



**The Owner of the West Village Expansion
Project, Durham, NC, Failed to Comply With Its
Regulatory Agreement With HUD**



Issue Date: July 27, 2012

Audit Report Number: 2012-AT-1014

TO: Dottie R. Troxler, Director, Greensboro Multifamily Housing Hub, 4FHMLA

//signed//

FROM: James D. McKay, Regional Inspector General for Audit, Atlanta Region, 4AGA

SUBJECT: The Owner of the West Village Expansion Project, Durham, NC, Failed To Comply With Its Regulatory Agreement With HUD

Enclosed is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General (OIG), final results of our review of the West Village Expansion Project.

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 404-732-2393.



July 27, 2012

The Owner of the West Village Expansion Project, Durham, NC, Failed To Comply With Its Regulatory Agreement With HUD

Highlights

Audit Report 20XX-XX-XXXX

What We Audited and Why

We audited the West Village Expansion Project, a U.S. Department of Housing and Urban Development (HUD) Section 220-insured property, due to a citizen's hotline complaint. The anonymous complainant alleged that the principals of L8, LLC, the managing member of the ownership entity, spent an excessive amount of project funds on legal fees, transferred more than \$500,000 to another entity owned by it, and failed to keep the mortgage current. Our objectives were to evaluate the merits of the complaint and determine whether the owner administered the project in accordance with its regulatory agreement with HUD.

What We Recommend

On July 20, 2012, a new investor provided funds to bring the mortgage and required escrows current as well as fund the unauthorized distributions cited in this report. Accordingly, all issues have been resolved, and our recommendations will be closed upon issuance.

What We Found

The owner violated its regulatory agreement by using project funds for unauthorized purposes. The owner repaid \$502,127 for previous advances from its managing member's principals, paid \$225,000 for unnecessary legal expenses, did not timely pay its mortgage, and underfunded the project's replacement reserve account by \$36,400. It took these actions without HUD approval at a time when the property had no surplus cash and the mortgage was delinquent. As a result, the project had fewer funds to operate, pay for future repairs, and keep the mortgage out of default, thus placing HUD at risk for the \$54 million mortgage.

TABLE OF CONTENTS

Background and Objectives	3
Results of Audit	
Finding: The Project's Owner Failed To Comply With Regulatory Agreement Requirements	4
Scope and Methodology	8
Internal Controls	10
Appendixes	
A. Schedule of Questioned Costs and Funds To Be Put to Better Use	11
B. Auditee Comments and OIG's Evaluation	12

BACKGROUND AND OBJECTIVES

The West Village Expansion Project is the second phase of the West Village development in downtown Durham, NC. The project contains six buildings built between 1884 and 1923 for use in the tobacco industry and redeveloped in 2008 into a residential and commercial development. These buildings house 212 apartment units, 103,424 square feet of leasable commercial space, and 25,284 square feet of storage space.

The project is owned by Fuller Street Development, LLC, and the managing member of the ownership entity is L8, LLC. During our audit period, Drucker and Falk, LLC, was the owner's management agent. The project has a complex operating and ownership structure. It operates using a master lease structure for tax credit and investment reasons. The management agent collects rents and deposits the funds with entities called a commercial subtenant and residential subtenant. The subtenants use the funds to pay for necessary project expenses and make monthly lease payments to another entity called the master tenant, which in turn makes a lease payment to the owner. The owner then uses the lease payment to make the mortgage payment and fund the replacement reserve account.

The U.S. Department of Housing and Urban Development (HUD) entered into a regulatory agreement with the owner on June 22, 2006, under HUD's Section 220-insured multifamily program. The Section 220 program insures mortgages on new or rehabilitated housing located in designated urban renewal areas and in areas with concentrated programs of code enforcement and neighborhood development. The program provides mortgage insurance to the lender on the mortgage but does not provide HUD assistance to tenants or restrict tenancy. The \$54.6 million mortgage was financed at a fixed interest rate of 5.59 percent and was to be repaid in 480 monthly payments of \$285,065.

HUD notified the owner in a February 22, 2011, letter that it was in violation of its regulatory agreement for failing to file required 2009 audited financial statements. HUD's Departmental Enforcement Center issued a limited denial of participation to the owner on November 4, 2011, for failing to file the financial statements but rescinded it on December 21, 2011, after the financial statements were filed.

We received an anonymous hotline complaint alleging that the principals of L8, LLC, were not following the requirements in the regulatory agreement. Specifically, the complaint alleged that the owner spent an excessive amount of project funds on legal fees, transferred more than \$500,000 to another entity that it owned, and failed to keep the mortgage current. The complainant's allegations proved to be generally accurate.

Our objectives were to evaluate the merits of the complaint and determine whether the owner administered the project in accordance with its regulatory agreement with HUD.

RESULTS OF AUDIT

Finding: The Project's Owner Failed To Comply With Regulatory Agreement Requirements

The owner violated its regulatory agreement with HUD by using project funds for unauthorized purposes. Principals of L8, LLC, the managing member, improperly repaid \$502,127 in advances from project funds to another entity owned by them, paid \$225,000 for unnecessary legal expenses, did not timely pay the mortgage, and underfunded the project's replacement reserve account by \$36,400. The violations occurred because the owner disregarded the regulatory agreement requirements. This occurred without HUD's knowledge or approval at a time when the project did not have surplus cash¹ and was delinquent on its mortgage payments. As a result, the project had fewer funds to operate, pay for future repairs, and keep the mortgage out of default, thus placing HUD at risk for the \$54 million mortgage.

The Owner Improperly Repaid Advances

The managing member's principals advanced funds to the project from another entity that they owned because the project's rental revenues did not meet expectations and were, therefore, not sufficient to pay all operating expenses. However, the owner then disregarded its regulatory agreement when it used funds meant for normal project operation and payment of the mortgage to improperly repay the advances. Normally, the commercial and residential subtenants made the required lease payments to the master tenant, which in turn made the lease payment to the owner so that it could make the mortgage payments. Instead, between April and July 2011, the owner used these funds to make 11 transfers totaling \$502,127 to its other entity to repay the advances. At the time, the project had no surplus cash, and the mortgage was delinquent. HUD Handbook 4370.2 REV-1 Section 2-11 allows for repayment of advances only from surplus cash with prior written approval from HUD.

The Owner Paid Unnecessary Legal Expenses

The owner used funds meant to pay the mortgage to instead pay \$225,000 in legal expenses not necessary to operate the project. HUD Handbook 4370.2 explains that eligible legal expenses consist of services incurred on behalf of the project

¹ Surplus cash is defined in section 13(f) of the regulatory agreement as any cash remaining after the payment of all sums due under the terms of the mortgage, all amounts required to be deposited in the replacement reserve account, and all other obligations of the project unless deferment of the payment has been approved by HUD.

such as legal fees for eviction. It specifically excludes legal fees paid on behalf of the mortgagor. The owner stated that these expenses, paid between April and June 2011, were for legal work to achieve final endorsement on the HUD-insured loan and for an unsuccessful attempt to refinance that loan at a significant interest rate reduction. Supporting documentation provided by the owner confirmed that use of the funds. The principals could not agree on the terms required to achieve final endorsement, and the refinance effort failed because it was contingent on the final endorsement. Section 6 of the regulatory agreement required written HUD approval before the owner could pay any expenses not needed to operate the project when the project did not have surplus cash or was delinquent on its mortgage. HUD officials stated that they would not have granted approval because of the project's financial condition.

The Owner Did Not Timely Make Mortgage and Replacement Reserve Payments

The owner was consistently behind on its mortgage and replacement reserve payments. Section 1A of the regulatory agreement required the owner to make all payments due under the note and mortgage in a timely manner. The \$285,065 monthly mortgage payment (principal and interest) was considered to be delinquent after 30 days of nonpayment and in default after 60 days. The lender could elect to assign it after 75 days of delinquency. Between January 2010 and March 2011, the owner was delinquent on 10 of the 15 monthly mortgage payments. Beginning in March 2011 and continuing through July 2012, the owner consistently made the mortgage payment after the 60 day mark, but before the 75 day mark, thus maintaining a rolling default status.

The owner made the replacement reserve payments, along with the monthly mortgage payment, to an account controlled by the mortgage servicer. Section 2(a) of the regulatory agreement required the owner to deposit \$18,200 per month into the account to ensure the availability of funds for future repairs. However, as of February 2012, the owner was 2 months behind on its mortgage, leaving the replacement reserve account underfunded by \$36,400.

If the owner had not elected to disregard HUD requirements by improperly repaying more than \$500,000 in previous advances and \$225,000 in ineligible legal fees, it would have been able to bring the mortgage and replacement reserve payments current.

The Owner Complied With Other Requirements

The owner and the property management agent generally complied with other regulatory agreement requirements. The owner, through the management agent, properly accounted for tenant security deposits and lease receipts and properly accounted for and paid project operating expenses. In addition, the property was well maintained. The mortgage servicer conducted a physical inspection of the property on July 8, 2011, and found the property to be in excellent condition. The inspection report stated that there were no health or safety issues, no accessibility or regulatory noncompliance issues, no maintenance issues that would impair the value of the property, and no deferred maintenance.

Conclusion

The owner violated its regulatory agreement with HUD by using project funds for unauthorized purposes. It repaid \$502,127 for previous advances from its managing member's principals, paid \$225,000 for unnecessary legal expenses, failed to timely pay its mortgage, and underfunded the project's replacement reserve account by \$36,400. These violations occurred without HUD's approval at a time when the project did not have surplus cash and the owner was delinquent on its \$54 million HUD-insured mortgage. However, the owner, through its management agent, properly complied with other regulatory requirements and maintained the project in excellent condition. The owner must repay amounts totaling \$763,527 to the proper project account(s) and use the funds to bring the mortgage and replacement reserve account current. The owner's actions also make the owner liable for sanctions under HUD's regulations and civil action under Title 12 of the United States Code.

On July 20, 2012, a new investor provided funds to bring the mortgage and required escrows current as well as fund the unauthorized distributions cited in this report. Accordingly, all issues have been resolved, and our recommendations will be closed upon issuance.

Recommendations

We recommend that the Director of the Greensboro Office of Multifamily Housing

- 1A. Recover the \$502,127 in unauthorized distributions and \$225,000 used for unauthorized legal expenses. The funds should first be used to bring the mortgage (1B) and replacement reserve account current (1C), and any remaining funds should be deposited into the project's replacement reserve

or a restricted capital account which requires HUD approval for release of the funds.

- 1B. Require the owner to pay \$570,130 in principal and interest, or other amount required to bring the mortgage current.
- 1C. Require the owner to deposit \$36,400, or the current unfunded amount, into the replacement reserve account to bring the account current.

SCOPE AND METHODOLOGY

Our objectives were to evaluate the merits of the complaint and determine whether the owner administered the project in accordance with its regulatory agreement with HUD.

To accomplish our objectives, we reviewed

- The regulatory agreement between HUD and the project entities and HUD Handbooks 4370.2, REV-1 (Financial Operations and Accounting Procedures for Insured Multifamily Projects); 4350.1 (Multifamily Asset Management Project Servicing); and 4381.5 (Management Agent Handbook, appendix 3b: HUD-9839-B, Project Owner's and Management Agent's Certification for Multifamily Housing Projects for Identity-of-Interest of Independent Management Agents).
- The owner's and management agent's accounting records, audited financial statements for 2009 and 2010, general ledgers, bank statements, tenant listings, property inspection reports, cash receipts and disbursements, invoices, and employee listings.

The complaint contained specific allegations, all of which we were able to confirm. The owner did use \$225,000 of project funds to pay legal fees and transferred \$502,000 to another entity owned by its managing member's principals while the project was in default on its mortgage (finding 1). Also, project funds did not always flow through the master tenant and owner as outlined in the operating agreement, and the project's equity partner did make two loan payments on behalf of the project as alleged in the complaint. We noted the flow of funds as a minor deficiency and discussed it with the owner's representative since it had no apparent impact to HUD.

We interviewed the owner's finance director, management agent employees, and the HUD Greensboro Office of Multifamily Housing staff members involved with oversight of the project. We selected several nonstatistical samples as described below. The results from these samples apply only to the sampled items and were not projected to the universe as a whole.

We selected a nonstatistical sample of 5 months from a universe of 32 months to test the tenant security deposit accounts. This included the 31 months in our review scope, and we expanded our universe to include 1 additional month. These 5 months were randomly selected using a random number generator, and we used the same 5 months for both the residential and commercial security deposit accounts.

We selected a nonstatistical sample of 3 months from a universe of 31 months in our review scope to test lease payment deposits. These 3 months were randomly selected using a random number generator, and we used the same 3 months for both the residential and commercial security deposit accounts.

We selected a nonstatistical sample of 50 checks for residential expenses from a universe of 2,851 checks written during our audit scope and a sample of 25 checks for commercial expenses

from a universe of 854 checks written during the same period. We selected these checks using a random number generator.

We tested all electronic data relied upon during the performance of the various review steps. We conducted tests and procedures to ensure the integrity of computer-processed data that were relevant to our audit objective. The tests included but were not limited to comparisons of computer-processed data to invoices and other supporting documentation. We found the electronic data to be generally reliable.

We performed our onsite work from December 20, 2011, through February 17, 2012, at the project's administrative offices located at 604 West Morgan Street, Durham, NC. The review generally covered the period April 2009 through October 2011 and was expanded as determined necessary.

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 control was relevant to our audit objectives:

- Compliance with applicable laws and regulations – Policies and procedures to ensure that resource use is consistent with laws and regulations.

We assessed the relevant control 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 item is a significant deficiency:

- The owner failed to comply with HUD requirements (see finding 1).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS

<u>Recommendation number</u>	<u>Ineligible 1/</u>
1A	\$727,127
1B	570,130
1C	<u>36,400</u>
Total	<u>\$1,333,657</u>

- 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.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

FULLER STREET DEVELOPMENT, LLC
THE POWER HOUSE • 300 FULLER STREET • DURHAM, NORTH CAROLINA 27701
(919) 956-6957 • FAX (919) 956-7038

June 28, 2012

Mr. James D. McKay
Regional Inspector General for Audit

Mr. David Butcher
Assistant Regional Inspector General for Audit
Region 4 Office of Inspector General
Office of Audit, Box 42
United States Department of Housing and Urban Development
75 Spring Street, SW Room 330
Atlanta, Georgia 30303-3388

Re: West Village Expansion Project
Durham, North Carolina

Dear Messrs. McKay and Butcher:

On behalf of Fuller Street Development, LLC, and its Managing Member, we have reviewed the attached letter from our counsel, Haight Brown & Bonesteel, and are completely in accord with the contents set forth in that letter.

Sincerely,



Christian Laettner



Haight Brown & Bonesteel LLP
555 South Flower Street
Forty-Fifth Floor
Los Angeles, California 90071
213.542.8000
213.542.8100 fax
www.hbblaw.com

Ted M. Handel
direct: (213) 542-8082
thandel@hbblaw.com

June 28, 2012

VIA EMAIL AND U.S. MAIL

Mr. James D. McKay
Regional Inspector General for Audit

Mr. David Butcher
Assistant Regional Inspector General for Audit
Region 4 Office of Inspector General
Office of Audit, Box 42
United States Department of Housing and
Urban Development
75 Spring Street, SW Room 330
Atlanta, Georgia 30303-3388

Re: West Village Expansion Project, Durham, North Carolina

Dear Messrs. McKay and Butcher:

This letter is being sent on behalf of our client, Fuller Street Development, LLC (the "**LLC**"), in response to the draft audit report that the Office of Inspector General ("**OIG**") has prepared on the West Village Expansion Project in Durham, North Carolina (the "**Project**"). For the reasons set forth in this letter, the LLC disagrees with the analysis and conclusions contained in this audit and it will vigorously contest any attempt by the United States Department of Housing and Urban Development ("**HUD**") to impose civil money penalties as well as seek double damages under the civil equity skimming statute (12 U.S.C. § 1715z4a).

The LLC generally objects to the report on the following grounds:

- Project mortgage payments were made in accordance with applicable statutory and HUD regulatory requirements.
- The Project's Replacement Reserve account is not "underfunded."
- The OIG audit report contains ambiguous and conflicting statements about payments made by the Managing Member of the LLC for Project

FS23-0000001
3958155.2

Los Angeles • San Francisco • Orange County • Riverside • San Diego

Mr. James D. McKay
Regional Inspector General for Audit

Mr. David Butcher
Assistant Regional Inspector General for Audit
Region 4 Office of Inspector General
United States Department of Housing and Urban
Development
June 28, 2012
Page 2

operating expenses.

- The OIG audit report fails to give due consideration to the adverse financial circumstances of the Project and the efforts that the Managing Member made and are continues to be make to address this situation through a comprehensive refinance of the Project.
- The legal fees incurred in accomplishing the refinance of the Project in 2011 were reasonable and appropriate given the acknowledgement by HUD that the Project's financial and ownership structure is very complex.
- HUD lacks the legal authority to impose civil money penalties and/or seek double damages under 12 U.S.C. §1715z4(a).

Comment 1

A. The OIG Misrepresents The Issue Of Delinquencies In Project Mortgage Payments

1. The OIG Allegations

a) Mortgage Payments

The draft audit report alleges the following on page 6:

“The owner was **consistently** two months behind on its mortgage . . . payments. Section 1A of the regulatory agreement required the owner to make all payments due under the note and mortgage in a timely manner. The \$285,065 monthly mortgage payment (principal and interest) was considered to be in default after 60 days of delinquency, and the lender could elect to assign it after 75 days of delinquency. The owner **consistently** made a mortgage payment after the 60 day mark, but not the 75 day mark, maintaining a rolling default status.” (emphasis added.)

Mr. James D. McKay
Regional Inspector General for Audit

Mr. David Butcher
Assistant Regional Inspector General for Audit
Region 4 Office of Inspector General
United States Department of Housing and Urban
Development
June 28, 2012
Page 3

i) 2010 Mortgage Payments

The financial records of the LLC indicate that Project mortgage payments were made on the following dates in 2010:

January	A partial loan payment of \$250,000 was made on January 15, 2010, and the balance was paid on January 28, 2010.
February	The mortgage was paid in full on February 11, 2010.
March	The mortgage was paid in full on March 12, 2010.
April	A partial payment was made on April 15, 2010, and the balance was covered the following day.
May	The mortgage was paid in full on May 17, 2010.
June	The mortgage was paid in full by June 28, 2010.
July	The mortgage was paid in full on July 14, 2010.
August	The mortgage was paid in full on September 10, 2010.
September	The mortgage was paid in full by October 1, 2010.
October	A partial mortgage payment of \$204,467.02 was made on October 15, 2010, and the balance was paid on December 9, 2010.
November	The mortgage was paid in full on November 15, 2010.
December	The mortgage was paid in full on January 7, 2011.

As the foregoing indicates, the only mortgage payment that was paid more than 60 days after it was due was the partial one made to cover the October payment. Thus, any statement that the LLC was **consistently** past due more than 60 days in making loan payments is incorrect insofar as it relates to such payments in 2010.

Mr. James D. McKay
Regional Inspector General for Audit

Mr. David Butcher
Assistant Regional Inspector General for Audit
Region 4 Office of Inspector General
United States Department of Housing and Urban
Development
June 28, 2012
Page 4

ii) 2011 Mortgage Payments

As discussed in more detail below in the context of the HUD's authority to seek civil money penalties, the Managing Member of the LLC retained the Reznick Group ("*Reznick*") to prepare the attached document entitled "Independent Accountants' Report On Applying Agreed Upon Procedures Fuller Street Development, LLC Determination Of Average Daily Cash Balances For Ability To Meet Debt Service Requirements," dated June 7, 2012 (the "*Reznick Average Daily Cash Balance Report*"). Reznick is an accounting firm which is recognized nationally as one of the preeminent firms on financial and regulatory matters relating to HUD-regulated projects. After reviewing the relevant financial data for 2011 and compiling this schedule, the Reznick Average Daily Cash Balance Report concludes that based on the average daily balance of the bank statements as set forth in Exhibit One of the report, "the Company made the required debt service payment when there was cash available to do so." Reznick Average Daily Cash Balance Report, p. 2, Findings Paragraph 2. (emphasis added.)

Comment 2

B. The Project's Replacement Reserve Account Is Not "Underfunded"

In several instances, the OIG states in the draft audit report that the Project's Replacement Reserve account is "underfunded." For example, the report states in the second paragraph on page 6 that "The Owner was consistently two months behind on its . . . replacement reserve payments." However, the report fails to acknowledge that based on the Project's audit for 2011, the reserve for replacements account had been funded in the amount of \$564,854 as of December 31, 2011. Further, the report also fails to identify any particular months during 2010 and 2011 when the LLC was actually behind in making replacement reserve payments.

Comment 3

C. The Draft Audit Report Contains Ambiguous And Conflicting Statements Regarding The LLC's Payment Of Project Operating Expenses

The draft audit report states on page 5,

"The managing member's principals advanced funds to the project from another entity that they owned because the project's rental revenues did not meet expectations and were, therefore, not sufficient to pay all operating expenses. However, the owner then disregarded its regulatory agreement when it used funds for normal project operation and payment of the mortgage to improperly repay the

Mr. James D. McKay
Regional Inspector General for Audit

Mr. David Butcher
Assistant Regional Inspector General for Audit
Region 4 Office of Inspector General
United States Department of Housing and Urban
Development
June 28, 2012
Page 5

advances.”

Two pages later, however, the report states, “**The owner**, through the management agent, . . . **properly accounted for and paid project operating expenses.**” (emphasis added.)

The clear implication of the text quoted from page 5 is that the principals of the Managing Member improperly diverted project operating funds to repay certain unspecified advances to the detriment of the Project; however, the draft audit report fails to provide any substantiation that funds were actually transferred and/or that Project operations suffered even if any such transfers were made. Absent this information, the LLC is unable to respond further to these accusations. More importantly, the OIG itself refutes these claims when it states in its draft report on page 7 that “the property was well maintained. The mortgage servicer conducted a physical inspection of the property on July 8, 2011, and **found the property to be in excellent condition.**” (emphasis added.)

Comment 4

D. The Project’s Financial Circumstances And The Ongoing Refinancing Efforts Of The LLC’s Managing Member

Since the Project was completed in 2008, it has experienced financial adversities similar to those experienced by other mixed-used developments throughout the country that are caused by the current and long standing economic recession. In this particular case, occupancy levels for the commercial and retail space and parking garage for the Project were considerably lower than had been projected when this development was first conceived. Attempts to raise occupancy levels for the former space have been hampered by the inability of the LLC to have sufficient funds to cover tenant improvements and attract prospective tenants. In addition, the Project has also encountered higher than anticipated operating expenses.

Comment 5

Notwithstanding this financial situation, the Managing Member of the LLC was able to identify an investor who first agreed to contribute needed capital to the Project in 2011. The investor, Federal Capital Partners (“*FCP*”), initially offered to contribute certain funds in exchange for a majority interest in the Managing Member of the LLC subject to Final Endorsement being achieved with HUD.

Contrary to the statement in the draft audit report on page 6 that this refinance effort failed, it remains quite viable as evidenced by the attached letter, dated May 15, 2012, as

Mr. James D. McKay
Regional Inspector General for Audit

Mr. David Butcher
Assistant Regional Inspector General for Audit
Region 4 Office of Inspector General
United States Department of Housing and Urban
Development
June 28, 2012
Page 6

executed by the principals of the LLC and authorized representatives of FCP and Wells Fargo. The letter sets forth in considerable detail the terms by which a FCP affiliate, FCP West Village Phase II, LLC, will make a Mezzanine Loan to the Managing Member of the LLC. The proceeds of this loan will be used, among other things, to pay all costs and expenses required to achieve Final Endorsement with HUD. In addition, the letter also contemplates that the Managing Member will apply to Wells Fargo or another HUD lender to refinance the existing HUD loan through a new Section 223(a)(7) loan. Finally, as the letter suggests at the end, the overriding reason why this deal has not closed is that FCP wants a resolution of all HUD enforcement issues raised in a letter from the Departmental Enforcement Center, dated May 10, 2012.

Comment 6

E. The Legal Fees Incurred In The Refinance Were Entirely Appropriate

The OIG acknowledges on page 4 of the draft audit report that the “project has a complex operating and ownership structure. It operates using a master lease structure for tax credit and investment reasons.” As noted above, the Managing Member initiated a refinance of the Project in 2011 that not only involved restructuring the outstanding loans but also included a change in the overall ownership and management structure of the LLC. This restructuring involved, among other things, drafting, negotiating, and executing a surplus cash agreement in order to achieve Final Endorsement and then contemplated having the LLC apply for and obtain a 223(a)(7) loan from a HUD lender.

According to the draft audit report, “The Owner used funds meant to pay the mortgage to instead pay \$225,000 in legal expenses **not necessary to operate the project.**” (emphasis added.) The report then asserts that HUD Handbook 4370.2 defines eligible legal expenses as those related to fees incurred in evicting tenants and expressly excludes those paid on behalf of the mortgagor.

We reviewed the HUD Handbook and we were unable to find any reference to such a limitation. More importantly, however, we respectfully disagree with the OIG’s conclusion that these expenses were not needed for Project operations. The tasks performed by the various law firms were absolutely essential towards accomplishing this restructuring. And the time that they spent on these tasks was commensurate with that which would be expected in working with a complex financial and ownership structure. If this restructuring is not eventually put into place, the Project’s HUD-insured loan will invariably go into default which is completely contrary to the interests of not only all the members of the LLC but HUD itself. This is the very reason why

Mr. James D. McKay
Regional Inspector General for Audit

Mr. David Butcher
Assistant Regional Inspector General for Audit
Region 4 Office of Inspector General
United States Department of Housing and Urban
Development
June 28, 2012
Page 7

the Managing Member of the LLC continues to work assiduously with FCP and the Project's tax credit investor to get the transaction described above closed and achieve Final Endorsement as well as obtain a 223(a)(7) loan to take out the existing HUD loan.

Lastly, the findings of the draft audit report are lacking in two other material respects. The first is that the OIG does not identify a single time entry in any of the law firm invoices that it actually considered to be "excessive." In addition, the report disregards the fact that when these legal fees were paid, Wachovia timely made the Project's loan payments and, therefore, the LLC was not in default of this financial obligation.

F. HUD Lacks The Legal Authority To Impose The Recommended Penalties

1. The LLC Did Not Commit Any Knowing And Material Violations With Regard To Payment Of The HUD-Insured Mortgage

Contrary to the suggestion in the audit report that a breach of the Regulatory Agreement entitles HUD to impose a civil money penalty for such breaches, federal law requires the department to prove substantially more before a recommendation to assess such a penalty can be made, much less actually assessed. Specifically, the relevant federal statute provides that:

"A penalty may be imposed under this section upon any liable party . . . that **knowingly and materially** takes any of the following actions:

- (xii) Failure to make promptly all payments due under the note and mortgage, including mortgage insurance premiums, tax and insurance escrow payments, and payments to the reserve for replacements **when there is adequate project income available to make such payments.**" 12 U.S.C. §1537f-15(c)(1)(B). (emphasis added.)

a) Availability Of Project Income To Timely Make Loan Payments

As noted above, recognizing the seriousness of these allegations, the Managing Member of the LLC retained Reznick to prepare a schedule documenting (a) the available cash on a

Comment 4

Mr. James D. McKay
Regional Inspector General for Audit

Mr. David Butcher
Assistant Regional Inspector General for Audit
Region 4 Office of Inspector General
United States Department of Housing and Urban
Development
June 28, 2012
Page 8

monthly basis during 2011 for each operating entity of the LLC and (b) the ability of the LLC to timely pay the HUD-insured mortgage during this period.

In response to the Managing Member's request, Reznick prepared the attached document entitled "Independent Accountants' Report On Applying Agreed Upon Procedures Fuller Street Development, LLC Determination Of Average Daily Cash Balances For Ability To Meet Debt Service Requirements," dated June 7, 2012 (the "*Reznick Average Daily Cash Balance Report*"). After reviewing the relevant financial data and compiling this schedule, the Reznick Average Daily Cash Balance Report concludes that based on the average daily balance of the bank statements as set forth in Exhibit One of the report, "**the Company made the required debt service payment when there was cash available to do so.**" Reznick Average Daily Cash Balance Report, p. 2, Findings Paragraph 2. (emphasis added.)

b) Knowledge

The terms "knowing or knowingly" are defined by HUD to mean "[h]aving actual knowledge of or acting with deliberate ignorance of or reckless disregard for the prohibitions under subpart B of this part or under 24 CFR part 4." 24 C.F.R. §30.10. The draft audit report lacks any factual support for the proposition that the LLC or its Managing Member had the requisite knowledge or that they acted with deliberate ignorance or reckless disregard of the prohibition applicable to the situation in contention here.

The findings of the Reznick Average Daily Cash Balance Report completely refute any notion that the LLC and/or its Managing Member knew that Project loan payments were being delayed after there were sufficient cash reserves to cover these payments or that the LLC and/or its Managing Member were acting out of "deliberate ignorance" or "reckless disregard" for the statutory prohibitions. On the contrary, as the report unequivocally states, Project loan payments were made as cash flow became available or, in certain instances, the LLC sought to make arrangements with its members or investors to cover any deficiency in this obligation.

b) Materiality

HUD regulations define "material" or "materially" as the natural tendency or potential to influence, or when considering the totality of the circumstances, in some significant respect or to some significant degree. 24 C.F.R. §30.10. Materiality requires a consideration of the eight

Comment 7

Mr. James D. McKay
Regional Inspector General for Audit

Mr. David Butcher
Assistant Regional Inspector General for Audit
Region 4 Office of Inspector General
United States Department of Housing and Urban
Development
June 28, 2012
Page 9

regulatory factors set forth in 24 C.F.R. §30.80. *See, U.S. Department of Housing and Urban Development v. Premier Investments I, Inc. and David K. Reed*, HUDALJ 06-022-CMP (June 29, 2007). The following are those eight criteria:

(i) Gravity of the Offense

The Managing Member of the LLC acknowledges that nonpayment of a loan is a serious matter. At the same time, however, the HUD regulations indicate that the imposition of a civil money penalty is only permitted in those instances where payment is not made despite the borrower having sufficient project income to make such payment. Here, the Reznick report and supporting financial support clearly substantiate that the LLC made loan payments in 2011 when there was sufficient Project income to do so or else the LLC sought to make arrangements with its members or investors to cover this obligation.

Comment 4
Comment 7

(ii) History of Prior Offenses

The LLC has no prior history of offenses with HUD as it relates to this specific issue.

Comment 8

(iii) Ability to Pay Penalty

The LLC and its Managing Member do not have the current financial resources to pay any civil money penalty, especially any in the amounts suggested in the report.

(iv) Injury to the Public

According to one HUD administrative law decision, “Injury to the public” has been defined as an assessment of “the harm caused to the integrity of HUD’s programs and the costs of enforcement and litigation that resulted therefrom” *See, U.S. Department of Housing and Urban Development v. Crestwood Terrace Partnership*, HUDALJ 00-002-CMP (January 30, 2001). The integrity of HUD’s programs are placed at risk when a borrower fails to make payments on a loan, provided, as HUD acknowledges in its regulations, that the borrower has the financial resources from its project at that moment in time to meet that obligation. In this particular instance, the LLC made loan payments as Project income became available or else sought to arrange to have these obligations covered with non-Project funds.

Mr. James D. McKay
Regional Inspector General for Audit

Mr. David Butcher
Assistant Regional Inspector General for Audit
Region 4 Office of Inspector General
United States Department of Housing and Urban
Development
June 28, 2012
Page 10

Comment 9

(v) Any Benefits Received by the Violator

The LLC derived no benefit from its alleged failure to make Project loan payments on a timely basis.

(vi) The Extent of Potential Benefit to Other Persons

The LLC is not aware of any other persons who benefitted from the transactions at issue here.

(vii) Deterrence

The Managing Member of the LLC does not believe that any particular conduct needs to be deterred here by the imposition of civil money penalties.

(viii) The Degree of the Violator’s Culpability

**Comment 4
Comment 7**

The Managing Member of the LLC does not believe that there is any evidence that the LLC was somehow “culpable” for failing to make loan payments given that there was insufficient Project income to cover this obligation.

2. HUD Has No Basis For Asserting A Claim Of Double Damages

The OIG recommends in the audit report that HUD seek double damages against the principals of the Managing Member under 12 U.S.C. §1715z-4a(c).

A federal appeals court has held that:

“Double damages for the government on a deterrence rationale make sense primarily where the defendant is guilty of substantial or repeated fault. There is obviously a spectrum, with fraudulent intent or recklessness at one end and a lost record or close-call judgments on the other . . .” *United States v. Cofield*, 215 F.3d 164, 171 - 172 (1st Cir. 2000) (“*Cofield*”). (emphasis added.) (citations omitted.)

Comment 10

The draft audit report alleges the principals of the Managing Member made 11 transfers

Mr. James D. McKay
Regional Inspector General for Audit

Mr. David Butcher
Assistant Regional Inspector General for Audit
Region 4 Office of Inspector General
United States Department of Housing and Urban
Development
June 28, 2012
Page 11

of unspecified amounts in violation of the proscription in the Project Regulatory Agreement against repayment of owner advances without HUD approval. The OIG does not provide any facts substantiating that the principals made these transfers or if any of them did so, that such conduct rose to the level of "substantial or repeated fault." In addition, the OIG does not suggest nor can it suggest that any of these principals acted with fraud or recklessness. Further, and perhaps most significant, any attempt to make such claim is belied by two key facts. The first is that the LLC made or caused to be made Project mortgage payments during the period in question. In addition, the OIG acknowledges in its draft audit report that "The owner, through its management agent, . . . properly accounted for and paid project operating expenses." OIG Audit Report, p. 7. When all of these matters are given the appropriate consideration and placed within the spectrum suggested by the court in *Cofield*, there is no legal support for a claim of double damages against the principals of the Managing Member. Accordingly, these principals respectfully request that the OIG delete any recommendation that HUD seek the imposition of double damages against them in the final version of the audit report.

If you have any questions regarding the information contained in this letter or you would like to discuss any of these matters further, please feel free to contact me at (213) 542-8082.

On behalf of Fuller Street Development, LLC, and its Managing Member, we thank you and your other colleagues at HUD in advance for your time and thoughtful consideration of the matters discussed in this letter.

Sincerely,



Ted M. Handel
Attorney
Haight Brown & Bonesteel LLP

TH:cad
Attachments
cc: Christian Laettner
Brian Davis
Tom Nieman
Anthony Delfre

OIG Evaluation of Auditee Comments

- Comment 1** We modified the report to reflect that prior to the March 2011 payment, mortgage payments were regularly delinquent, and the consistent rolling default status did not begin until that date. We also noted that section 1 of the regulatory agreement states that “Owners, except as limited by paragraph 17 hereof, assume and agree to make promptly all payments due under the note and mortgage.” The requirement gives no consideration to whether there are available funds to promptly make all payments. In addition, as stated in the report, the owner would have had funds available to make the required mortgage payments had it not elected to improperly repay advances or pay mortgagor legal expenses with project funds.
- Comment 2** A schedule of reserve for replacement account activity provided by the mortgagee showed that as of February 2, 2012, the owner was two months behind on its scheduled deposits. Specifically, the schedule shows that the owner had not made reserve for replacement payments for May 2011 and October 2011.
- Comment 3** While the owner, through its management agent, properly paid expenses necessary to operate the project and maintained its physical condition, the 11 improper advance repayments were detrimental to the project because it was deprived of the funds needed to bring the mortgage current.
- Comment 4** We recognized that the project had experienced periods of less revenue than anticipated; however, we also noted that if the owner had not elected to improperly repay more than \$500,000 in previous advances and pay \$225,000 in unnecessary legal expenses then funds would have been available to bring the mortgage current.
- Comment 5** The report correctly states that the 2011 mortgage refinancing effort failed for the reasons stated. The owner’s comments state that there is a planned cash infusion by a new investor and the owners still plan to refinance the mortgage.

On July 20, 2012, we were informed by HUD that control of L8, LLC, the managing member of Fuller Street Development, LLC, had changed. As part of this change, a new investor provided funds to bring the mortgage and required escrows current as well as fund the unauthorized distributions cited in this report.

- Comment 6** According to HUD Handbook 4370.2, the legal expense account should only be used for fees associated with operating costs such as rental collections, not expenses of the mortgagor. We recognize that while the legal expenses may have been related to the project, they were not a necessary requirement to operate the project. Section 6b of the regulatory agreement requires that all expenses paid from the project be reasonable and necessary to operate the project unless HUD has granted prior written approval for the expense.

- Comment 7** While the Reznick Average Daily Cash Balance report provided as an attachment to the owner's comments made note of the payments made to the owner from the residential and commercial subtenants, this did not necessarily indicate that the funds transferred to the owner actually went towards debt service payments as indicated by the Reznick report. For example, in April 2011, the Reznick report indicated that \$665,019 was transferred from the subtenants to the owner and noted these payments were debt service payments. Upon review of the owners' bank statements, we verified the transfers from the subtenants but determined that only \$359,013 of the \$665,019 actually went towards debt service payments. The remainder was used to repay owner advances and owner legal expenses not necessary to operate the project.
- Comment 8** While the project may not have had prior violations of the regulatory agreement with regard to improper payment of advances, unnecessary legal fees, and delinquent reserve for replacement payments, the project was cited by HUD's Departmental Enforcement Center for failure to timely submit annual audit reports, which is also a violation of the regulatory agreement with HUD.
- Comment 9** Concluding that the LLC derived no benefits from the improper repayment of advances and the unnecessary legal expenses is an inaccurate statement. The improper repayment of advances represents an inflow of cash to the owner in excess of \$500,000, and if the \$225,000 in legal expenses had not been paid from project funds the owner would have had to make the payments from its own funds.
- Comment 10** The improper repayment of advances and the unnecessary legal expenses are both substantial and repeated activities. These activities amount to more than \$700,000 in ineligible expenses, an arguably substantial amount. In addition, the improper repayment of advances took place in 11 transactions over the course of 4 months, and the unnecessary legal expenses took place in 5 transactions over the course of 3 months. The transactions were not only substantial, they were repetitive in nature.

On July 20, 2012, a new investor provided funds to bring the mortgage and required escrows current as well as fund the unauthorized distributions cited in this report. Accordingly, we deleted the recommendation that HUD consider administrative sanctions and civil money penalties against the owner for violating the project's regulatory agreement.