



**Marina Village Apartments
Sparks, NV**

Section 221(d)(4) Multifamily Insurance Program



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Audit Report Number: 2014-LA-1001

TO: Thomas Azumbrado, Director, San Francisco Multifamily Housing Hub,
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Tanya E Schulze

FROM: Tanya Schulze, Regional Inspector General for Audit, Los Angeles Region 9,
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SUBJECT: Marina Village Apartments, Sparks, NV, Was Not Always Administered in
Accordance With HUD 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 Marina Village 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 8L, requires that OIG post its publicly available reports on the OIG Web site. 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 213-534-2471.



October 24, 2013

Marina Village Apartments, Sparks, NV, Was Not Always Administered in Accordance With HUD Requirements

Highlights

Audit Report 2014-LA-1001

What We Audited and Why

We audited Marina Village Apartments as a result of the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) internal audit of HUD's servicing of multifamily HUD-held mortgages and a risk analysis. The objectives were to determine whether project funds were used in compliance with the regulatory agreement and HUD requirements and whether the project operated in compliance with its use agreement.

What We Found

The owner did not use project funds in compliance with the regulatory agreement and HUD requirements. The project paid \$106,288 for related party loans, nonproject expenses, and an unauthorized reimbursement to a partner. It took these actions when the project had no surplus cash or while the mortgage was in default. The project also did not always follow procurement and contracting requirements. Lastly, the project allowed overincome tenants to move into vacant units in violation of its use agreement.

What We Recommend

We recommend that HUD require the owner to (1) make a \$45,656 payment toward the HUD-held second mortgage from nonproject funds; (2) deposit \$45,413 into the project's reserve for replacement or a restricted capital account for the ineligible disbursements made to related entities; and (3) certify, along with the management agent, that it understands the requirements in HUD Handbook 4381.5. We also recommend that HUD (1) monitor the project to ensure procurement is conducted in accordance with HUD requirements and (2) verify that the owner and management agent's corrective action is effective in ensuring compliance with the use agreement.

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BACKGROUND AND OBJECTIVES

Marina Village Apartments is a 240-unit apartment complex located in Sparks, NV. The project is insured under section 221(d)(4) of the National Housing Act, and its regulatory agreement was executed on September 1, 2003. The project is owned by a limited liability company, Marina Village Apartments, LLC.

The project was not in a surplus-cash position between 2008 and 2010. The owner defaulted on its Federal Housing Administration (FHA)-insured mortgage in 2010. In February 2011, the U.S. Department of Housing and Urban Development (HUD) made a partial payment of claim and created a HUD-held second mortgage. The partial payment reduced the monthly payment on the FHA-insured mortgage from \$130,748 to \$56,811. Payment on the HUD-held second mortgage is due annually and is equal to 75 percent of surplus cash of the previous year. The partial payment also created a use agreement that requires the project to rent vacant units to income-eligible families at rents that are no more than 30 percent of 80 percent of the area median income.

We initiated the audit as a result of an internal audit of HUD's servicing of multifamily HUD-held mortgages and a risk analysis of the multifamily projects with HUD-held mortgages. In the internal audit, we identified weaknesses in HUD project managers' monthly accounting report reviews. The inadequate reviews increased the risk that project owners took unauthorized distributions or repaid loans and advances to recoup their investments when the project had no surplus cash. In the risk analysis, we identified Marina Village Apartments to be the most at risk due to

- The HUD project manager's lack of review of the monthly accounting reports;
- A lack of surplus cash, although it had been nearly a year since the partial payment of claim (according to audited financial statements for fiscal year 2011 submitted to HUD's Real Estate Assessment Center),¹ which reduced the mortgage payment by more than \$70,000;
- Fluctuating amounts over the years for loans and notes payable, unrelated to the FHA-insured mortgage, which could be an indication of unauthorized distributions; and
- The Real Estate Assessment Center's previous flagging of the project for potentially unauthorized distributions and referral of the project to the Departmental Enforcement Center, which had informed the project owner that future program noncompliance would likely result in the imposition of civil money penalties or other enforcement actions.

Our objectives were to determine whether project funds were used in compliance with the regulatory agreement and HUD requirements and whether the project operated in compliance with its use agreement.

¹ Contrary to what the project's former certified public accountant reported to the Real Estate Assessment Center in the audited financial statements, we found that the project had surplus cash at the end of fiscal year 2011.

RESULTS OF AUDIT

Finding 1: The Project Improperly Disbursed \$106,288 in Project Funds to Identity-of-Interest Entities

The owner did not comply with the terms of the project's regulatory agreement when the project improperly disbursed \$106,288 in project funds to identity-of-interest entities during a period when the project did not have surplus cash available for distribution or was in default on its FHA-insured mortgage. Specifically, the project paid the owner and related parties for reimbursement for the cost of repairing owner-caused freeze damage, interest and principal payments of owner advances and loans, and travel expenses related to the partial payment of claim. The problems occurred because the owner misunderstood HUD requirements. As a result, \$106,288 in project funds was not available for reasonable operating expenses and necessary repairs.

The Project Used \$60,875 From Its Reserve for Replacement Account To Repay a Partner

In August 2011, the project paid \$60,875 to Schaefer Partners (a partner of the ownership entity) for contributing funds to the reserve for replacement account at the partial payment of claim closing. As a condition of the partial payment, HUD required the owner to fund the project's reserve for replacement account to pay for freeze-damaged units caused by the owner's turning off utilities in the vacant units against the advice of the management agent.

At HUD's request, the owner deposited nonproject funds into the reserve for replacement account at the partial payment closing. Later, the project paid for the repairs using project funds and then submitted a request to HUD for a withdrawal from its reserve for replacement account. HUD approved the request but did not authorize the project to reimburse the owner or the partner. Upon HUD's approval, the lender released the funds from the reserve for replacement account and deposited the funds into the project's bank account in August 2011. On the same day, the owner instructed the project accountant to issue the \$60,875 disbursement to repay Schaefer Partners. The owner mistakenly believed that HUD's required deposit into the reserve for replacement account was equivalent to a deposit for a loan guarantee and that it could repay the partner when HUD approved the release of funds from the reserve for replacement account.

The Project Paid \$44,634 for Owner Advances

Project funds totaling \$44,634 were used for ineligible loan repayments and interest payments as follows:

- In August 2010, the project disbursed \$11,800 to Marina Village Apartments, LLC, without HUD approval to repay an advance the owner had provided to cover the project's operating shortfall. The project made this repayment when it had no surplus cash and while it was in default of its FHA-insured mortgage.
- Between April 2009 and February 2010, the project made two disbursements totaling \$16,000 to Marina Village, LLC (a partner of the ownership entity). The project disbursed \$6,000 in April 2009 and \$10,000 in February 2010 to repay advances provided by the related party. The project made these repayments when it had no surplus cash and without HUD approval.
- In June 2009, the project reimbursed Marina Village, LLC, \$678 for interest paid on a nonproject personal home equity loan that belonged to a principal of the ownership entity when the project had no surplus cash and without HUD approval.
- Between August 2008 and October 2010, the project made 24 disbursements totaling \$16,156 for interest on 2 home equity loans that belonged to a principal of the ownership entity. The owner claimed that the proceeds from these home equity loans went to the project. However, there was no evidence that any of the proceeds were deposited into the project's bank account and used for project operations. The project made these interest payments when it had no surplus cash or while it was in default of its FHA-insured mortgage and without HUD approval.

According to HUD Handbook 4370.2, REV-1, owner advances made for reasonable and necessary operating expenses may be repaid only from surplus cash or with HUD approval. Paragraph 6(f) of the regulatory forbids the owner from incurring any liability or obligation not in connection with the project without first obtaining written approval from HUD. In December 2008, HUD sent a letter reminding the owner that all repayments of principal and interest on owner advances needed to be supported by prior-year surplus cash and that future violations could lead to enforcement actions. Yet the owner believed that these owner advances could be repaid as long as the advance and corresponding repayment occurred within the same reporting period.

Project Funds Were Used for \$779 in Other Nonproject Expenses

In November 2010, the project paid \$779 to Marina Village, Inc. (the manager of the ownership entity), for the owner's travel expenses related to the partial payment of claim and other miscellaneous expenses. The owner understood these expenses to be project expenses. According to HUD Handbook 4350.1, expenses incurred related to the partial payment of claim could not be charged to the project.

Conclusion

The owner used \$106,288 in project funds for ineligible payments to identity-of-interest entities. Despite a December 2008 warning letter from HUD, the owner misunderstood the HUD requirements and continued to use project funds in an unauthorized manner in violation of the project's regulatory agreement. These ineligible payments reduced the surplus cash available at the end of the corresponding year. Specifically, the reimbursement to Schaefer Partners that occurred in 2011 reduced the surplus cash available at the end of fiscal year 2011.² This ineligible reimbursement, in turn, reduced the payment toward the HUD-held second mortgage in 2012 because the payment was equal to 75 percent of the prior year's surplus cash. In other words, if the ineligible reimbursement had not occurred, the project would have paid \$45,656 (60,875 x 75 percent) more toward the HUD-held second mortgage in 2012.

The other ineligible payments occurred between 2008 and 2010 when the project had no surplus cash and before the partial payment of claim. Although these other ineligible payments would not have affected the payment on the HUD-held second mortgage, they might have contributed to or worsened the mortgage default.

² Contrary to what the project's former certified public accountant reported to the Real Estate Assessment Center in the audited financial statements, the project had surplus cash at the end of fiscal year 2011. Based on the amount of surplus cash available at the end of fiscal year 2011, the project paid \$400,389 toward the HUD-held second mortgage in 2012.

Recommendations

We recommend that the Director of HUD's San Francisco Office of Multifamily Housing require the owner to

- 1A. Make a payment of \$45,656 toward the HUD-held second mortgage from nonproject funds.
- 1B. Deposit \$45,413, using nonproject funds, for the ineligible disbursements³ cited in this report into the project's reserve for replacement or a restricted capital account that requires HUD approval for the release of the funds.

³ The \$45,413 ineligible disbursements included \$44,634 of ineligible loan repayments and interest payments and \$779 of ineligible expenses related to the partial payment of claim.

RESULTS OF AUDIT

Finding 2: The Project Did Not Always Follow Procurement and Contracting Requirements

The project paid \$56,234 for carpet and vinyl installations in 2012, but it did not have a contract, and the management agent did not obtain written cost estimates from at least three contractors as required by HUD regulations. This condition occurred because the management agent was not aware of the HUD requirements. As a result, the project could not demonstrate that the prices paid were reasonable and competitive.

The Project Did Not Have a Contract and Did Not Obtain Cost Estimates

In 2012, the project paid \$56,234 for carpet and vinyl installations without a contract. The management agent did not obtain written cost estimates from at least three contractors as required by HUD Handbook 4381.5, REV-2, paragraphs 6.50(a) and 6.50(c), because the management agent was not aware of the specific requirements. Because there were no cost estimates, the project could not support that the prices paid for carpet and vinyl installations were competitive and in accordance with HUD requirements.

Although the project did not have support for this procurement activity, we do not believe it is necessary for the project to demonstrate the price reasonableness to HUD since the payments were made to an unrelated third-party vendor and potential overpayments would not likely be material. However, we recommend that the owner and the management agent certify that they understand and will comply with HUD requirements to ensure that all future expenditures are for reasonable costs.

Conclusion

The project paid for carpet and vinyl installations in 2012 outside procurement and contracting requirements. This condition occurred because the management agent was not aware of HUD requirements. As a result, the project could not demonstrate that the prices paid were reasonable and competitive.

Recommendations

We recommend that the Director of HUD's San Francisco Office of Multifamily Housing

- 2A. Require the owner and the management agent to certify that they understand and will comply with the requirements in HUD Handbook 4381.5, The Management Agent Handbook, including those related to project procurement and contracting.
- 2B. Monitor the project to ensure procurement is conducted in accordance with HUD requirements.

RESULTS OF AUDIT

Finding 3: The Project Did Not Comply With Its Use Agreement

The project allowed overincome families to move into vacant units that should have been set aside for families with incomes not exceeding 80 percent of the area median income. This condition occurred because the owner and the management agent misunderstood the requirements of the project's use agreement. As a result, the project did not meet the terms of the use agreement.

The Project Allowed Overincome Families To Move Into Vacant Units

The project allowed overincome families to move into vacant units and had not reached the 72 set-aside affordable units required by its use agreement. The use agreement specified that all vacant units as of August 16, 2011 were to be set aside as affordable units to be rented to families with incomes not exceeding 80 percent of the area median income. After that date, as additional units became vacant, the vacant units would be added to the pool of affordable units until the project met the 30 percent requirement. On its August 2012 report to HUD, the project reported that it had 19 set-aside units. As of December 2012, the project had 25 set-aside units. The use agreement permits the project to request a waiver from the local HUD Office of Multifamily Housing to allow the renting of vacant units to families with incomes over the threshold when the overall vacancy for the previous month exceeds 7 percent. However, the project did not request a waiver and rented vacant units to overincome families. Of six randomly selected vacant units, only one unit was rented to an income eligible family, four were rented to overincome families, and one was not income verified by the project at move-in.

The Owner and the Management Agent Misunderstood the Requirements

The owner and the management agent thought that the project met all of the terms in the project's use agreement because the market rents were below the maximum affordable set-aside rents so that essentially all units were affordable. However, they misunderstood the requirements. The market rents may have been lower than the maximum affordable set-aside rents, which are set at no more than 30 percent of 80 percent of the area median income, but the project was still required

to rent vacant units to income-eligible families until there were 72 set-aside units unless it obtained a waiver from HUD.

Future Noncompliance Would Impact the Availability of Affordable Units

The project did not comply with the terms of its use agreement. There was no significant impact because market rents were generally at or below the maximum rents for affordable units in the area. However, if the market rents increase and the project does not correct its practice, affordable units may not be available for families with incomes at or below 80 percent of the area median income.

Conclusion

The project allowed overincome families to move into vacant units that should have been set-aside affordable units. This condition occurred because the owner and the management agent misunderstood the requirements of the project's use agreement. As a result, the project did not meet the terms of its use agreement, and units were not available for families with incomes at or below 80 percent of the area median income. The management agent acknowledged that the project was in violation of its use agreement and agreed to take action immediately.

Recommendations

We recommend that the Director of HUD's San Francisco Office of Multifamily Housing

- 3A. Verify that the owner and management agent's corrective action is effective in ensuring compliance with the use agreement.

SCOPE AND METHODOLOGY

We performed our onsite audit work at the project's management agent's office in Reno, NV, between May and June 2013. Our audit generally covered January 1, 2009, through December 31, 2012. We expanded our scope as necessary.

To accomplish our audit objectives, we

- Reviewed the project's mortgage documents, regulatory agreements, and use agreement;
- Reviewed HUD handbook requirements as applicable;
- Interviewed HUD staff, the owner, and the management agent's staff as appropriate;
- Reviewed the management agent's policies and procedures for administering the project;
- Reviewed the project's accounting records pertaining to receipts, collections and expenditures, and disbursements; and
- Reviewed tenant applications, income verifications, and leases.

As part of the disbursement testing, we selected the supporting documents for all disbursements made to those payees who were identified as identity-of-interest entities or individuals of the project and received more than \$5,000 in any calendar year from January 1, 2009, to December 31, 2012.

For the procurement testing, we selected the procurement activities of those vendors that were paid more than \$50,000 in any calendar year from January 1, 2009, to December 31, 2012.

To test the project's compliance with its use agreement, we used the RAT-STATS computer software to randomly select units that were vacant as of August 2011 and August 2012. We selected a random sample of 6 vacant units from a universe of 37 vacant units to test whether the new tenants who moved into these units were income eligible.

To achieve our audit objective, we relied in part on computer-processed data. The data included Marina Village's expenditures, procurement records, and other computer-generated data. Although we did not perform a detailed assessment of the reliability of the data, we did perform a minimal level of testing and found the data to be adequate for our purposes.

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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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 objectives:

- Policies and procedures that management has implemented to ensure that project funds are used in accordance with HUD requirements.
- Policies and procedures that management has implemented to ensure that affordable units are rented to eligible families in compliance with the project's use agreement.

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 Deficiencies

Based on our review, we believe that the following items are significant deficiencies:

- The owner and the management agent did not have a comprehensive understanding of the applicable HUD requirements to ensure that project funds were used only to pay eligible and reasonable project expenses, pay

distributions of surplus cash permitted, and repay owner advances authorized by HUD (findings 1 and 2).

- The owner and the management agent did not have an adequate understanding of the requirements of the project's use agreement to ensure that affordable units were rented only to eligible families (finding 3).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

Recommendation number	Ineligible 1/	Funds to be put to better use 2/
1A		\$45,656
1B	\$45,413	

- 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. These ineligible costs consist of project funds that were used to repay owner advances when the project had no surplus cash or while it was in default of its FHA-insured mortgage, to pay nonproject expenses, and to reimburse a partner for repair costs that should have been paid by the owner.
- 2/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified. In this instance, if the project had not made ineligible repayments of advances to Schaefer Partners, \$45,656 could have been available to pay down the second mortgage.

Appendix B

AUDITEE COMMENTS

We provided the owner an opportunity to respond to this report in writing, which would be included as an appendix to the report, with a submission due date of September 27, 2013. The owner informed us at the exit conference on September 25, 2013 that it was not submitting written comments.

Appendix C

CRITERIA

Marina Village Apartments, LLC's Regulatory Agreement:

- Paragraph 6(b) mandates that the owner may not, without the prior written approval of the Secretary of HUD, assign, transfer, dispose of, or encumber any personal property of the project, including rents, or pay out any funds except from surplus cash, except for reasonable operating expenses and necessary repairs.
- Paragraph 6(e) prohibits the project owner from making or receiving and retaining any distribution of assets or any income of any kind of the project except surplus cash unless HUD has given prior written approval.
- Paragraph 6(f) forbids the owner from incurring any liability or obligation not in connection with the project without first obtaining written approval from HUD.
- Paragraph 9(g) stipulates that all rents and other receipts of the project must be deposited in the name of the project in a bank and that such funds may be withdrawn only in accordance with the provisions of the agreement for expenses of the project. Any owner receiving funds of the project must immediately deposit such funds into the project's bank account and, failing to do so in violation of the agreement, must hold such funds in trust. At such time as the owner has lost control or possession of the project, all funds held in trust must be delivered to the lender to the extent to which the mortgage indebtedness has not been satisfied.
- Paragraph 12 stipulates that upon default, the owner is not permitted to collect and retain any rents due or collected thereafter.
- Paragraph 17 stipulates that the project owner, Marina Village Apartments, LLC, remains liable under the agreement "a) for funds or property of the project coming into their hands which, by the provisions hereof, they are not entitled to retain; and b) for their own acts and deeds or acts and deeds of others which they have authorized in violation of the provisions hereof."

HUD Handbook 4350.1, REV-2, Multifamily Asset Management Project Servicing, Chapter 14 – Partial Payments of Claims

Section 6. POST-CLOSING REQUIREMENTS

14-14. POST CLOSING REQUIREMENTS

- B. Field: Expenses should also be closely examined to ensure no expenses have been incurred related to the PPC [partial payment of claim].

HUD Handbook 4370.2, REV-1, Financial Operations and Accounting Procedures for Insured Multifamily Projects

2-6. REGULAR OPERATING ACCOUNT

- E. All disbursements from the Regular Operating Account (including checks, wire transfers and computer generated disbursements) must be supported by approved invoices/bills or other supporting documentation. The request for project funds should only be used to make mortgage payments, make required deposits to the Reserve for Replacements, pay reasonable expenses necessary for the operation and maintenance of the project, pay distributions of surplus cash permitted and repay owner advances authorized by HUD.

2-11. REPAYMENT OF OWNER ADVANCES

- A. Advances made for reasonable and necessary operating expenses may be paid from surplus cash at the end of the annual or semi-annual period. Such repayment is not considered an owner distribution. It is considered a repayment of advances. Repayment of owner advances when the project is in a nonsurplus cash position will subject the owner to criminal and civil monetary penalties.

HUD Handbook 4381.5, The Management Agent Handbook, Chapter 6 – Program Monitoring

6.50 CONTRACTING GUIDELINES

- a. When an owner/agent is contracting 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 or the threshold established by the HUD Area Office with jurisdiction over the project.
- c. Documentation of all bids should be retained as a part of the project records for three years following the completion of the work.

Marina Village Apartments, LLC's Use Agreement:

2. Definitions.

- e. "Moderate Income Families" are persons or families whose annual incomes do not exceed 80% of AMI [area median income].
 - f. "Affordable Unit" are Units where the initial rents are set at 30% of 80% of AMI or Units in which rents are 30% of 80% of AMI and are occupied by Current Tenants that are willing to document their eligibility as Moderate Income Families as of the date of this Agreement or at a subsequent renewal.
4. Use Restrictions. Throughout the Term, 100% of the Units in the Project shall be used as rental housing Units; 30% of the Units in the Project shall be used as Affordable Units for Moderate Income Families; and no Current Tenant shall be required to relocate solely on the basis of his or her income.
- a. Affordable Units shall be rented to Moderate Income Families. The Owner shall obtain from each prospective New Tenant for an Affordable Unit, prior to admission to the Project, a certification of income signed by such New Tenant. The Owner will make a

reasonable effort to certify the accuracy of the income certification made by the New Tenant.

- c. Notwithstanding the foregoing, in recognition of the necessity to phase in the obligations set forth in this Agreement all vacant Units as of August 16, 2011 are designated as Affordable Units for Moderate Income Families. After such date, as additional Units become vacant, such additional Units will be added to the pool of Affordable Units until Units that are occupied with families that meet the affordable test at occupancy (i.e. Moderate Income Families), together with vacant Units, equal the 30% requirement.
- d. Notwithstanding the foregoing to ensure this Agreement does not adversely affect the economic viability of the project, the parties agree that the project may request a waiver from the local HUD Hub allowing the renting of vacant Units to families that do not meet the definition of Moderate Income Families. The waiver may only be requested when the overall vacancy for the previous month exceeds 7% and the Project has documented their efforts to attract Moderate Income Families. In considering the waiver request, the HUD Hub Director may grant the request, deny the request, or attach additional requirements to the request and grant a modified waiver within 10 business days, or the waiver will be considered approved as submitted. The waiver (as modified, if applicable) will be valid for 90 calendar days.