroactively amend its approval of the 5.13% fee approved through the proper processing with HUD. Future approvals should be subject to properly noticed and implemented HUD requirements.

C. **Bookkeeping Fees** (Recommendations 1G, 1H, 1I)

In the Draft Report, HUD OIG concludes that Vesta has not proven that its bookkeeping fee of \$6 per unit per month was reasonable. We appreciate the point that while actual bookkeeping fees could be charged, a higher flat fee cannot. Of course, as occurred here, a flat bookkeeping fee that is *lower* than actual cost is entirely consistent with the purpose of the HUD Handbook guidance prohibiting additional fees on top of actual fees.

HUD OIG asserts that Vesta failed to provide documentation showing actual cost. This entirely is incorrect. Vesta did explain the actual fee and the methodology for the actual fee calculation. Vesta provided this information, in specific detail, on July 24, 2018 (*see* July 24, 2018 letter at 14). Vesta explained the components of its actual bookkeeping expense, which, when totaled, equate to more than 30% more than the \$6 per unit per month it charged to the project. HUD OIG did not ask Vesta to produce further secondary back-up documentation showing its actual cost. Notwithstanding the foregoing, in further support of this amount, Vesta will provide, under separate cover, documentation that shows the actual compensation of each individual noted on the previously provided documentation.

Accordingly, we submit that HUD OIG's recommendations corresponding to bookkeeping fees (Recommendations 1G, 1H, and 1I) must account for the following:

Comment 6

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments

Comment 6

- Vesta should not be required to reimburse the project for bookkeeping fees because it has provided sufficient documentation to support that the charged fee was significantly *less than* actual cost. Taking less than actual cost reimbursement, sacrificing for the project, and then being asked to pay sums on top of it, is a completely unsupported finding.

Comment 5

- As stated above with respect to management fees, HUD should publish its office specific management fee limit, where such exists, and in future processing instruct that 9839b forms be amended to include a per-unit per-month limit if, in fact, that is what HUD intends by its approvals.

Comment 7

D. Security Deposits (Recommendation 1J)

The Draft Report's conclusions about Vesta's handling of security deposits are incorrect. Page 1 of the Draft Report ("Highlights") asserts that security deposits "were not maintained in the project's security deposit bank account." This is completely false. Vesta did have a separate account for security deposits and a procedure in place for ensuring that the account balance covered or exceeded the full potential security deposit liability. The Draft Report on page 7 confirms that Vesta maintained a separate bank account for security deposits. As Vesta repeatedly explained during the audit process, it kept this separate account funded so that the balance would meet, and often exceed, the total potential security deposit liability at any time. Vesta personnel track the security deposit liability against the balance in the account every month, and Vesta's annual audits submitted to HUD contain a line item for "Tenant security deposits liability."

Comment 8

Vesta maintains that its practice with respect to security deposits (*i.e.*, establishing a fully separate account in which it maintained a balance equal to or greater than the total security deposit liability, in escrow) achieved the important goal of ensuring that potential deposit liability was always escrowed separately from the Operating Account. This procedure is consistent with industry standard, and when reviewed by HUD program staff, never was raised as an issue.

E. Reasonableness of Expenses Incurred for Work by Vendors (Recommendations 1A, 1B, 1C, 1D, and 1E)

Comments 2 and 9

In the Draft Report, HUD OIG challenges more than \$2 million in disbursements to vendors who performed work at and for the property, concluding that these expenses were not adequately supported reasonable operating expenses. Vesta vehemently disagrees with this conclusion, and submits that it has provided voluminous documentation supporting the reasonableness of these expenses. For some expenses, it does not appear that HUD OIG fully reviewed or understood the information Vesta provided. For others, HUD OIG concludes that Vesta did not supply documentation to support a particular point, when in fact HUD OIG did not seek this documentation from Vesta. We address each questioned expense in turn below.

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Comment 10

We note that, with respect to these questioned expenses, Appendix A to the Draft Report does not list them by vendor. We have used information previously provided by HUD OIG, along with descriptive information in the Draft Report, to determine which specific vendor costs HUD OIG is questioning. For some challenged expenses, we could not determine with certainty the line items to which they correspond. If the assumptions we have made are incorrect, please let us know.

1. Reasonableness of Expenses – General Principles

Comment 11

The Draft Report uses the phrase “reasonable operating expenses,” but nowhere discusses what that means, or whether the expenses it challenges adhered to commonly accepted principles of reasonableness. In fact, the Draft Report recommends that HUD require Vesta to “support the reasonableness” of the various challenged expenses, entirely ignoring the fact that Vesta has already provided HUD OIG with both factual and legal justifications for the reasonableness of the challenged expenses.

The definition of reasonable expense is an important benchmark here. A reasonable cost is one that does not exceed what a prudent person would incur, taking into account the circumstances existing at the time the decision to incur the cost is being made.² In the Fair Housing context, what constitutes a reasonable project expense, in nature and amount, is left to the owner under the Regulatory Agreement in place at the time.

In responding to HUD OIG’s questions concerning the reasonableness of project expenses, Vesta pointed to the seminal case concerning reasonableness of expenses in the fair housing context, *Arizona Oddfellow-Rebekah Housing, Inc. v. HUD*, 125 F.3d 771 (9th Cir. 1997), which is highly relevant here. In *Oddfellow*, the Ninth Circuit identified a central principle pertaining to reasonableness of expenses: “to be operating expenses, expenses must primarily ‘benefit the project,’ rather than the owner.” *Id.* at 774. The court also stated the following:

“In our view, “reasonable” is a broad and inherently amorphous term, not susceptible to precise definition. It is therefore telling that the Regulatory Agreement uses the term “reasonable,” rather than narrower or more precise language, to limit the set of permissible operating expenses. To us, this suggests a “hands off” approach, **an intent to allow project owners to engage in a wide range of normal project operations** without fear of violating the Regulatory Agreement. Therefore, while operating expenses that are extraordinary in amount or character may be “unreasonable,” we conclude that **operating expenses that are typically or predictably incurred in the course of operating a project**

²See, e.g., OMB Circular A-122 at Attachment A, ¶ 3.

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Comment 2

and are within normal limits as to amount are “reasonable” for the purposes of the HUD Regulatory Agreement.”

125 F.3d at 776 (emphasis added).

The expenses Vesta incurred in operating Rainbow Terrace were reasonable, necessary, and benefited the project. Contracting vendors to perform specialized services and addressing issues effectively with known vendors are two examples of reasonable behaviors that benefited the project. Moreover, where, as here, there is no limitation on distribution, any cost savings would fall to Vesta as owner, not to the Section 8 program. Therefore (and consistent with *Oddfellow*), Vesta was particularly motivated to pay reasonable costs. At the same time, Vesta was incentivized to spend efficiently over the term of its operation of the property, and therefore to select vendors that could perform the work most effectively and efficiently, not just most cheaply.

HUD OIG asserts that entire amounts paid to vendors should be reimbursed (or further clarified) even where there is no question that the vendors provided the underlying services, to the property's benefit. Even if HUD OIG disagrees that a particular amount associated with a vendor expense was reasonable, disallowing the entire amount, without regard for the services provided, is incorrect.

2. Specific Vendor Expenses

Pages 4-6 of the Draft Report describe particular vendor expenses, divided into various groups by amount. HUD OIG does not dispute that these services were provided, or that they benefited the residents. Rather, HUD OIG concludes that the expenses were either (1) not reasonable operating expenses or necessary to the operation of the project, or (2) not supported by sufficient documentation during the audit process.

We respond to each of these questioned expenses, as grouped together by HUD OIG in the Draft Report, as follows.

a. \$484,615 -- Security services

This amount corresponds to payments to a security firm that provided services to the property for more than 13 years. HUD OIG does not dispute that these services were performed, or that they benefited the residents. Rather, HUD OIG recommends reimbursement of payments to this firm occurring between 2006 through 2016 because the parties' contract reached its term in 2006, and they did not execute another form contract.

Comment 12

Although the form contract reached its term in 2006, the parties mutually extended their relationship beyond that timeframe, at the same terms in the original contract. The continued performance by the vendor, and Vesta's continued payment of invoices for that performance,

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Comment 12

demonstrates the intent of both parties to continue the contractual relationship. Additionally, the invoices provided by the vendor referenced the contract number even after 2006, further evidencing the parties' intent.

This vendor provided security services for Rainbow Terrace for thirteen years. For twelve of those thirteen years, it did so at exactly the same hourly rates stated in the original contract. Only in 2016 did the vendor raise the rate for one category of security officers, and even then, the raise was modest (a \$1.85/hour increase). There is no question that the rates charged by this vendor were reasonable – indeed, they were unchanged for more than a dozen years, which is virtually unheard of for hourly services with rates typically subject to standard yearly inflation, cost of living increases, and the like.

b. \$1,719,736 -- Pertaining to 11 payees performing various services

Comment 10

Given the general descriptions in the Draft Report and the summary nature of Appendix A, we are unable to determine with certainty the line items to which this amount corresponds, aside from the fact that they correspond to 11 payees. We are making assumptions about the expenses to which this amount pertains, based on requests made and information exchanged during the audit process. If our assumptions are incorrect, please let us know.

HUD OIG does not allege that any of these challenged expenses are for services that were not provided, or services that did not benefit the residents. Instead, HUD OIG recommends further clarification or reimbursement of these expenses because they were not supported by documentation showing that Vesta obtained "three required bids" and that the costs were reasonable. (Draft Rep. at 4-5).

Comment 13

As you are aware, there is no procurement requirement or process applicable to privately owned properties receiving Section 8 HAP contracts. Similarly, there is no procurement process for FHA mortgage insurance programs. While there are HUD procurement regulations at 24 CFR Part 85, those regulations expressly do not apply to Section 8 HAP programs. *See* 53 Fed. Reg. 8050 (March 11, 1988). Consistent with *Oddfellow*, in the FHA context, the intent is to permit owners "to engage in a wide range of normal project operations" and to vest owners with the discretion to determine what expenditures are necessary to benefit the property.

Comment 13

We agree that guidance concerning bidding for project work is found in HUD Handbook 4385.1, REV-2. But this guidance is incomplete (as it discusses amounts from \$1,000 to \$5,000 and above \$10,000, but not the sums between \$5,000 and \$10,000) and, to the extent it does provide guidance, the two paragraphs appear to contradict one another (one discusses written evidence and the other only oral evidence). Even if the guidance in the HUD Handbook applicable to work exceeding \$10,000 can be applied here, any deviation from that guidance necessarily must be viewed in the context of the work performed and the benefit to the project. Here, all costs incurred for Rainbow Terrace were of the nature and type typical of the operation of a multifamily apartment complex, and there is no question that these expenses benefited, and

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Comment 14

were essential for the proper operation of, the project. Any oversight relating to bidding for work exceeding \$10,000 is mitigated by other factors, including the steps Vesta took to evaluate the service provider, the overall reasonableness of the cost, the necessity of the work, and the benefit to the project from the work performed, as well as the discretion vested in Vesta as owner. Disallowing these costs would be an unfair penalty. There is no dispute that the services were performed and that Vesta paid for them. There is no allegation that Vesta engaged in any sort of intentional misconduct or misappropriation of funds. To disallow \$1.7 million in expenses—the majority of which pertain to security services provided to ensure tenant safety—simply because HUD OIG believes that Vesta failed to obtain “three required bids” (or, even worse, merely did not retain documentation to show that it did) is a draconian penalty that is wildly disproportionate to the administrative oversights alleged, and the regulatory and historical context.

Moreover, Vesta has explained (in detail, repeatedly, and with supporting documents) that there were mitigating circumstances that caused it to engage certain vendors without engaging in a three-bid process. HUD OIG acknowledges in the Draft Report that Vesta provided this information, but assigns it no weight whatsoever. These mitigating circumstances include situations where the vendor was providing specialized services; where the services sought were of a proprietary nature; where a dearth of available contractors prevented Vesta from obtaining three adequate bids; where urgent repairs necessitated immediate action; and where the vendor had previously performed quality work at reasonable rates on other projects for Vesta.

Comment 15

The last three circumstances (lack of available contractors, urgent repairs, and knowledge of cost and capability from prior work performed) are largely self-explanatory. As to availability of vendors, Vesta identified and provided documentation detailing specific instances in which it contacted multiple vendors for bids, but only a fraction of them responded (some failed to respond entirely, while others informed Vesta that they provided different services than what was needed for the project). Vesta should not be penalized for the fact that certain vendors it contacted ultimately declined to submit bids. As far as Vesta's vetting of contractors based on their prior work with Vesta is concerned, it is inherently reasonable for Vesta to judge the capability, quality, and cost-efficiency of a vendor based on prior work performed. As concerns urgent repairs, Vesta notes that some of the challenged expenses pertain to necessary repairs made on an emergency basis. By way of example, if HUD OIG's draft conclusions are adopted, expenses incurred for concrete repairs to the exterior of the property during winter in Cleveland – a matter directly affecting tenant safety on the premises – will be disallowed because Vesta did not seek “three required bids” before engaging the vendor to do the work.

Comment 16

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Comment 16

Comment 17

Comment 13

We address the other two circumstances (specialized services and proprietary services) as follows:

i. Specialized Services

Over the years, Vesta has engaged certain members of specialty professions (law and accounting) to provide services for Rainbow Terrace. These individuals possess particular, unique skills. The costs for their services were appropriate in nature and amount, reasonable in relation to the services rendered, and inured to the project's benefit.

When it assumed ownership of the property, Vesta engaged a local attorney with particular and unique knowledge of local real estate tax abatements relating to affordable housing. Since that time, this attorney has consistently demonstrated high quality work and specialized knowledge of local real estate valuation at reasonable rates. HUD OIG did not find that the services this attorney performs, or the rates charged, are unreasonable or unwarranted.

Dating back to 2001, Vesta also has worked with a national accounting firm with well-recognized expertise in HUD-assisted properties. This firm, too, has consistently demonstrated high quality work at reasonable rates. HUD OIG did not find that the services this firm performs, or the rates charged, are unreasonable or unwarranted.

We further note that Vesta disclosed the costs for these specialized professional services to HUD year after year without any objection, and therefore Vesta reasonably believed that HUD agreed that the costs for these specialized services were reasonable.

Professional services and unique services, such as legal and specialized accounting services, are often the subject of acquisition without bidding or competitive bidding. We are unaware of any applicable guidance in the HUD context, but note that other guidance advises that considering a service provider's special and/or unique skill set is permissible, and that the inquiry turns on reasonableness in relation to the services rendered. We have provided HUD OIG with cites to numerous cases showing that it is common for professional services involving unique and/or specialized skill not to be subjected to competitive bidding requirements. Further, to the extent it provides a logical construct, OMB Circular A-122 states that professional services costs for work performed by persons who are members of a specialized profession and/or possess a special skill are allowable "when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Federal Government," and when the persons performing the services "are not officers of employees of the organization." All of those criteria were satisfied here.

ii. Proprietary Services

While there are certainly services that can be provided by a number of different vendors, on occasion the service or good sought is so proprietary that engaging an ostensible competitor

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Comment 18

to bid either is impossible, or would result in unnecessary additional costs. For example, during the audit period, Vesta needed to have upgrades done to the closed circuit television (CCTV) system on the property, which is a fundamental security measure. The company that designed and installed the CCTV system at Rainbow Terrace in 2012—which Vesta selected out of a number of bids—was engaged in 2016 to perform these upgrades to the system. HUD OIG asserts that the cost associated with this upgrade work should be reimbursed because Vesta did not obtain other bids from other, outside companies to provide the upgrades. This ignores the fact that the vendor was selected in 2012 following a competitive bidding process during which Vesta evaluated the reasonableness of the costs it charged. But even setting that aside, having a new company come in and contend with updating another company's proprietary installation does not make sense from a cost perspective. The cost necessarily would have included the time it would have taken the new vendor to understand the system, and it also very likely could have resulted in additional costly compatibility issues. This was explained to HUD OIG on multiple occasions, but completely ignored in the Draft Report. It was reasonable for Vesta to have the installing company make the upgrades.

a. \$27,653 -- Cleaning services

HUD OIG does not dispute that the janitorial company to which this amount was paid provided the services described, or that the services benefited the residents. Rather, HUD OIG recommends further clarification or reimbursement of this amount because it was incurred during a six-month period when the parties' prior contract had expired and before they negotiated a new one. During this period, by mutual agreement of the parties, the company continued to perform (and was paid for) janitorial services. Accordingly, the project received the benefit of the services for which these funds were paid.

b. \$39,060 -- Floor installation and cleaning services

Given the general descriptions in the Draft Report and the summary nature of Appendix A, we are unable to determine with certainty the line items to which this amount corresponds. Setting that aside, Vesta is aware that a few *de minimis* errors in some of the invoices associated with these flooring and cleaning services were discovered during the audit. As HUD OIG notes in the Draft Report, with respect to the flooring services—which we believe to account for more than 90% of this amount—Vesta proactively reached out to the vendor and obtained multiple credits from the vendor that will be applied to future work at Rainbow Terrace.

Comment 19

Comment 20

As to the cleaning services, we note that Vesta explained to HUD OIG during the course of the audit that a unit typically is cleaned at the time of tenant move-out, in anticipation of a new tenant moving in. Occasionally, the new tenant scheduled to move in ends up not being able to do so—either at the time scheduled, or at all—and the unit, once made ready for a tenant, ends up sitting vacant for weeks or longer. During this time, the unit may be viewed by various potential tenants who walk through it, or, even if it sits vacant, is gathering dust and lacking any fresh air. Accordingly, in these circumstances, it is necessary and proper to have

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the unit re-cleaned before the new tenant moves in (as that tenant is entitled to a unit in the same condition as one that is turned over more immediately). To the extent there are other alleged errors in the invoices from the cleaning service not attributable to this circumstance, Vesta will work with the program office, and if an issue remains, determine the precise amount and address any issue(s) with the vendor.

c. \$7,091 -- Pest control and emergency mold mitigation

This amount consists of disbursements to a vendor who performed pest control services at the property (\$3,159.00) and another vendor who performed emergency mold mitigation (\$3,931,86). Vesta supplied invoices for these expenses to HUD OIG. HUD OIG does not dispute that this work was performed, or that the services benefited the residents. Nonetheless, HUD OIG recommends these expenses be further clarified or reimbursed on the grounds that the invoices do not sufficiently describe what services were performed and where.

With regard to the pest control expense: Vesta's contract with this vendor, which it supplied to HUD OIG during the audit process, set out a weekly fee that corresponded to scheduled exterminating for general pests. The contract detailed, by name, the types of pests covered. This "ongoing cycled service," as the contract describes it, applied to all units at the property, not only to certain units. Accordingly, invoices for this weekly fee must be read in conjunction with the contract documents that appropriately set forth the scope and detail of the services.

Comment 22

The emergency mold mitigation expense was required based on real-time findings during restoration work on a unit damaged during a fire. The discovery necessitated additional, unexpected work, for which the vendor separately invoiced Vesta. Vesta provided HUD OIG with the specific invoice corresponding to this work, which clearly states that it is for emergency mold mitigation. Of note, the vendor submitted this invoice on the same day it submitted an invoice for the balance of the overall restoration work on the unit.

d. \$46,024 – Pertaining to 29 disbursements

Comment 23

Given the general descriptions in the Draft Report and the summary nature of Appendix A, we are unable to determine with certainty the line items to which this amount corresponds. However, as described in the Draft Report, this amount pertains to disbursements incurred in connection with (1) travel and overtime costs for supervisory staff from other projects, (2) entertainment costs, (3) contract costs for HUD file reviews, (4) a payment error, and (5) expenses for other properties.

Comment 24

Because Vesta has already acknowledged the payment error and the expenses for other properties mistakenly attributed to Rainbow Terrace in the amount of \$3,732.52, and said amount has already been reimbursed to Rainbow Terrace after HUD OIG brought it to Vesta's attention, we do not address those again here. Below we address the three other types of expenses identified.

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i. Travel for supervisory staff

HUD OIG recommends reimbursement of travel and overtime costs incurred by three Vesta employees not typically assigned to Rainbow Terrace who performed work there on a temporary basis due to project need. Based on the analysis provided, these expenses appear to total approximately \$6,200 (it is not clear to us from the Draft Report whether HUD OIG objects to some or all of the travel expenses). Vesta has previously provided, and will again provide, detail concerning why these employees had to travel from their existing sites to Rainbow Terrace to assist the project.

Comment 25

For a limited time period, Rainbow Terrace was in between property managers (meaning, the existing property manager had departed and a replacement had not yet been hired). The property manager position is an allowable and justified site cost. The property was also short staffed in the office. During this time, Vesta asked a Regional Manager to step in on a temporary basis and perform project level work, acting as interim site manager while Vesta sought a new property site manager. None of the Regional Manager's salary was allocated to or paid for by Rainbow Terrace. The expenses questioned correspond only to her travel, lodging, and food for the time she spent going back and forth to the property. These incidental expenses are appropriate project expenses, particularly where the project was not incurring any charges for project manager work at the time, and therefore the operating account was actually realizing savings in the form of the money that otherwise would have been expended on a front-line project management.

Comment 26

In addition to the Regional Manager, two other employees assigned to other properties traveled to Rainbow Terrace to perform maintenance work there at certain time periods. The maintenance team also was short staffed at the time. HUD OIG asserts that Vesta did not provide documentation to substantiate that the tasks performed by these employees were front-line tasks. Of note, HUD OIG never even asked Vesta to provide this documentation.

Vesta did not pay any portion of these employees' salaries out of project funds, even though it arguably could have per HUD Handbook 4381.5, REV-2, paragraph 6.39(c)(2), which allows for the payment of at least a portion of the salary of temporary supervisor out of project funds. The payment of these incidental expenses is particularly immaterial where Vesta was arguably entitled to allocate project funds for some portion of the employees' salaries, but did not do so. To the extent there are particular travel expenses HUD OIG regards as ineligible for some other reason, please inform us, and we will work with HUD program staff to address those particular expenses.

ii. "Entertainment" expenses

HUD OIG recommends reimbursement of expenses related to "efforts to promote community safety" (Draft Rep. at 6) on the grounds that they are impermissible entertainment expenses. These expenses were incurred in connection with "National Night Out," which is not

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entertainment in any traditional sense, but rather is an annual national program designed to promote safety in the community by increasing tenant awareness about and familiarity with local police programs. This is a very large apartment complex, physically spread over a campus-like setting, but in an extremely low income area that houses thousands of school-age children. This outreach was not only reasonable but also, we submit, a basic effort to work with the community and promote community safety.

i. Review of tenant files

Comment 27

HUD OIG recommends reimbursement of expenses associated with Vesta's engagement of a contractor to review tenant files and identify and correct deficiencies in those files. HUD OIG does not dispute that the work was performed, or that review and shoring up of deficiencies in tenant files is a necessary and proper exercise. Rather, HUD OIG asserts that review of tenant files is not properly a front-line expense, and was part of the services encompassed in the monthly management fee.

As Vesta has previously explained, the contractor that performed this work is a consulting company with many years of experience in this specific type of work. The company was not "designing procedures [or] systems," which is the type of work the HUD Handbook (4381.5, paragraph 6.39(b)(1)) states should be paid out of management funds instead of operating expenses. The work the company performed was precisely the sort of front-line operational work a project manager or other staff would perform, if those staff were fully in place and had sufficient availability to undertake this review among their many other duties (which they did not).

* * *

Comments 2 and 16

In light of all of the above, we submit that Vesta has provided sufficient documentation and explanations (subject to the limited instances acknowledged above) to support that the expenses questioned by HUD OIG in connection with Recommendations 1A, 1B, 1C, and 1D were reasonable operating expenses, as that term must be given full meaning. With respect to HUD OIG's Recommendation 1E, Vesta will work with HUD program staff for proper protocols for emergencies and engagement of unique or unusual services, and will provide supplemental training to its staff at Rainbow Terrace and appropriate higher-level managerial staff to ensure that there is consistent application of the protocol for engaging and working with vendors.

Comment 28

Thank you for the opportunity to provide this response. We welcome the opportunity to discuss the foregoing information with you as you finalize your report. If you would like to discuss any of the matters raised in this letter, please contact me.

Sincerely,

/s/ Richard Michael Price

OIG Evaluation of Auditee Comments

- Comment 1 Vesta's representative stated that Vesta was disappointed that the report did not contain an acknowledgment concerning Vesta's extensive cooperation during the audit. We expressed our appreciation for the cooperation of Vesta's management throughout the audit.
- Comment 2 Vesta's representative stated that the report contains inaccurate characterizations that leave the reader with the incorrect impression that valuable services were not fully performed by third-party vendors. The audit report did not question the services provided, it stated that the project's owner and management agent did not always provide sufficient documentation to support that project funds were used for reasonable operating expenses or necessary repairs of the project.
- Comment 3 Vesta's representative stated that the project owner was a for-profit owner without limitation on distribution. The project has been in a non-surplus cash position since at least 2015. The audit period was October 2015 through September 2017. Paragraph 6(b) of the project's regulatory agreement states that without the prior written approval of HUD, the owner must not convey, 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.
- Comment 4 Vesta's representative stated that it is unclear why the audit report discusses the Mark-to-Market refinancing that took place in October 2017. In our report, we included the Mark-to-Market refinancing information for the purpose of providing background information about the project. We did not use this information in our audit analysis.
- Comment 5 Vesta's representative stated that the conclusion that the project owner should reimburse the project more than \$95,000 in management fees in excess of the maximum yield and the corresponding recommendation contradicts what HUD-OIG conveyed to Vesta Corporation during the audit and that Vesta should not be required to reimburse funds attributable to management fees when it was not aware of a per-unit maximum. The management fees newsletter, effective November 2014, and a memorandum for project owners and management agents, effective March 2016, both issued by the HUD's Detroit Satellite Office, stated that the approved maximum yield was \$44 per unit per month. The president of the project's owner signed the regulatory agreement stating that the project would comply with HUD's rules and regulations. Therefore, we believe it is the owner's responsibility to be aware of HUD's requirements. Vesta Corporation should work with HUD Multifamily Midwest Region's Detroit Satellite office to resolve recommendation 1F in the audit report.
- Comment 6 Vesta's representative stated that it provided documentation supporting the actual bookkeeping fees incurred by the project through an explanation of the fees in a

letter dated July 24, 2018, and that it would provide, under separate cover, documentation that shows the actual compensation of each individual noted on the previously provided documentation. On September 21, 2018, Vesta Corporation provided a spreadsheet showing annual salaries for accounting staff and Vesta Corporation's calculation of the actual bookkeeping cost per unit per month. However, Vesta Corporation did not provide documentation supporting the employment and salary information used for the calculation.

- Comment 7 Vesta's representative stated that the statement in the audit report regarding the security deposits not being maintained in the project's security deposit bank account is completely false. We disagree. As stated in the audit report, from October 2015 through September 2017 the project's operating account was used to deposit and refund tenants' security deposits. Therefore, the owner and management agent did not use the security deposit bank account to deposit and withdraw security deposit funds.
- Comment 8 Vesta's representative stated that having a separate account for security deposits and a procedure in place ensuring that the account balance covered or exceeded the full potential security deposit liability is consistent with industry standards. According to paragraph 2-12(A)(2) of HUD Handbook 4370.2, REV-1, CHG-1, and paragraph 6(g) of the project's regulatory agreement, any funds collected as security deposits must be kept separate and apart from all other project funds. Therefore, maintaining a separate security deposit account and having procedures in place regarding the account balance does not fully comply with HUD's requirement since the project's operating account was used to maintain and disburse tenants' security deposits.
- Comment 9 Vesta's representative stated that for some questioned expenses it does not appear that HUD-OIG fully reviewed or understood the information Vesta Corporation provided and for some others HUD-OIG audit concluded that Vesta did not provide documentation to support a particular point, when in fact HUD-OIG did not seek the documentation from Vesta. Vesta Corporation did not specify the documentation it believed HUD-OIG did not review or understand. The audit staff met with the management agent and owner throughout the audit and requested documentation on more than one occasion regarding the expenses questioned in this audit report. In addition, with the exception of a spreadsheet to show its calculation for bookkeeping fees, Vesta did not provide documentation with its written response to the discussion draft audit report to support questioned expenses.
- Comment 10 Vesta's representative stated that it had used information previously provided by HUD-OIG, along with descriptive information in the draft audit report, to determine which specific vendor costs HUD-OIG is questioning. We provided supporting schedules on July 16, 2018 and on August 23, 2018, along with the draft finding outline.

- Comment 11 Vesta's representative stated that the draft report entirely ignores the fact that Vesta has already provided HUD-OIG with both factual and legal justifications for the reasonableness of the challenged expenses. Although we received explanations for the questioned expenses, Vesta Corporation did not provide sufficient documentation to support that the costs were reasonable. Vesta Corporation should work with HUD Multifamily Midwest Region's Detroit Satellite office to support that the costs were reasonable.
- Comment 12 Vesta's representative stated that although the form contract reached its term in 2006 for one of the security services contractors, the parties mutually extended their relationship beyond the timeframe at the same terms in the original contract. However, according to the invoices we reviewed during the audit, the project was paying for security office dispatch services, which were not a part of the services provided under the expired contract and the hourly rate for the security officers was an additional \$1.85 per hour.
- Comment 13 Vesta's representative stated that there is no procurement process for FHA mortgage insurance programs. Paragraph 6.50(a) of HUD Handbook 4381.5, REV-2, states that when an owner or agent contracts for goods or services involving project income, an agent is expected to solicit written cost estimates from at least three contractors or suppliers for any contract, ongoing supply, or service, which is expected to exceed \$10,000 per year. In addition, Vesta Corporation's Property Management Standard Operating Procedure Manual states that a minimum of three bids must be obtained for every contract.
- Comment 14 Vesta's representative stated that HUD-OIG audit disallowed \$1.7 million in expenses. We did not disallow \$1.7 million in expenses. The audit report stated that the owner and management agent did not provide sufficient documentation showing that contracts associated with nearly \$1.8 million in disbursements to 11 payees were properly procured.
- Comment 15 Vesta's representative stated that it identified and provided documentation detailing specific instances in which it had contacted multiple vendors for bids, but only a fraction of them responded. For the most recent security services provider, Vesta Corporation provided a list of contractors that supposedly responded to Vesta Corporation's bid request. However, the list did not provide the contractors' contact information, dates when the contractors were contacted, or any other information to support that the contractors had been contacted.
- Comment 16 Vesta's representative stated that it was inherently reasonable for Vesta to judge the capability, quality, and cost-efficiency of a vendor based on prior work performed. Paragraph 6.50(a) of HUD Handbook 4381.5, REV-2, states that when an owner or agent contracts for goods or services involving project income, an agent is expected to solicit written cost estimates from at least three contractors or suppliers for any contract, ongoing supply, or service, which is expected to exceed \$10,000 per year. In addition, Vesta Corporation's Property Management Standard Operating Procedure Manual states that a minimum of three bids must

be obtained for every contract. Further, it did not provide support to show the costs it had paid for similar work.

- Comment 17 Vesta's representative stated that HUD-OIG did not find that the real estate tax abatements services, or the rates charged are unreasonable or unwarranted for the for the real estate tax abatements fees it questioned. HUD-OIG did not review the reasonableness of the fees due to the lack of procurement documentation.
- Comment 18 Vesta's representative stated that the cost of the upgrades to the closed circuit television (CCTV) system on the property was reasonable because the purchase of the CCTV system from the same contractor was properly procured 4 years before the upgrades. Vesta Corporation also stated that having a new company come in and contend with another company's proprietary installation does not make sense from a cost perspective. However, Vesta Corporation did not provide any documentation supporting its statements.
- Comment 19 Vesta's representative stated that given the general description in the audit report, it was unable to determine with certainty the line items to which the \$39,060 in floor installation and cleaning services corresponds. We provided lists of the questioned costs for the floor installation and the cleaning services as part of a documentation request via email dated July 16, 2018.
- Comment 20 Vesta's representative stated that occasionally units cleaned might need to be re-cleaned for various reasons. However, it did not provide documentation supporting that the cleaning expenses we questioned were for units that needed to be re-cleaned.
- Comment 21 Vesta's representative stated that the \$3,159 disbursed to a vendor that performed pest control services was for ongoing cycled services described in the contract and that it applied to all units, not only to certain units and that invoices for this weekly fee must be read in conjunction with the contract documents. However, the weekly fee for 25 units in the contract was \$300. We could not match that amount to the invoice. Further, if the units that were receiving services were not listed, there is no way of accounting for the services completed. In addition, the other invoices from this contractor included more specifics.
- Comment 22 Vesta's representative stated that the invoice for the emergency mold mitigation expense questioned clearly stated that it was for emergency mold mitigation. However, the invoice did not include the location (unit) and the size of the area where mold was mitigated. Other invoices from this same contractor included specifications of the work completed.
- Comment 23 Vesta's representative stated that given the general description in the audit report, it was unable to determine with certainty the line items to which the \$46,024 pertaining to 29 disbursements corresponds. We provided a list of the questioned costs pertaining to the 29 disbursements along with our finding outline on August 23, 2018.

- Comment 24 Vesta's representative stated that it had already acknowledged the payment error and the expenses for other properties mistakenly attributed to the project in the amount of \$3,732.52 and had already reimbursed the project after HUD-OIG brought it to Vesta's attention. However, Vesta did not provide support for the reimbursement. Therefore, it should work with HUD to address the recommendations.
- Comment 25 Vesta's representative stated that the travel expenses incurred by the three Vesta were necessary expenses. However, it did not provide any supporting documentation other than the above explanation. Further, HUD Handbook 4381.5, REV-2, states that travel expenses for the management agent's supervisory staff must be paid from management fee funds.
- Comment 26 Vesta's representative stated that the travel and overtime costs incurred by an interim site manager was appropriate because she was acting as the interim site manager. It also stated that the incurred expenses for two maintenance leads for different projects were appropriate operating expenses because these individuals had performed front-line tasks at the project. However, Vesta Corporation did not provide documentation showing that the maintenance leads performed front-line tasks at the project when the expenses had been incurred.
- Comment 27 Vesta's representative stated that project funds used to pay a contractor to perform HUD tenant file review services were allowable front-line expenses. The audit report did not state that the services were not allowable. It stated that according to the management agent's contract, these services were supposed to be provided by the management agent as part of the project's monthly management fee.
- Comment 28 Vesta's representative stated that it would work with HUD's program staff for proper protocols for emergencies and engagement of unique services and would provide training to its staff. We acknowledge Vesta Corporation's willingness to work with HUD and provide training to its staff.