Issue Date
September 26, 2007
Audit Report Number
2007-AT-1011

TO: Dominique Blom, Deputy Assistant Secretary for Public Housing Investment, PI

William H. Melvin, Director, Atlanta Multifamily Property Disposition Center, 4AHMLAT

Henry S. Czauski, Acting Director, Departmental Enforcement Center, CV

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

SUBJECT: The Wilmington Housing Authority, Wilmington, North Carolina, Did Not Follow HUD Requirements for Its Nonprofit Development Activities

HIGHLIGHTS

What We Audited and Why

As part of the U.S. Department of Housing and Urban Development (HUD), Office of the Inspector General's (OIG) strategic plan, we audited the Wilmington Housing Authority (Authority) in Wilmington, North Carolina. Our audit objective was to determine whether the Authority violated requirements when it noncompetitively procured services from its affiliate, Housing and Economic Opportunities, Inc., and whether it returned program income to HUD in accordance with its Up-Front Grant Special Warranty Deed.

What We Found

The Authority did not follow requirements for selection of its affiliated nonprofit entity to be a development partner for two of the Authority's development

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projects. As a result, it inappropriately paid its affiliate more than $296,000 in HOPE VI funds. Also, in violation of its Special Warranty Deed with HUD's Multifamily Property Disposition Center, the Authority inappropriately allowed its affiliate to retain more than $1.2 million in program income it received from home sales.

What We Recommend

We recommend that HUD require the Authority to (1) repay $296,655 from nonfederal funds to its HOPE VI program, (2) implement procedures to ensure that it follows Notice: PIH-2007-15 for transactions with its affiliate, (3) return to HUD $1.2 million in program income received by its affiliate, and (4) implement procedures to ensure that the affiliate recaptures home sales proceeds and returns the appropriate amount to the Federal Housing Administration insurance fund.

We also recommend that the director of the Atlanta Enforcement Center, in coordination with the director of the Multifamily Division, take appropriate administrative action against the Authority and affiliate for not complying with Up-Front Grant Special Warranty Deed requirements.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We discussed the findings with the Authority and HUD officials during the audit. We provided a copy of the draft report to Authority officials on August 21, 2007, for their comments and discussed the report with the officials at the exit conference on August 30, 2007. The Authority provided its written comments to our draft report on September 12, 2007.

The Authority generally disagreed with the findings and recommendations. The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVES

The Housing Authority of the City of Wilmington, North Carolina (Authority), was incorporated on December 9, 1940, pursuant to the North Carolina Housing Authorities Law. The Authority's primary objective is to provide decent, safe, and sanitary housing for eligible families in a manner that promotes serviceability, economy, efficiency, and stability of the projects and the economic and social well-being of the tenants. The Authority administers 1,163 units funded under the public housing program and more than 1,700 housing choice vouchers. A nine-member board of commissioners appointed by the mayor of Wilmington governs the Authority with R.T. Horton, Jr., serving as chairperson. Benjamin Quattlebaum, II, has served as the executive director of the Authority since 2001.

The Authority is the parent company of Housing and Economic Opportunities, Inc., an affiliate corporation organized in 1998 exclusively to develop and operate affordable housing and to promote comprehensive economic development. The affiliate's staff is a mix of employees on loan from the Authority and affiliate employees. The affiliate's board of directors currently consists of eight members from the Authority's board of commissioners and two additional board members not associated with the Authority. The Authority's executive director is the chief executive officer of the affiliate.

In 1996, HUD awarded the Authority a HOPE VI grant to demolish existing structures and develop affordable housing, public housing, and a community center for a project known as Jervay Place. In 2004, HUD awarded the Authority a HOPE VI grant to demolish the Taylor Homes low-income public housing development. The Authority and its affiliate entered into agreements whereby the affiliate acted as developer for each of the projects.

In 2001, HUD sold a foreclosed property, formerly known as Dove Meadows Apartments, to the Authority for $1. HUD also provided the Authority with a $6 million Up-Front Grant to develop 130 single-family homes for the project, now known as Sunset South. The Authority also entered into a memorandum of understanding with its affiliate whereby the affiliate became the developer and was given sole responsibility for all construction of the Sunset South project.

On March 9, 2007, we issued audit report 2007-AT-1004, regarding the Authority's failure to implement adequate internal controls to ensure that program funds were used only for eligible program activities or that costs were properly allocated and supported. As a result of those weaknesses, we decided to review the Authority's development activities with its affiliate. Our objective for this audit was to determine whether the Authority violated requirements when it noncompetitively procured services from its affiliate, Housing and Economic Opportunities, Inc., and whether it returned program income to the U.S. Department of Housing and Urban Development (HUD) in accordance with its Up-Front Grant Special Warranty Deed.

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RESULTS OF AUDIT

Finding 1: The Authority Did Not Follow Federal Regulations for Obtaining Services from Its Affiliate

The Authority did not follow requirements for selection of its affiliated nonprofit entity, Housing and Economic Opportunities, Inc., to be a development partner for two of its development projects. Specifically, the Authority did not properly procure its affiliate for one project and did not document a cost reasonableness analysis and assess the ability of its affiliate to perform as the developer for another project. This occurred because Authority officials incorrectly considered the affiliate to be an instrumentality rather than an affiliate. Thus, they believed that procurement, cost reasonableness analysis, and performance assessments were not required. As a result of the failure to follow requirements, the Authority inappropriately paid its affiliate more than $296,000 in HOPE VI funds.

The Authority Inappropriately Paid $296,655 to Its Affiliate

The provisions of 42 U.S.C. [*United States Code*] 1437k and its implementing regulations, found at 24 CFR [*Code of Federal Regulations*] 943.140, allow the Authority and its affiliate to enter into agreements for services using noncompetitive, sole source procurement. These agreements are considered partnerships or joint ventures between the Authority and its affiliate. Selection of a partner through noncompetitive, sole source procurement is not subject to the federal procurement requirements of 24 CFR Part 85 as long as the Authority conducts and documents a cost reasonableness analysis of its selection and assesses the ability of the selected group to perform.

Mixed-finance projects are subject to 24 CFR 941, subpart F. For mixed-finance projects, the Authority must select a developer/partner based on competitive bidding (24 CFR 85), or qualifications (24 CFR 941.602(d)), or an alternative procurement plan (non-competitive procurement) that has been approved by HUD.

The Authority obtained the services of its affiliate to serve as a development partner for three developments - Jervay Place, Taylor Homes, and Sunset South. It did not follow procurement regulations for any of the three projects. For the Jervay Place and Taylor Homes developments, the Authority inappropriately paid its affiliate $247,744 and $48,911, respectively. For Sunset South, the Up-Front Grant agreement allowed the Authority to use the affiliate as the developer. Finding 2 addresses other issues regarding Sunset South.

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Jervay Place

In 1996, HUD awarded the Authority a HOPE VI grant to demolish existing structures and develop affordable housing, public housing, and a community center. The Authority also utilized funds from sources other than HOPE VI to develop the project, known as Jervay Place, making the project a mixed-finance activity.

The Authority properly procured a developer for the project using competitive bidding and entered into a contractual agreement with the developer. After years of minimal progress, the developer and the Authority agreed to allow the Authority's affiliate to serve as codeveloper. The developer and the affiliate formed a limited liability corporation, whereby the affiliate became a codeveloper.

Phase II of the development, construction of a community center, did not progress in a timely manner. Thus, the Authority elected to remove the developer, with which its affiliate had formed the partnership, from this phase. However, when the Authority released the developer and negated its contract, there was no existing contract between the Authority and its affiliate, only a Memorandum of Understanding. The Memorandum of Understanding between the Authority and affiliate does not comply with the requirements listed in 24 CFR 941, subpart F. A proper contract is required between an Authority and all non-instrumentality development partners.

We do not question non-HUD funds paid to the affiliate by the Authority for the mixed-finance project. However, the $247,744 in HOPE VI grant funds that the Authority paid the affiliate for developer's fees, construction costs, and other services rendered for the community center development is ineligible.

Taylor Homes

In 2004, HUD awarded the Authority a HOPE VI grant to demolish the Taylor Homes low-income public housing development. The Authority's affiliate provided oversight services for the demolition. However, the Authority did not consider cost reasonableness or the ability of the affiliate to perform before obtaining the services as required by 24 CFR 943.140. Thus, the $48,911 that the Authority paid its affiliate for salary expenses, administrative expenses, and developer fees is ineligible.

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Planned Developments Involving the Affiliate

According to its HUD-approved annual plan and its internally generated master plan, the Authority had planned development activities estimated to cost $123 million, of which activities costing approximately $38 million were planned to begin by August 2008. The sources of funds for these planned activities were uncertain. However, it is likely that the Authority's affiliate would be the developer because of a memorandum of understanding between the Authority and its affiliate that gave the affiliate the first right of refusal for all future development activities. The Authority did not have necessary procedures in place to ensure that it followed regulations before hiring its affiliate as the developer. Thus, the Authority needs to implement procedures to ensure that it complies with requirements before it obtains additional services from its affiliate.

Recommendations

We recommend that the Deputy Assistant Secretary for the Office of Public Housing Investment require the Authority to

1A. Repay $247,744 from nonfederal funds to its HOPE VI program, representing ineligible amounts paid to the affiliate for phase II Jervay Place development services.

1B. Repay $48,911 from nonfederal funds to its HOPE VI program, representing ineligible amounts paid to the affiliate for oversight services at Taylor Homes.

1C. Implement procedures to ensure that the Authority follows the requirements of Notice: PIH-2007 – 15 (HA), Subject: "Applicability of Public Housing Development Requirements to Transactions between Public Housing Agencies and their Related Affiliates and Instrumentalities" if it contracts with the affiliate for future development activities.

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Finding 2: The Authority Did Not Follow the Terms of Its Up-Front Grant Special Warranty Deed

In violation of Rider 4 and Rider 5 of the Up-Front Grant Special Warranty Deed, the Authority did not report or return to HUD more than $1.2 million in program income received from home sales.[1] Rather, it allowed its affiliate to retain all of the proceeds. This condition occurred because Authority officials misinterpreted the equity participation restrictions on program income as listed in the Special Warranty Deed. As a result, the funds were not available to the Federal Housing Administration (FHA) insurance fund for future use.

Background

On August 20, 2001, the Authority entered into an agreement with the HUD Atlanta Multifamily Property Disposition Center, whereby HUD sold a foreclosed property, formerly known as Dove Meadows Apartments, to the Authority for $1. The Authority was to demolish the existing structures, rebuild single-family homes, and sell the properties to eligible purchasers. HUD provided the Authority with a $6 million grant to develop 130 single-family homes. The Authority then deeded the property, now known as Sunset South, to its affiliate, Housing and Economic Opportunities, Inc., on March 26, 2003, and provided the affiliate the remaining grant proceeds of approximately $5.3 million.[2] The Authority also entered into a memorandum of understanding with its affiliate on May 12, 2004, whereby the affiliate became the developer and was given sole responsibility for all construction of the Sunset South project. In addition to the grant funds, the affiliate obtained a bank loan for $370,592, borrowed $300,560 against a line of credit, and used more than $14.7 million in home sales proceeds to finance the development. Thus, total funds for the development totaled nearly $21.4 million.

Uses of Funds

As the Authority or affiliate incurred development expenses, it submitted requisition requests to HUD's Atlanta Multifamily Property Disposition Center, listing the actual expenditures and/or invoices due and payable within the next 30 days. The Authority or affiliate drew down the full amount of $6 million. The funds were reportedly used primarily for construction hard costs (more than $5.7 million). A small portion went for building permits ($250,000) and an environmental survey ($5,000). We did not review the costs to determine their validity.

[1] The HUD Multifamily Property Disposition Center awarded the grant using FHA funds. Thus, the Authority should return program income to HUD for deposit to the insurance fund for future use.
[2] The Authority previously used $674,226 of the grant funds for demolition expenses.

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The affiliate used the funds from the bank loan ($370,592) and line of credit ($300,560) to pay for infrastructure, residential development, and related soft costs.

The third source of funding for the development project was the proceeds from the home sales. The affiliate selected a contractor to build the single-family homes. The contractor agreed to build the homes at fixed prices based on the model of the home. The contractor paid all construction costs and was reimbursed by the affiliate for each home as the affiliate sold the home and received the sales proceeds. Generally, the affiliate sold the homes for more than the price charged by the contractor. Gross sales proceeds were more than $14.7 million. In addition to paying the contractor, the affiliate used the sales proceeds to pay off the bank loan and line of credit, pay itself for developer and contingency fees, and pay other development costs.

Sources and Uses of Funds Statement Inaccurate

The affiliate submitted a sources and uses of funds statement to HUD on August 14, 2006, showing funding sources totaling more than $21.2 million. Both the reported sources and their amounts were inaccurate. For example, the affiliate claimed that it received a loan for $8.47 million, which it did not receive. Further, the affiliate did not report any of the $14.7 million in sales proceeds.

The total funds received were nearly $21.4 million, including grant funds, bank loan proceeds, and gross home sales proceeds. The following table shows the reported and actual sources of funds.

Source of funds	Reported	Actual
HOPE VI grant	$ 2,140,000	$ 0
Wilmington Housing Authority	500,000	0
Authority's special projects account	2,229,642	0
Bank loan	8,470,000	0
Bank loan	1,007,012	370,592
Bank loan/line of credit	900,000	300,560
Up-Front Grant	6,000,000	6,000,000
Sales of homes	0	14,724,808
Total	**$ 21,246,654**	**$ 21,395,960**

Upon completion of the development, the affiliate submitted a certificate of actual costs to HUD showing total costs of more than $20.18 million. The difference between actual sources and certified uses equaled $1,209,306 ($21,395,960 -

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$20,186,654). As previously stated, the affiliate used all of the grant funds and paid back the bank loan and line of credit in full. Thus, the net difference of $1,209,306 is attributable to home sales proceeds received by the affiliate.

As part of the property conveyance, HUD and the Authority executed a Special Warranty Deed containing additional requirements and restrictions. Rider 4, paragraph 2, of the deed required that all of the sales proceeds from homes sold within 15 years from the date HUD sold the property to the Authority, less any expenses incurred, be returned to HUD. In violation of the Special Warranty Deed, the Authority inappropriately allowed its affiliate to retain the $1,209,306. The Authority did not follow the deed because it misinterpreted the provision requiring these proceeds to be returned.

Affiliate Allowed to Retain Home Sales Proceeds

Rider 5 of the Special Warranty Deed governed the sale of the homes by the qualified homebuyers. It provided that if a homebuyer sold his/her home within 15 years from the date of the deed, the homebuyer would be required to return a percentage of the sales proceeds, less approved expenses, to the affiliate.[3] If a homebuyer sold his/her home within the first five years, he/she would be required to return 100 percent of any sales proceeds. Paragraph 7 of the Special Warranty Deed provided that 50 percent of all such proceeds must be returned to HUD. During our review period, six homebuyers sold their homes and generated total sales proceeds of $27,405 after deducting allowed expenses. The homebuyers were required to return the $27,405 to the Authority's affiliate, and the affiliate was required to return 50 percent, or $13,702, to HUD. However, the homebuyers only returned $3,681 to the affiliate. None of the proceeds were returned to HUD.

The affiliate did not have adequate procedures to restrict the homebuyers from selling the homes without notifying the affiliate and returning any net sales proceeds. Rather than placing restrictions on the deeds to prevent sales without its knowledge, the affiliate added an addendum to the sales contracts that required the homebuyers to notify the affiliate before selling their homes and to provide a copy of the settlement statement to the affiliate immediately following the sale.

[3] For this purpose, "sales proceeds" is defined as all amounts paid or obligations assumed by the new purchaser of a unit except reasonable transaction costs; purchase price paid by the original qualified homebuyer; and costs incurred by the original qualified homebuyer related to improvements, renovation, and rehabilitation but specifically excluding routine maintenance and repairs.

Recommendations

We recommend that the director of the Atlanta Multifamily Division require the Authority to

2A. Return more than $1.2 million to the FHA insurance fund, representing program income retained from home sales proceeds for the Sunset South development project.

2B. Return $13,702 to the FHA insurance fund, representing sales proceeds received by homebuyers upon sales of their properties.

2C. Implement procedures to ensure that the affiliate recaptures home sales proceeds and returns the appropriate amount to the FHA insurance fund.

We also recommend that the acting director of the Departmental Enforcement Center, in coordination with the director of the Atlanta Multifamily Division,

2D. Take appropriate administrative action against the Authority and affiliate for not complying with Up-Front Grant Special Warranty Deed requirements.

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SCOPE AND METHODOLOGY

Our audit objective was to determine whether the Authority violated procurement regulations when it noncompetitively procured services from its affiliate and whether it returned program income to HUD in accordance with its Up-Front Grant Special Warranty Deed. To accomplish our objective, we

- Reviewed applicable laws, regulations, and other HUD program requirements, including applicable sections of 24 CFR [*Code of Federal Regulations*], 42 U.S.C. [*United States Code*] 1437(k), and HUD Handbook 7460.8.

- Interviewed HUD, Authority, and affiliate management and staff.

- Reviewed various Authority and affiliate documents, including memorandum of understanding agreements, grant agreements, minutes from board meetings, policies and procedures, financial records, and files for each development project.

We conducted our audit from February through June 2007 at both the Authority's and the affiliate's offices in Wilmington, North Carolina. Our audit period was from April 1, 2001, through March 31, 2007. We expanded our audit period as needed to accomplish our objectives.

We performed our review in accordance with generally accepted government auditing standards.

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INTERNAL CONTROLS

Internal control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

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

- Compliance with laws and regulations - Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

- Safeguarding of resources - Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Significant Weaknesses

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

- The Authority did not have procedures to ensure that it followed federal procurement regulations when dealing with its affiliate corporation (finding 1).

- The Authority did not have proper procedures to ensure that the affiliate returned

program income generated from the grant project as required by the Special Warranty Deed (finding 2).

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FOLLOWUP ON PRIOR AUDITS

Office of Inspector General (OIG) audit report 2007-AT-1004, issued March 9, 2007, reported that Authority management failed to implement adequate internal controls to ensure that program funds were used only for eligible program activities or that costs were properly allocated and supported. As a result, in violation of its annual contributions contract with HUD, the Authority inappropriately used $744,916 in operating subsidies to pay expenses of other federal and nonfederal programs. In addition, it could not support that it appropriately spent more than $880,000 in accordance with requirements. The report was issued during our field work; however, we were aware of the weaknesses and considered them in planning and conducting our review. The report contained 20 recommendations, two of which impacted our audit objectives:

1A. Develop and implement procedures which ensure that program funds are used only for eligible program activities.

1I. Exclude all public housing funds from its central account until such time as the director determines that the Authority has adequate internal controls over its cash disbursements.

We agreed with HUD's management decisions on all 20 of the recommendations on June 25, 2007. Fifteen of the recommendations remain open pending completion of corrective actions.

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APPENDIXES

Appendix A

SCHEDULE OF INELIGIBLE COSTS

Recommendation number	Ineligible 1/
1A	$ 247,744
1B	48,911
2A	1,209,306
2B	13,702
Total	$1,519,663

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 polices or regulations.

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Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation | **Auditee Comments**

BENJAMIN J. QUATTLEBAUM, II,
EXECUTIVE DIRECTOR

DEPARTMENTS:

EXECUTIVE
FINANCE
HUMAN RESOURCES
OPERATIONS
RESIDENT SERVICES
SECTION 8
TENANT SELECTION

COMMISSIONERS

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LENWOOD S. "Bo" DEAN, JR. V CHAIRMAN
WINDELL DANIELS
R. T. HORTON, JR
ALFREDIA McDONALD
DEBRA H. QUARANTA
JON VINCENT
LEE D. WEDDLE. SR.

September 12, 2007

Mr. R. J. Dawson, Auditor
U. S. Department of Housing & Urban Development
Asheville Building
1500 Pinecroft Road, Suite 401
Greensboro, NC 27407-3838

Re: Housing Authority of the City of Wilmington, North Carolina (the "WHA")
Housing and Economic Opportunities, Inc. ("HEO, Inc.")

Dear Mr. Dawson:

In response to the O. I. G. Draft Audit Report, dated August 21, 2007, I submit the following responses:

Responses to Finding 1 of the Draft Audit Report dated August 21, 2007 ("Draft Report") prepared by the Office of Inspector General ("OIG"): The Authority did not Follow Federal Regulations for Obtaining Services from its Affiliate

The provisions of 42 U.S.C. [United States Code] 1437k and its implementing regulations, found at 24 CFR [Code of Federal Regulations] 943.140, allow the Authority and its affiliate to enter into agreements for services using noncompetitive, sole source procurement. These agreements are considered partnerships or joint ventures between the Authority and its affiliate. Selection of a partner through noncompetitive, sole source procurement is not subject to the federal procurement requirements of 24 CFR Part 85 as long as the Authority conducts and documents a cost reasonableness analysis of its selection and assesses the ability of the selected group to perform.

The Authority obtained the services of its affiliate to serve as a development partner for three developments – Jervay Place, Taylor Homes and Sunset South. It did not document a cost reasonableness analysis and assess the ability of the affiliate to perform for any of the three projects. For the Jervay Place and Taylor Homes developments, the Authority inappropriately paid its affiliate $247,744 and $48,911, respectively. For Sunset South, the grant agreement allowed the Authority to use the affiliate as the developer. Finding 2 addresses other issues regarding Sunset South.

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Ref to OIG Evaluation | **Auditee Comments**

Comment 1

Response: We believe that Housing and Economic Opportunities, Inc. ("HEO") is a *wholly-owned or controlled subsidiary*, not an *affiliate* of the Authority under 42 U.S.C. 1437k and Subpart C of 24 CFR 943. Notwithstanding the above, we believe that the provisions of 42 U.S.C. 1437k and Subpart C of 24 CFR 943 apply only to HEO's work in the demolition of the Taylor Homes public housing development, and not to its work on the community center for Robert S. Jervay Homes ("Jervay"). We agree with the OIG that the requirements of 24 CFR 943, Subpart C do not apply to Sunset South.

Comment 2

24 CFR 943.140(a) specifically excludes "activities of a PHA that are subject to the requirements of part 941, subpart F, of this title" from the requirements of Subpart C of 24 CFR 943. All phases of the Jervay revitalization are mixed-finance developments subject to the requirements of part 941, subpart F. The Authority properly procured Telesis North Carolina Corporation ("Telesis") to serve as master developer for the Jervay revitalization. Phase II of the Jervay revitalization (the "Project") is a mixed-finance development which consists of one hundred (100) low-income housing tax credit rental units (with seventy-one (71) of the one hundred (100) units being set aside as public housing units) and a community center. Financing sources for the Project include HOPE VI funds, CDBG funds and low-income housing tax credit equity. New Dawson Limited Partnership, the owner of the Project, entered into a development agreement ("Development Agreement") with Telesis and HEO for the development of the Project. Under the Development Agreement, Telesis and HEO would perform certain development services on the Project. When the Authority determined that Telesis failed to make substantial progress on the development of the community center, WHA and Telesis reached an agreement that HEO will complete the construction of community center. HEO received $27,954 in developer fee for completion of the community center from tax credit equity. HEO was properly procured under part 941, subpart F, and the requirements of Subpart C of 24 CFR 943 do not apply to its work on the Jervay community center.

Comment 3

We agree that 24 CFR 943.148(b) applies to HEO's work on the demolition of the Taylor Homes public housing development, and that WHA is required to "maintain documentation that indicates both the cost reasonableness of the selection of HEO and the ability of HEO to perform the demolition." Even though the Authority did not conduct a "formal" cost reasonableness test in the selection of HEO for providing oversight of the Taylor Homes demolition, it did consider the qualifications of HEO (e.g., its involvement in previous development work, the experience of its staff) and the cost reasonableness and benefits in selecting its subsidiary rather than a third party to perform the work. As indicated in our May 9, 2007 letter to Ms. Jerica Hamilton at the OIG, the Authority did not conduct a "formal" cost reasonableness test in the selection of HEO for the Taylor Homes demolition. The letter provided a rationale for determining HEO's ability to oversee the demolition work as well as the basis for the Authority's determination that the compensation paid to HEO on Taylor Homes was well below industry standard. Specifically, the letter stated HEO received a $45,000 fee, which equals 4.1% of the total demolition costs of $1,100,000. Even though a cost reasonableness analysis and assessment of the ability of HEO to perform were not performed formally, it is important to note that the $44,533 fee paid to HEO for the Taylor Homes demolition was used for low-income housing purposes, in accordance with 24 CFR 943.144.

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Ref to OIG Evaluation **Auditee Comments**

Jervay Place

In 1996, HUD awarded the Authority a HOPE VI grant to demolish existing structures and develop affordable housing, public housing, and a community center. To develop the project, known as Jervay Place, the Authority entered into a contractual agreement with a developer After years of minimal progress, the developer and the Authority agreed to allow the Authority's affiliate to serve as codeveloper. The developer and the affiliate formed a limited liability corporation, whereby the affiliate became a codeveloper.

Phase II of the development, construction of a community center, did not progress in a timely manner. Thus, the Authority elected to remove the developer, with which its affiliate had formed the partnership, from this phase. Later, without HUD approval, the affiliate became the sole developer. Further, in violation of requirements, the Authority did not document a cost reasonableness analysis and assessment of the affiliate's ability to perform before allowing the affiliate to act as the sole developer. Thus, the $247,744 in HOPE VI grant funds that the Authority paid the affiliate for developer's fees, construction costs, and other services rendered for the community center development is ineligible.

Comment 2

Response: As stated in our first response, we believe that 24 CFR 943.140(a) specifically excludes the mixed-finance activities of Jervay, including the construction of the community center, from the requirements of Subpart C of 24 CFR 943. We further seek to clarify the description of the relationships between the parties, as well as the events that led to HEO's role in the completion of the community center at Jervay.

As stated above, the Authority procured Telesis to serve as master developer for the Jervay revitalization. The Jervay revitalization including the following phases:

Phase I consists of the construction of fourteen (14) homeownership units. Phase II consists of one hundred (100) low-income housing tax credit rental units (with seventy-one (71) of the one hundred (100) units being set aside as public housing units) and a community center. Phase III consists of forty (40) homeownership units, and Phase V consists of the acquisition of an apartment building with twenty-four (24) off-site rental units.

Telesis completed the construction of fourteen (14) Phase I homeownership units and one hundred (100) Phase II rental units. For the development of the Phase II (the "Project"), New Dawson Limited Partnership ("NDLP"), a North Carolina limited partnership, was formed as owner of the Project. The Managing General Partner for NDLP is New Dawson, LLC (with an affiliate of Telesis and HEO as Co-Managers/Members), and the Investor Limited Partner is AMTAX Holdings. NDLP entered into a development agreement ("Development Agreement") with Telesis and HEO for the development of the Project. Under the Development Agreement, Telesis and HEO will perform certain development services related to the Project. As the development of the community center became "stalled" by Telesis, the Authority reached an agreement with Telesis, as evidenced by Telesis' payment of $261,744 to HEO so that HEO could complete the construction of the community center. HEO received $27,954 in developer fee for completion of the community center from tax credit equity. It is again important to note that the $27,954 fee paid to HEO for the completion of the community center was used for low-income housing purposes.

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Ref to OIG Evaluation	Auditee Comments

Taylor Homes

In 2004, HUD awarded the Authority a HOPE VI grant to demolish the Taylor Homes low-income public housing development. The Authority's affiliate provided oversight services for the demolition. However, the Authority did not consider cost reasonableness or the ability of the affiliate to perform before obtaining the services. Thus, the $48,911 that the Authority paid its affiliate for these services is ineligible.

Comment 3

Response: As stated in our first response, even though the Authority did not conduct a "formal" cost reasonableness test in the selection of HEO for providing oversight of the Taylor Homes demolition, it did consider the qualifications of HEO (e.g., its involvement in previous development work, the experience of its staff) and the cost reasonableness and benefits in selecting its subsidiary rather than a third party to perform the work. The letter dated May 9, 2007 to Ms. Jerica Hamilton provided a rationale for determining HEO's ability to oversee the demolition work as well as the basis for the Authority's determination that the compensation paid to HEO on Taylor Homes was below industry standard. Specifically, the letter stated HEO received a $45,000 fee, which equals 4.1% of the total demolition costs of $1,100,000. Additionally, it is important to note that the $44,533 fee paid to HEO for the Taylor Homes demolition was used for low-income housing purposes, in accordance with 24 CFR 943.144.

We recommend that the Deputy Assistant Secretary for the Office of Public Housing Investment require the Authority to

1A. Repay $247,744 from nonfederal funds to its HOPE VI program, representing ineligible amounts paid to the affiliate for phase II Jervay Place development services.

1B. Repay $48,911 from nonfederal funds to its HOPE VI program, representing ineligible amounts paid to the affiliate for oversight services at Taylor Homes.

1C. Implement procedures to ensure that the Authority follows federal regulations it if contracts with the affiliate for development activities.

Response: As stated above, we believe that 24 CFR 943.148(b) applies only to HEO's work on the demolition of the Taylor Homes, and not to its work on the community center for Jervay. We believe that as the $44,533 fee paid to HEO for the Taylor Homes demolition was properly used for low-income housing purposes, and the "deficiency" in the selection of HEO was procedural (i.e. the lack of formal analysis and documentation), the proposed recommendation should relate to ensuring that the proper procedures are implemented for the selection of the Authority's affiliate, subsidiary or instrumentality to perform various services, and not the payment of $48,911 from nonfederal funds.

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Ref to OIG Evaluation **Auditee Comments**

Responses to Finding 2 of the Draft Audit Report dated August 21, 2007 ("Draft Report") prepared by the Office of Inspector General ("OIG"): The Authority did not Follow the Terms of Its Grant Agreement.

Response: One of your audit objectives was to determine whether Wilmington Housing Authority ("WHA") and its affiliate Housing and Economic Opportunities, Inc. ("HEO") returned program income to HUD in accordance with the Up-Front Grant agreement for the former Dove Meadows property now known as Sunset South ("Sunset South"). The report alleges that WHA and HEO are in violation of its grant agreement with HUD's Multifamily Property Disposition Center, when WHA allowed HEO to retain approximately $1.2 million in program income it received from home sales. Your office states that this condition occurred because WHA officials misinterpreted the Special Warranty Deed restrictions on program income. Specifically, your office references the Special Warranty Deed which transferred the Dove Meadows Apartments from the U.S. Department of Housing and Urban Development ("HUD") to WHA for $1.00 alleging that Paragraph 2 of Rider 4 of the deed required that all of the sale proceeds from homes sold within fifteen (15) years from the date HUD sold the property to the WHA less any expenses WHA and HEO incurred be returned to HUD.

The Report makes reference to the Special Warranty Deed entered into on August 20, 2001 by HUD and WHA ("Deed") as being the source of WHA and HEO's misinterpretation of each entity's ability to keep the sales proceeds from the homes in Sunset South. The Deed includes ten (10) Riders which are incorporated and made part of the Deed. The Report relies specifically on Rider 4, Section 1, the definition of "Sale" which:

shall meet an event when the Purchaser sells, refinances, assigns, transfers or conveys the Property or any portion thereof, other than (1) for homeownership in accordance with this deed, (2) to finance the cost of improvements or repairs to the Property in amounts approved by seller, or (3) to finance the renovation on new construction of rental units (including with tax credits, and whether for families, elderly or special populations) through conveyance to "owner entity" that includes the Purchaser (or an affiliate of the Purchaser) as having a general partner interest or membership interest in such Owner Entity.

This read in connection with Section 2 of Rider 4 which states:

if purchaser conducts a Sale, then the Sale proceeds, less any expenses incurred by the Purchaser, as approved by Seller, consisting of: (1) reasonable transaction costs; (2) purchase price paid by Purchaser for the Property; (3) amounts previously paid by Purchaser to the Seller under Paragraph 3 of this section or (4) other of Purchaser's costs (whether paid or incurred but not paid) related to the construction of improvements, or renovation and rehabilitation, but not including (i) cost of routine maintenance and repairs; or (ii) cost funded by grants provided by seller; shall be assigned to the Seller in the following amounts: (a) between the date of the Deed and 15 years from the date of the deed, 100%; (b) between 15 years, one day and 20 years from the date of this deed, seventy-five (75) percent; (c) between 20 years, one day and 30 years from the date of this deed, 50%; and (d) over 30 years from the date of this deed, twenty-five (25) percent.

Comment 4

Although the Report does not specify what it relies on for its interpretation or why WHA's or HEO's interpretation is misconstrued, based upon a telephone conference on September 5, 2007 with William H. Melvin, Director of the U.S. Department of Housing and Urban Development of the Multi-Family Property Disposition Center in Atlanta and

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Ref to OIG Evaluation | **Auditee Comments**

R.J. Dawson of OIG, it is OIG's position that the language in Section 1 of Rider 4 "other than (1) for homeownership in accordance with this deed" applies to homeownership only as set forth in Rider 5. Rider 5 deals with the language that must be included in the deeds which are issued from WHA/HEO to the end homeowner. This is OIG's position despite the undisputed fact that Rider 5 is never cross-referenced in this portion of Rider 4 when dealing with the definition of "sale" and such cross-references exist with regard to other sections of Rider 4.

Comment 4

It is our position that the transfer of the individual lots to homeowners was exempt from the definition of "sale" and therefore the transfers were exempt from the recapture provision of Section 2 of Rider 4. We reach this conclusion based on the following factors:

1. The definition of "sale" as set forth in Section 1 of Rider 4 is unambiguous.
2. Throughout the entire Deed there are many instances of cross-references from one Rider section to others. This specific section including the definition of "sale" and exemption of sale does not include such a cross-reference.
3. Nowhere in the Deed is there any reference to a mechanism, notice, or inspection with respect to sale proceeds or a timetable for their return to HUD.
4. HUD knew that WHA/HEO had completed the Sunset South project and never required an accounting of the proceeds from the home sales prior to disbursing the remaining grant funds which were in excess of $250,000.
5. Exhibit B which is attached to the Up-Front Grant agreement contains the sources and uses but does not contemplate nor does it include a line item for amounts retained in excess of the purchase price for the sale of homes.
6. At no time prior to the OIG's Report has HUD ever requested an accounting or asked to see the closing statements for the individual lots have been sold and it has been over a year since the last property in Sunset South was sold.

Comment 5

If it is OIG and HUD's position that despite the clear definition of "sale", that the intent of the Deed, in particular Rider 4 is for WHA and HEO to make no profit on the sale of the homes in Sunset South, such language should have been clearly stated on the face of the Deed or in the Up-front Grant Agreement and provided HUD with a mechanism to capture such costs at the completion of the project.. WHA and HEO should not be held responsible for HUD's failure to properly craft the Deed as it had no knowledge of HUD's "intent" with regard to such exemption.

Sincerely,

Benjamin J. Quattlebaum, II
Executive Director

c: Michael A. Williams
Charles S. Pagano

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OIG Evaluation of Auditee Comments

Comment 1 Authority officials stated that they believed Housing and Economic Opportunities, Inc. was an instrumentality of the Authority and not an affiliate.

We used criteria contained in Title 24 [*Code of Federal Regulations*] 811 by which HUD considers an entity to be an instrumentality. The criteria define an instrumentality as a non-profit authorized to work with low-income housing, which has a specified relationship with a governmental entity, the "parent entity PHA," that also works with low-income housing. The regulations go on to state that the parent Public Housing Authority must possess various rights and powers over the instrumentality, including: (1) the power to approve the agency or instrumentality's charter and bylaws; (2) the power to approve its projects, programs and expenditures; (3) a right of access to its books and records; and (4) a right to its real and personal property upon dissolution.

While the relationship with Housing and Economic Opportunities, Inc. satisfies several criteria mentioned above, in our opinion, it does not rise to the level of an agency or instrumentality PHA. Specifically, the entity's Articles of Incorporation did not list the Authority as the recipient of real and personal property upon dissolution. Additionally, the former Director of Housing and Economic Opportunities, Inc. stated on numerous occasions that he believed the entity was an affiliate and that it planned to conduct development work for entities other than the Authority. He said the Authority would not have control over all activities if Housing and Economic Opportunities, Inc. conducted development activities for third parties. Based on the fact that the criteria were not fully met, we consider Housing and Economic Opportunities, Inc. an affiliate of the Authority and not an instrumentality.

After completion of our field work, HUD issued Notice: PIH-2007 – 15 (HA), Subject: "Applicability of Public Housing Development Requirements to Transactions between Public Housing Agencies and their Related Affiliates and Instrumentalities". This Notice provides additional guidance to PHAs to assist them in avoiding violations. The criteria we used during the audit are consistent with the guidance contained in the Notice. However, we incorporated the new Notice in recommendation 1C.

Comment 2 We agree with the Authority's response that Jervay Homes is a mixed-finance project and clarified the finding that these activities are subject to Title 24 CFR 941, subpart F as opposed to 24 CFR 943.

For mixed-finance projects, the Authority must select a developer/partner based on competitive bidding (24 CFR 85), or qualifications (24 CFR

941.602(d)), or an alternative procurement plan (non-competitive procurement) that has been approved by HUD. We agree with the statement that Telesis North Carolina Corporation was properly procured as the developer of the Jervay project using competitive bidding procurement. Furthermore, Telesis partnered with Housing and Economic Opportunities, Inc. to complete phase II of the Jervay project. However, when Telesis's contract was negated and it was released from developer duties, there was no existing contract between the Authority and Housing and Economic Opportunities, Inc. meeting the procurement requirements listed above, only a Memorandum of Understanding. The Memorandum of Understanding between the Authority and affiliate does not comply with 24 CFR 85, 24 CFR 941.602(d), and was not approved by HUD. As an affiliate (see comment 1), a proper contract is required between an Authority and development partners. Thus, we maintain that the affiliate was not properly selected as sole developer and $247,744 in funds paid from the Authority's HOPE VI grant accounts to its affiliate is ineligible.

Comment 3 The Authority did not follow 24 CFR 943.148(b) for noncompetitive, sole source selection of its affiliated nonprofit entity, Housing and Economic Opportunities, Inc., to be a development partner for Taylor Homes. Specifically, it did not complete a formal cost reasonableness analysis and an assessment of the affiliate's ability to perform. The May 9, 2007 letter to HUD-OIG "providing rationale for determining HEO's ability to oversee the demolition work as well as the basis for the Authority's determination that the compensation paid to HEO on Taylor Homes was well below industry standard" does not constitute a formal cost reasonableness analysis or assessment of the affiliate's ability to perform.

The Authority's lack of a cost reasonableness analysis and assessment of the affiliate's ability to perform is more than just a procedural deficiency. As noted previously, Housing and Economic Opportunities, Inc. is an affiliate of the Authority. As such, the Authority was required by federal regulations to conduct proper procurement measures in selecting a project manager for the Taylor Homes project. The applicable federal regulations require either competitive procurement (24 CFR 85.36) or cost reasonableness analysis and assessment of performance (24 CFR 943.148) when selecting an affiliate for development services. The Authority failed to conduct these requirements, thus, it violated federal regulations.

Comment 4 As discussed in the report, our position is based on Riders 4 and 5 of the Special Warranty Deed.

The Authority contended they were exempt from the recapture provisions because Rider 5 was not cross-referenced to the portion of Rider 4 dealing with the definition of "sale."

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We discussed the equity participation riders with the Atlanta HUD Multifamily Property Disposition Center. HUD interprets Riders 4 and 5 of the Special Warranty Deed identically for all Up-Front Grants. HUD explained the intention of Up-Front Grant projects is not for the Authority or its affiliate to profit from home sales of low-income housing or to use home sales proceeds for separate housing projects. Although there is no specific cross reference from Rider 4 to Rider 5, we believe the intent of the riders is clear. Rider 4 is entitled "Equity Participation (Other than Homeownership)." Rider 5 is entitled "Equity Participation for Homeownership Purchasers as Set Forth in Redevelopment Plan”. These titles indicate that Rider 4 diverts requirements dealing with homeownership to Rider 5.

WHA and its affiliate did not list gross home sale proceeds as a source in the final certified source and use statement or indicate that there were net home sale proceeds upon completion of the project. Therefore, HUD did not have a reason to question possible profit from home sales. Our position remains that home sale proceeds should have been returned as required.

Comment 5 We did not question the profit from developer fees, administrative fees, construction manager fees, and contingency fees paid to the affiliate. Our issue concerns home sale proceeds retained by the affiliate that should be returned to HUD as required.

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