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Audit Report Number 2009-NY-1001
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TO: Vincent Hom, Director, Community Planning and Development, 2ADM1

FROM: *Edgar Moore*  
Edgar Moore, Regional Inspector General for Audit, 2AGA

SUBJECT: The City of Newburgh, New York, Needs to Make Improvements in Administering Its Section 108 Loan Guarantee Program

## **HIGHLIGHTS**

### **What We Audited and Why**

We audited the City of Newburgh, New York's (City) administration of its Section 108 Loan Guarantee program. We selected the City for review based upon previous U.S. Department of Housing and Urban Development (HUD) on-site monitoring reviews and indicators from our internal audit of HUD's monitoring of the Community Development Block Grant (CDBG) program, which identified concerns with the City's administration of its various programs. The objectives of our audit were to determine whether the City ensured that (1) Section 108 loans and related activities were administered in compliance with CDBG program objectives and (2) subsequent CDBG funds used for Section 108 loan repayments were necessary, reasonable, and in accordance with all applicable contracts, agreements, and federal regulations.

### **What We Found**

Contrary to the loan agreement and regulations, the City failed to ensure that all Section 108 Loan Guarantee funds and related project costs pertaining to the Front Street Marina redevelopment project were proper, necessary, and fully supported. Specifically, the City (1) failed to enforce loan agreement provisions and adequately pursue loan collateral to satisfy the debt, (2) did not ensure that all funding sources were supported and documented, (3) unnecessarily used CDBG funds to repay the loan and deprived its activity from receiving program income,

and (4) overpaid the developer for duplicate costs. These issues occurred because the City failed to properly administer its Section 108 loan program by not ensuring that all costs incurred were proper and in accordance with the Section 108 agreements. As a result, the City's CDBG program was deprived of funds that could have been used for other activities, and Economic Development Initiative (EDI) funds were improperly expended. Thus, the CDBG program will be hindered from effectively using future CDBG funds to provide maximum benefit to low- and moderate-income residents.

In addition, the City did not achieve the primary objective of job creation for the industrial park project, loan proceeds remained unused in a bank account for more than seven years, possible collateral or program income for loan repayment was not pursued, and the City did not ensure that the industrial site was feasible for commercial development and job creation. As a result, the failure of the industrial park project had and will continue to have a large negative impact on the City's CDBG program, as CDBG funds were used to repay the Section 108 debt and additional CDBG funds were scheduled to retire the debt.

### **What We Recommend**

We recommend that the Director of HUD's New York Office of Community Planning and Development instruct the City to (1) enforce the loan provisions on the marina redevelopment project within 90 days or reimburse the CDBG program from nonfederal funds the \$449,817 used for debt repayment, (2) take appropriate actions against the marina developer and ensure that nonfederal funds are used to repay the remaining \$1.3 million in future loan obligations, (3) reimburse the EDI program from nonfederal funds the \$144,341 paid for ineligible duplicate costs, (4) establish a plan for the industrial park site within 90 days or reimburse the CDBG program from nonfederal funds the approximate \$1.8 million used for debt repayment, and (5) reprogram the approximate \$1.7 million in CDBG funds currently scheduled to be used for future repayments of the industrial park project loan.

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 results of our review during the audit, provided a copy of the draft report to City officials, and requested their comments on August 11, 2008. We held an exit conference on September 3, 2008, and City officials provided their written comments on September 12, 2008, at which time they generally disagreed with our findings. 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**

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The Section 108 Loan Guarantee program is the loan guarantee provision of the Community Development Block Grant (CDBG) program. Section 108 loans provide grantees with a source of financing for economic development, housing rehabilitation, public facilities, and large-scale physical development projects. The principal security for the loan guarantee is a pledge by the applicant public entity of its current and future CDBG funds. Additional security can also be required to assure repayment of guaranteed obligations. The additional security requirements are determined on a case-by-case basis but could include assets financed by the guaranteed loan.

For purposes of determining eligibility, the CDBG rules and requirements apply. As with the CDBG program, all projects and activities must meet the CDBG's primary objective, which is that 70 percent of the funds used must benefit low- and moderate-income persons and one of the following three national objectives: (a) principally benefit low- and moderate-income persons, (b) assist in eliminating or preventing slums and blight, or (c) assist with community development needs having a particular urgency. Section 108 guaranteed loans may be for terms up to 20 years.

Section 108 guaranteed loan commitments can be paired with U.S. Department of Housing and Urban Development (HUD) Economic Development Initiative (EDI) grants, which are grants that directly enhance the security of Section 108 guaranteed loans or improve the viability of the same Section 108-assisted project. EDI grants can be used to pay predevelopment costs of a Section 108-funded project. EDI grants enable localities to carry out eligible economic development activities in which public and private dollars can be leveraged to create jobs and other benefits, especially for low- and moderate-income persons, and reduce the risk of potential future defaults on Section 108 loan guarantee-assisted projects. Section 108 and EDI funds must assist with the same project.

The City of Newburgh, New York (City), is a CDBG entitlement recipient that has applied for and received several Section 108 guaranteed loans to pursue physical and economic revitalization projects. The two major Section 108 guaranteed loans reviewed during our audit were primarily for economic development projects with the goal of job creation, including a marina project consisting of both Section 108 loan and EDI funding. The files and records related to the City's Section 108 Loan Guarantee program are maintained in City Hall, located at 83 Broadway, Newburgh, New York.

We audited the City's Section 108 Loan Guarantee program based upon previous HUD on-site monitoring reviews and indicators from our internal audit of HUD's monitoring of the CDBG program (Report No. 2008-NY-0001, issued December 31, 2007), which identified concerns with the City's administration of the CDBG program. The objectives of our audit were to determine whether the City ensured that (1) Section 108 loans and related activities were administered in compliance with CDBG program objectives and (2) subsequent CDBG funds used for Section 108 loan repayments were necessary, reasonable, and in accordance with all applicable contracts, agreements, and federal regulations.

## RESULTS OF AUDIT

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### Finding 1: The City Failed to Properly Administer Its Section 108 Loan for the Front Street Marina Project

Contrary to the loan agreement and regulations, the City failed to ensure that all Section 108 Loan Guarantee funds and related project costs pertaining to the Front Street Marina redevelopment project were proper, necessary, and fully supported as required. Specifically, the City (1) failed to enforce loan agreement provisions and adequately pursue loan collateral to satisfy the debt, (2) did not ensure that all funding sources were supported and documented, (3) unnecessarily used CDBG funds to repay the loan and deprived its activity from receiving program income, and (4) overpaid the developer for duplicate costs. We attribute these issues to the City's failure to properly administer its Section 108 loan program by not ensuring that all costs incurred were proper and in accordance with the Section 108 loan agreements. As a result, the City was deprived of CDBG funds that could have been used for other activities within the City, and EDI program funds were improperly used to pay for costs already paid for with Section 108 funds. Thus, the City's CDBG program was negatively impacted and will continue to be hindered from effectively using future CDBG funds to provide maximum benefit to low- and moderate-income residents.

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#### Section 108 Loan Guarantee Application and Agreement

In November 2000, the City formally applied for a \$ 1 million Section 108 guaranteed loan for the Front Street Marina redevelopment project. The City had already received preliminary approval for a \$500,000 EDI grant to be combined with the Section 108 loan to assist with the marina project and related improvements. The total \$1.5 million in HUD funding was loaned to a private developer for the development and construction of a 60-foot pier, a 72-slip marina (accommodating 144 boats), improvement of the municipally owned Newburgh Landing, and shoreline stabilization improvements. Although the entire Marina redevelopment project was to cost \$2.85 million, the \$1.5 million in HUD funds were intended to be repaid to the City by the developer. The sources and uses of the funds for the total project were as follows:

<u>Sources of funds:</u>	
Section 108 loan	\$ 1,000,000
EDI grant	500,000
Clear Air/Water grant	450,000
State of New York (grant)	150,000
City of Newburgh (grant)	450,000
Equity	<u>300,000</u>
Total	<u>\$2,850,000</u>

<u>Uses of funds:</u>	
Utilities	\$ 169,500
Pier construction	100,000
Marina installation	820,500
Site work	290,000
Walkway	900,000
Soft costs	300,000
Newburgh Landing improv.	150,000
General costs-overhead/ profit	<u>120,000</u>
Total	\$2,850,000

In August of 2002, HUD and the City executed the contract for the \$1 million loan under the Section 108 Loan Guarantee program and \$500,000 in EDI grant funds. Key provisions of the agreement included that the City, to secure payment and performance of the secured obligations of the developer (obligor), would obtain the following collateral:

- A second lien on the landside property and a first lien on the submerged property.
- All rights, titles, and interests of the developer to any leases covering the properties.
- A personal guaranty from the developer of all payments due under the note.

Further, the contract provided that a default under the note and contract would occur upon failure by the borrower to pay when due an installment of principal or interest on the note or failure to punctually and properly perform, observe, and comply with any covenant, agreement, or condition contained in the contract, security agreement, deed of trust, mortgage, assignment, guarantee, or other contract securing payment of indebtedness evidenced by the note.

### **Loan Agreement and Mortgage for \$1.5 Million with Developer**

Also in 2002, the City and the developer executed the \$1.5 million loan agreement and related mortgage and note. Key provisions of these agreements included

- No disbursements of loan proceeds were to be made by the City until the developer had expended or deferred not less than \$300,000 in equity funds for eligible project costs. In addition, if total costs were less than the

\$2.85 million, the Section 108 and EDI loans would be reduced proportionately on a ratio of 2 to 1 by \$1.00 for each \$1.00 of such shortfall.

- The term of the \$1.5 million was for 10 years and was to commence no later than December 31, 2002.
- Within 90 days after the end of each fiscal year, the developer would deliver to the City, as attested to by a certified public accountant, (1) operating income and receipts from the marina, (2) a statement of net annual cash flow, and (3) a statement of the developer's equity.
- Principal and interest would become due at the option of the City after default in the payment of any installment of principal or of interest for 30 days after notice and demand.
- Under a default, the City had the right to enter upon and to take possession of the premises for the purpose of collecting the indebtedness and to let the premises or any part thereof and apply the rents and profits after payment of all necessary charges and expenses on account of such indebtedness.

### **Loan Agreement Provisions Not Enforced**

Despite the above requirements, the City failed to abide by and enforce the various contracts and agreements pertaining to the Front Street Marina redevelopment project completion and repayment of the loan. After receipt of the loan proceeds that were to be used to complete the Marina project, the developer (borrower) was required to begin making monthly loan payments in January 2003. However, monthly loan payments were never made, and the City failed to take effective action to remedy the situation. The first notification of overdue loan payments was not made until December 2005, more than two years after repayment was to begin. In addition, the notices sent to the developer contained inaccurate and incomplete loan repayment request information. Moreover, the City failed to declare the loan to be in default, although more than two years had passed since the first payment was due. Finally, the City failed to request financial statement information from the developer as required by the loan agreement. Specifically, in November of 2006, the City advised the developer that \$175,000 was due and payable for years 2004 through and 2006. However, the letter sent was inaccurate as to the amounts owed and did not formally declare the loan in default, although no payments had been made in nearly four years.

In March 2007, the City's corporation counsel declared the developer to be in default. However, although the developer was more than four years behind in loan payments, the City did not demand that the total loan be repaid. The City

calculated that the total back interest and principal owed was \$559,855 and demanded this payment by April 1, 2007. The City also requested that the developer provide the certified financial statements by April 1, 2007, for each fiscal year since 2003. However, the financial statements were not provided.

In July of 2007, the City informed HUD that the first payment of \$27,500 was received in May 2007; however, the City did not mention that the full payment due was \$46,250. The City also informed HUD that the next payment was due in July, although the July payment date agreed to by the developer was already past due. In addition, the City informed HUD that annual audited financial statements were requested from the developer and should be received by August 2007, which was later than expected. Consequently, the City did not properly enforce the loan provisions with the marina developer.

In December 2007, the City's corporation counsel informed the developer that failure to either repay the loan by December 31, 2007, or the outstanding balance by January 2, 2008, would mean that the loan was in default and that the City would be left with no further recourse but to pursue legal action to secure these funds. The City's corporation counsel did not provide an extension to this timeframe or a reconsideration of the terms. In March 2008, the City decided to enforce its rights and pursue the collateral specified under the loan agreement. A certified letter was sent to the developer demanding full payment of approximately \$1.8 million for the Front Street Marina project.

The City's lack of timely and effective action in pursuing all remedies available to enforce the loan provisions, such as aggressively pursuing the loan collateral, allowed the project loan to remain unpaid for more than five years. As a result, the City elected to use its CDBG funding to make the Section 108 loan payments that were required to be made by the developer.

### **Funding Sources Not Supported and Documented**

A review of the available documentation to support the approximate \$2.85 million in costs related to the Front Street Marina Redevelopment disclosed that the City did not maintain evidence that the developer provided the \$300,000 in required equity funds or that any of the other funding sources were provided before it disbursed the \$1.5 million in Section 108 and EDI funds to the developer. Therefore, the City did not ensure compliance with the loan provisions requiring developer equity and that the Section 108 and EDI loans would be reduced proportionately on a ratio of 2 to 1 by \$1.00 for each \$1.00 of any shortfall in leveraged funding. This condition represents another example of the City's not ensuring that its Section 108 loan program was administered in accordance with all requirements. As a result, the City had no assurance that the total required funding of \$2.85 million was invested in the marina redevelopment project and that the use of the \$1.5 million in HUD funds was necessary and appropriate.



## **CDBG Program Harmed and Program Income Not Realized**

Through February 2008, the City expended at least \$449,817 in CDBG funding to repay Section 108 loan obligations. Although Section 108 loan payments are guaranteed with CDBG funding, the use of the CDBG funding for this purpose is not reasonable or necessary. CDBG regulations at 24 CFR (*Code of Federal Regulations*) 85.22 provide cost principles for determining allowable costs. Specifically, to be allowable under federal awards, costs must be necessary, reasonable, and adequately documented. The City's failure to enforce the loan provisions resulted in the unnecessary and unreasonable use of CDBG funds to repay the project debts.

According to City officials, the Front Street Marina project was operational and successful. Our recent inspection of the marina confirmed that it was open for the season and appeared to be successful as shown in the photographs of the waterfront below.



However, the failure of the City to adequately pursue and enforce collateral agreements with the developer caused the loss of CDBG funding. In addition, the City was deprived of the approximately \$600,941 (\$500,000 EDI loan to developer + \$100,941 in interest) in program income resources that would be available from EDI loan repayments from the developer. Further, the CDBG program will continue to be negatively impacted in the future from the Section 108 loan defaults. Future Section 108 loan debt payments will require \$865,968 in additional CDBG funds unless the City takes legal action to pursue the loan collateral.

### **Duplicate Project Costs Overpaid**

In addition to the above, the City's procedures for reviewing expenditures did not ensure that adequate supporting documentation was submitted and did not prevent double payments for certain costs. A payment of \$144,341 in EDI funds made on December 2, 2002, represents a duplicate payment for costs already claimed for a vendor and paid with Section 108 loan funds. The voucher and attached statement from the vendor showed a final balance due of \$144,341. However, the previous payment in Section 108 loan funds to the developer was also listed as payment in full to this vendor. Accordingly, the \$144,341 overpayment is considered ineligible under program requirements and should be repaid. Thus, the repayment of the \$144,341 overpayment would be considered program income to the City and the remaining balance due from the EDI loan would be \$456,600 (\$600,941-\$144,341).

### **Conclusion**

The City failed to properly administer the Section 108 guaranteed loan for the Front Street Marina redevelopment. While the marina project appeared to be successful, the City failed to adequately pursue and enforce the loan and collateral agreements with the developer to repay the \$1.5 million in HUD funding. In addition, the City did not ensure that all \$2.85 million in funding sources was provided and adequately supported. Also, the City unnecessarily used \$449,817 in CDBG funds to repay the loan and deprived its activity of \$600,941 in program income. Therefore, the City's CDBG program will continue to be negatively affected, as future Section 108 loan debt will require \$865,968 in additional CDBG funds. Further, the City overpaid the developer \$144,341 in federal EDI funds for duplicate project development costs. We attribute these issues to the City's failure to properly administer its Section 108 loan program. Thus, the City's lack of proper oversight on the marina redevelopment project impacted its CDBG program, which will continue to be negatively affected if the City continues to use CDBG funds rather than pursue repayment from the developer or use nonfederal funds to repay the Section 108 guaranteed loan. Consequently, the

City's ability to provide maximum benefit to low- and moderate-income residents was hindered.

## Recommendations

We recommend that the Director of HUD's New York Office of Community Planning and Development instruct the City to

- 1A. Enforce the loan provisions on the Front Street Marina within 90 days and reimburse the CDBG program from nonfederal funds the \$449,817 used for Section 108 debt repayment.
- 1B. Provide HUD with evidence that all funding sources for the Front Street Marina project have been received or reduce the Section 108 and EDI loans proportionately and repay the funds to HUD.
- 1C. Take appropriate action against the developer and ensure that nonfederal funds are used to repay HUD the \$1,322,568 in future Section 108 program loan obligations (\$865,968 due for the Section 108 loan and \$456,600 due for the EDI loan) so that future CDBG funds can be safeguarded and put to better use.
- 1D. Reimburse HUD from nonfederal funds the \$144,341 related to the ineligible duplicate payments paid to the developer for marina-related expenses.
- 1E. Implement policies and procedures to ensure that all future Section 108 projects are administered in accordance with all approved applications, loan agreements, and program requirements.

## Finding 2: The City’s Crystal Lake Project Remained Incomplete and Failed to Achieve Program Objectives

The City did not complete a \$2.13 million Section 108 Loan Guarantee project to facilitate a proposed light industrial park area known as Crystal Lake. The industrial park improvements were not completed, and the primary objective of job creation was not realized. Also, \$652,800 in Section 108 loan proceeds remained unused in a bank account for more than seven years, which was contrary to the Section 108 loan contract. In addition, the City did not pursue possible collateral or program income to use for Section 108 loan repayments as required by the loan application and contract agreement with HUD. We attribute these conditions to the City’s inadequate administration of its Section 108 loan program. Specifically, the City did not (1) ensure that the commercial site was feasible for commercial development and job creation, (2) amend its Section 108 loan program to reduce the funds needed, and (3) pursue collateral or program income for loan repayment. As a result, the failure of the industrial park project had and will continue to have a large negative impact on the City’s CDBG program, as at least \$1.8 million in CDBG funds was used to repay the Section 108 debt and an additional \$1.7 million in CDBG funds was scheduled to retire the debt. Thus, not only were the objectives of the Section 108 loan program not met, but also the CDBG program and its intended benefit to low- and moderate-income residents will be deprived of approximately \$3.4 million.

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### Background

In March 1999, the City applied for approximately \$2.13 million in Section 108 Loan Guarantee assistance, which was approved in May of 1999.<sup>1</sup> Approximately \$1.6 million was targeted to be used for infrastructure improvements, including water, sewer, power, and street reconstruction, along Temple and Ellis Avenues leading to the Crystal Lake industrial park site. This portion of the Section 108 loan proceeds was to meet the local and national objective of benefiting low- and moderate-income persons by facilitating commercial development that would create job opportunities.

### Industrial Park Incomplete and Not Feasible for Future Development

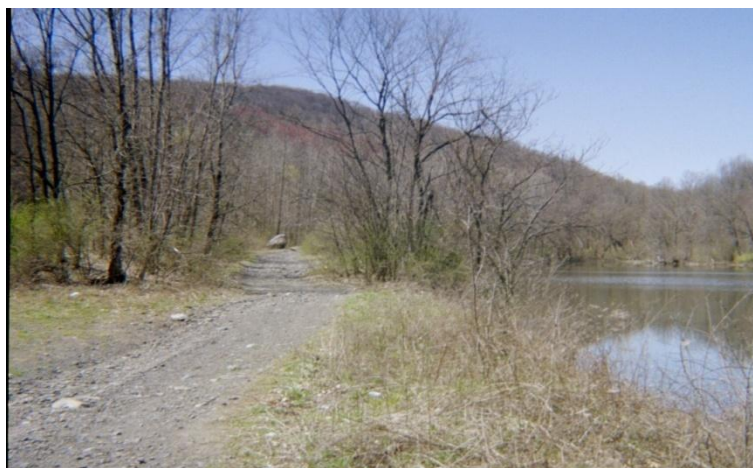
Of the approximately \$1.6 million in Section 108 loan proceeds targeted for infrastructure improvements to the Crystal Lake industrial park area, the City had only expended \$911,330 for the reconstruction of existing streets leading to the Crystal Lake area. According to City officials, the project was to be suspended

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<sup>1</sup> The approximate \$2.13 million in Section 108 Loan Guarantee assistance consisted of \$550,000 to purchase an aerial ladder fire truck for the city fire department and approximate \$1.6 million for the improvements to the Crystal Lake industrial park area.

until a suitable commercial developer could be identified. In the meanwhile, the City had been unable to attract development proposals and attributed the project's failure to the difficulty of designing and constructing commercial buildings on the narrow parcels of land wedged between the lake and a hilly area known as Snake Hill. As a result, the primary objective of job creation had not been realized.

Our inspection of the proposed commercial site confirmed the City's concerns that the area was not feasible for commercial development. There was no road access, and the land tract was very narrow along the lake area. The photograph shown below was taken from the entry area of the proposed industrial park site and reflects the status of the site.



The City did not adequately consider the difficulty of developing the Crystal Lake area before securing the Section 108 Loan Guarantee funds. Once the loan was received, the City proceeded to expend \$911,330 on existing infrastructure and street improvements but did not pursue completion of the industrial park development and did not expend the remaining available Section 108 loan funds of \$652,800. The partial work was completed years ago; however, the site remained undeveloped.

**Section 108 Loan Proceeds  
Unexpended in Violation of Loan  
Agreement**

The contract for the Section 108 Loan Guarantee assistance required that all of the Crystal Lake loan funds be withdrawn and disbursed by the City for approved activities by June 1, 2001. Any funds remaining after June 01, 2001, were to be transferred to an established loan repayment account. Despite this requirement, the City maintained unused Section 108 loan proceeds totaling \$652,800 in the

project bank account for more than seven years. The City did not have plans to use the funds to complete the project.

Instead of using the \$652,800 in unused proceeds to reduce the Section 108 loan debt, the City used more than \$1.7 million in CDBG funds to make the scheduled loan repayments. Including interest, the project bank account contained more than \$752,302. As a result, since the City did not plan to use these funds, the unused loan proceeds should be reimbursed to the CDBG program.

### **Collateral or Program Income to Repay Section 108 Loan Debt Not Pursued**

The City did not provide evidence that collateral or other sources of income were pursued or used to repay the Section 108 loan debt. Instead, the City used CDBG funds to make all of the Section 108 loan debt repayments. Although the City was not able to adequately account for all of the payments, at least \$1.7 million in CDBG funds had been expended. Future debt payments will require the use of nearly \$1.7 million in CDBG funds unless alternative methods of loan repayments are pursued.

Regulations at 24 CFR 85.22 provide that to be allowable under federal awards, costs must be necessary, reasonable, and adequately documented. Since the City did not complete the project as described in its approved funding application and did not pursue available collateral or sources of program income as required, the use of CDBG funds is considered unreasonable and unnecessary.

### **Conclusion**

The failure of the City to adequately plan, execute, and complete the Crystal Lake industrial park project as agreed upon in the approved Section 108 Loan Guarantee application had a large negative impact on the City's programs. The commercial site was not completed, and no job creation opportunities were realized. Moreover, several years later, the site remained virtually unusable for practical development and no collateral or sources of program income had been pursued to repay the Section 108 loan. We attribute these issues to the City's not having policies and procedures to ensure that Section 108 loan activities are administered in accordance with all program requirements. As a result, at least \$1.7 million in CDBG funds was used to repay the Section 108 debt, and nearly \$1.7 million in CDBG funding will be required to retire the debt. Therefore, not only were the objectives of the Section 108 Loan Guarantee program not met, but the CDBG program and its intended benefit to low- and moderate-income residents will be deprived of approximately \$3.4 million in needed CDBG funds. Accordingly, the use of the \$1.7 million in CDBG funds is considered unreasonable and unnecessary, and the future scheduled use of nearly \$1.7 million

in CDBG funds to retire this debt should be reprogrammed for other CDBG-eligible activities.

## Recommendations

We recommend that the Director of HUD's New York Office of Community Planning and Development instruct the City to

- 2A. Reimburse the CDBG program, from nonfederal funds, the \$752,302 in unused Section 108 funds to reduce the CDBG funds already used to repay part of the Section 108 loan.
- 2B. Establish a plan for the Crystal Lake industrial park site within 90-days or reimburse the CDBG program from nonfederal funds the \$1,002,849 used to repay the Section 108 loan debt (\$1,755,151 less \$752,302 in unused Section 108 funds and interest).
- 2C. Pursue the loan collateral or sources of program income and use those funds to repay the \$1,690,177 required for future Section 108 loan repayments. This would allow the City to reprogram the \$1,690,177 in CDBG funds scheduled to be used for future repayments of the industrial park project loan and put these funds to better use for other CDBG-eligible activities.
- 2D. Establish and implement policies and procedures to ensure that all future Section 108 projects are administered in accordance with all approved applications, loan agreements, and program requirements.

## SCOPE AND METHODOLOGY

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Our review focused on whether the City complied with applicable HUD regulations and all related contracts and agreements pertaining to the administration of two Section 108 loans. To accomplish our objectives, we reviewed relevant HUD regulations, contracts, and agreements. In addition, we reviewed the City's policies, procedures, and related agreements and interviewed key personnel responsible for administration of the City's Section 108 Loan Guarantee program and related CDBG activities.

For fiscal years 1999 through 2007, the City received a total of \$3,125,000 in Section 108 loan funding authority and \$500,000 in related EDI funding. At the time of our review, the City had expended \$2,472,200 on Section 108 loan activities consisting of the marina and industrial park projects. The City had also expended the \$500,000 in EDI funding for the marina project. We reviewed the Section 108 loan and EDI expenditures and related supporting documents for the activities to determine whether the expenditures met Section 108 and CDBG requirements, were reasonable, and complied with all agreements and contracts. We examined the City's internal controls over its Section 108 Loan Guarantee program. We also conducted site visits to each project to review the progress of the activities.

The review covered the period January 1, 2005, through December 31, 2007, and was extended as necessary. We performed audit work from December 2007 through May 2008 at the City's offices in Newburgh, New York. The review was conducted in accordance with generally accepted government auditing standards.



# INTERNAL CONTROLS

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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.

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## Relevant Internal Controls

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

- Program operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.
- Validity and reliability of data – Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.
- Compliance with 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 City did not have adequate controls over its program operations when it did not implement adequate procedures to ensure that its Section 108 Loan Guarantee program would meet all program objectives (see findings 1 and 2).
- The City did not have adequate controls over the validity and reliability of data pertaining to the Section 108 loan repayments related to the marina project, as the supporting documentation was found to be incomplete and unreliable (see finding 1).
- The City did not have adequate controls over compliance with laws and regulations, as it did not always comply with HUD regulations while disbursing Section 108 and CDBG funds (see findings 1 and 2).
- The City did not have an adequate system to ensure that resources were properly safeguarded when ineligible and unsupported costs were charged to the program and when it did not maintain adequate supporting documentation (see findings 1 and 2).

## APPENDIXES

### Appendix A

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

Recommendation number	Ineligible 1/	Unsupported 2/	Funds to be put to better use 3/
1A	\$449,817		
1C			\$1,322,568
1D	\$144,341		
2A			752,302
2B		\$1,002,849	
2C			\$1,690,177
Total	\$594,158	\$1,002,849	\$3,765,047

- 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.
- 2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.
- 3/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. This includes reductions in outlays, deobligation of funds, withdrawal of interest subsidy costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings which are specifically identified. In this instance, if the City implements our recommendations of taking appropriate action to collect on future loan obligations and reprogramming funds targeted to repay future loan obligations, CDBG funds can be used for other eligible activities, thus ensuring a cost savings to its CDBG program.


## Appendix B

# AUDITEE COMMENTS AND OIG'S EVALUATION

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### Ref to OIG Evaluation

### Auditee Comments

	<h2>CITY OF NEWBURGH</h2> <hr/> <p>OFFICE OF THE CITY MANAGER City Hall - 83 Broadway, Newburgh, New York 12550 <a href="http://www.cityofnewburgh-ny.gov">www.cityofnewburgh-ny.gov</a></p>	<p><a href="mailto:jmcgrane@cityofnewburgh-ny.gov">jmcgrane@cityofnewburgh-ny.gov</a> Phone: (845) 569-7301 Fax: (845) 569-7370</p>
<p>Jean-Ann McGrane, Esq., M.S. City Manager</p>		
<p>September 12, 2008</p>		
<p>Mr. Edgar Moore Regional Inspector for General Audit U.S. Department of Housing &amp; Urban Development NYS Office Jacob K. Javits Federal Building 26 Federal Plaza, Suite 3430 New York, NY 10278</p>		
<p>RE: City of Newburgh Section 108 Audit Report Report No. 2008-NY-10XX</p>		
<p>Dear Mr. Moore:</p>		
<p>This letter is in response to your Draft Section 108 Audit Report Number 2008-NY-10XX dated August 11, 2008. The several matters addressed in the Audit Report will be referenced herein according to the Finding and page numbers used in the Report.</p>		
<p>We request that you give due consideration to the various points identified and discussed in this response letter, and consider re-drafting the report with appropriate modifications in keeping with the City's responses. We further request that the report be re-drafted such that its findings conform to the Government Auditing Standards as issued by the Office of the Comptroller General of the United States. Among other provisions, these standards require references to the following:</p>		
<p><u>Criteria:</u> laws and regulations, policies, directives, advisory statements and aspects of the COSO Framework concerning deficiencies, material deficiencies and/or significant systems weaknesses as defined and implemented according to audit guides used by OIG;</p>		
<p><u>Conditions:</u> how and to what degree were errors and/or deficiencies quantified in terms of identification of each, number of times occurring, dollar costs attributable to such, etc.</p>		
<p><u>Causes:</u> what were the causes of such errors and/or deficiencies?</p>		

### Comment 1

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**Comment 1**

Effects: what effects resulted from such errors and/or deficiencies?

Recommendation: what guidance is offered to amend policies and procedures to prevent and detect instances or the potential for future non-compliance and to institute appropriate controls and best practices?"

Finding 1: The City Failed to Properly Administer its Section 108 Loan for the Front Street Marina Project

- (1) The City failed to enforce loan agreement provisions and adequately pursue loan collateral to satisfy the debt.

City Response:

**Comment 2**

The City has commenced a lawsuit in Supreme Court, Orange County, New York as of August 26, 2008 against Marina Ops to enforce loan agreement provisions and seek to collect and satisfy the debt. The City has the authority and opportunity to bring this action under several different theories of law and causes of action. After careful consideration, the City has brought the action in a form which maximizes the ability and opportunity for the City to proceed against the property of the defendant including but not limited to the project property and other assets. The objective of this strategy is to maximize the extent to which full value of both the loan and the collateral may be recovered.

**Comment 2**

Prior to instituting this action, the City pursued its remedies by employing methods which are consistent and harmonious with principles of standard commercial dealings of this kind. Such methods include formal demands, proposed payment plans and schedules, negotiations of terms and others. These efforts are consistent with the standards set forth in Federal laws and rules. (See Title 24 Housing and Urban Development Part 85 Section 22 et seq. and OMB Circular A-87 at Section 3b.) Other efforts having failed, the City has commenced the appropriate legal action. The recommendation that such action be undertaken has already been satisfied.

**Comment 3**

There were several references in the Draft Report to the amount that Marina Ops was required to pay. This is not accurate. While the entire project total was \$2.85 Million as stated in the Report, that total included funds provided to and by the City of Newburgh itself to be expended on a public shoreline walkway and Newburgh Landing, a City-owned facility. The more accurate figure which represents the loan to Marina Ops is \$1.5 Million. Also, the language of the Draft Report on pages 5 and 6 seems to overlook or ignore that the City did get a personal guarantee from the developer. It is this guarantee which is the basis of the legal action brought by the City. Such guarantees are a component of standard business practice and comply with the standards found in OMB Circular A-87 referenced above.

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**Comment 4**

- (2) The City did not ensure that all funding sources were supported and documented.

City Response:

The City has supported and documented all funding sources, in harmony with applicable Federal law and rule.

The multi-jurisdictional economic development initiative known as "Hudson River Partnership 2000" that jointly applied for EDI assistance was intended to "foster regional economic development for our citizens, encourage river town revitalization and increase public waterfront access in critical locations within the recently designated Hudson River Heritage Area." For this reason the City of Newburgh's participation in this application included public improvements to its shoreline and primary public space on the waterfront, Newburgh Landing Park. To date, the City of Newburgh has expended \$918,000 on shoreline stabilization and the construction of a riverfront walkway and \$597,038 on improvements to Newburgh Landing Park, including repairs to the park's dock and the construction of new restroom facilities. The two projects were funded, in part, by two separate grants from New York State, matched with an equal amount of monies by the City of Newburgh. Records of these grant funds and the project expenditures are maintained in separate files by the City to accommodate the record keeping under the state grant requirements. These files have been audited as part of the City's annual auditing process and are, of course, available for further inspection.

**Comment 4**

The amounts expended by the City, in excess of \$1.5 Million, exceeded the amounts required by the grant by almost \$500,000. We are providing herewith in Table 1 a summary of the following amounts: the Federal funds, state grants, the City match and the developer's equity as they were presented in the City's 108 loan/EDI application, and the ultimate expenditures made by the City.

TABLE 1

<u>Sources of Funds</u>	<u>Anticipated Amount</u>	<u>Actual Expenditures</u>
Section 108 Loan	1,000,000	994,003 <sup>1</sup>
EDI Grant	500,000	493,400 <sup>2</sup>
State Shoreline Stabilization Grant	450,000	459,000
Parks Grant	150,000	298,519
City of Newburgh <sup>3</sup>	450,000	757,519
Developer's Equity	<u>300,000</u>	<u>292,385</u>
	\$2,850,000	\$3,294,826

<sup>1</sup> Amount of 108 Loan less transaction fees

<sup>2</sup> Actual expenditures from grant

<sup>3</sup> City's match to the two (2) State grants

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**Comment 5**

It appears that there was a miscommunication between the City and the Auditor regarding the Auditor's request for documentation for the project. The City has kept files in different places for various elements of the project. Separate files with documentation for the grants are kept by the City. These are separate from the 108 Loan files. In responding to the Auditor's request for documentation of the project, the City provided the 108 Loan fund documentation. This information was available at the time of the audit, however, the Auditor's request for the additional documentation which included the grants was not clear to the City representatives and therefore not provided at that time. To address the Auditor's concerns that there should be cross linkage between the various files and documentation components of the project as a whole, all City files will contain cross-references so that the necessary information is included and accessible.

**Comment 4**

It is important to emphasize that the Draft Report mis-states the amount of the Marina Ops loan; it was \$1.5 Million, not \$2.85 Million. The use of the words "maintain evidence" here is misleading. The developer was required to and did provide approximately \$300,000 in required equity funding and/or funding from other sources. Further, no violation of the loan provisions requiring a 2-to-1 ratio of Section 108 and EDI grant funds occurred. The developer's equity was disbursed or deferred for project-related purposes including project construction, as well as legal fees, engineering costs, interest payments and other so-called "soft costs." This data has been maintained by the City; however, it was attached directly to vouchers and therefore may have been overlooked by the auditor.

**Comment 6**

**Comment 7**

Under OMB Circular A-87, the Basic Guidelines set forth in Section C1 defining authorized expenditures and applicable policies and procedures were followed. Likewise, the reasonable costs of the project satisfied the standards of Section C2 as administered according to generally-accepted sound business practices, goods and services were procured with expenditures at market rates, prudent business judgment was employed at all stages of development, and no deviation from the business judgment standard prevailing in the subject business environment was noted. All loan documents and contracts were submitted to, reviewed and approved by HUD representatives.

However, should HUD at any time require any additional justification, reconciliation or documentation, the City is fully prepared to provide all such upon request.

- (3) The City unnecessarily used CDBG funds to repay the loan which deprived its activity from receiving program income.

City Response:

**Comment 8**

There is no statutory or regulatory or customary prohibition against the use of CDBG funds for loan repayment. The expenditure of such funds was made fully in compliance with all standards and requirements which pertain to both CDBG funds and to the Section 108 and EDI programs. The Audit Report's usage of the words "not reasonable or

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**Comment 9**

necessary” are characterizations and relative, and are not further defined or placed in context in the Report (page 9, line 6). Other municipal awardees of CDBG funds have properly used same for purposes similar to the subject expenditures. The City has demonstrated that the expenditures were in fact necessary, reasonable and adequately documented. Indeed, immediately following, the second paragraph on page 9 declares that the HUD inspection disclosed that the marina was “open” and “successful.”

**Comment 10**

Section 108 loan repayments are required to be made on a semi-annual basis, irrespective of whether program income is being received to support the payment. Under the rules of that program, if the City of Newburgh fails to make a voluntary payment, HUD can and will make an automatic withdrawal of the funds from the City’s credit line. The City’s exercise of its discretion to use CDBG funds for this purpose is clearly the preferred business practice to an automatic withdrawal by HUD. Doing otherwise would in fact be a violation of the standards set forth in OMB Circular A-87.

**Comment 11**

(4) The City overpaid the developer for duplicate costs.

The City Comptroller has identified a check issued by the City’s Community Development Office payable to the City, and a second check in the identical amount issued by the City payable to the developer. This was done such that it was the City who would be the payor to the developer. It was the City’s practice at that time that City departments reimburse the City’s general fund from departmental budgets. The developer was paid the proper amount in the form of a two-party check, described below. No duplicate payment was made.

**Comment 12**

General Comments in Narrative & City Response:

p. 7: “...notices sent to the developer contained inaccurate and incomplete loan repayment request information.”

This information has not been shared with the City. It is the City’s contention that our figures are accurate. Please provide information and/or documentation on the amounts in dispute and the basis of the determination that the calculations are incorrect.

The methodology by which the Audit Report has been compiled and composed must be questioned. Again, the terms “inaccurate” and “incomplete” are otherwise undefined and unspecified. No reference is made to identify inaccurate or missing information, and the City has not received any communication from HUD identifying or requesting same.

**Comment 13**

p. 8: “...the City had no assurance that the total required funding of \$2.85 million was invested in the marina.”

The cost of the actual marina (i.e. marina ‘proper’) totaled approximately \$1.8 million, well below the total \$2.85 million in public and private funds secured for the redevelopment. The sources of funds referred to on page 5 reflect funding secured by the City of Newburgh to support the redevelopment of the area in and around the marina - not just for the



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**Comment 13**

marina proper. Those funds were expended and documentation supporting those costs are available upon request. There were no requirements either within the HUD or State agreements that required that the full \$2.85 million be invested in the marina proper.

**Comment 14**

p. 8: "...the City did not maintain evidence that the developer provide the \$300,000 in required equity funds or that any of the other funding sources were provided before it disbursed the \$1.5 million in Section 108 and EDI grant funds to the developer."

The Agreement between the City and HUD does not require that the funding sources be provided prior to disbursement of Section 108 and EDI grant funds.

**Comment 15**

p. 8: "In July of 2007, the City informed HUD that the first payment of \$27,500 was received in May 2007; however the City did not mention that the full payment due was \$46,250. The city also informed HUD that the next payment was due in July, although the July payment date agreed to by the developer was already past due. In addition, the City informed HUD that annual audited financial statements were requested from the developer and should be received by August 2007, which was later than expected."

Any and all communications between the City of Newburgh and HUD reflect an accurate understanding of the situation at the time. City staff had been in constant communication with the developer to determine when the required information would be received and had no reason to believe at the time that the developer would continue to default on deadlines issued. At no time did the City intentionally mislead HUD officials of the status of the loan.

p. 8: "...the City elected to use its CDBG funding to make the Section 108 loan payments that were required to be made by the developer."

p. 9: "...the use of CDBG funding for this purpose is not reasonable or necessary."

p. 9: "The City's failure to enforce the loan provisions resulted in the unnecessary and unreasonable use of CDBG funds to repay the debt."

**Comment 8**

Section 108 loan repayments are required to be made on a semi-annual basis, irrespective of whether program income is being received to support the payment. In fact, if the City of Newburgh does not make a voluntary payment, HUD will make an automatic withdrawal of the funds from the City's credit line. The City challenges the assumption that the payments were 'elective' 'unnecessary' or 'unreasonable'. Moreover, the City of Newburgh, as an entitlement community, is authorized to make such payments using sources at its discretion.

The Draft Audit Report makes numerous, repeated references to the possibility that CDBG funds could have been used for other purposes had they not been used to repay the Section 108 loan. As stated above, this use is allowed by law and rule and under the subject circumstances was in keeping with standards requiring the adoption of preferred business practices.

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**Comment 16**

p. 10: "Consequently, the City's ability to provide maximum benefit to low-and moderate-income residents was hindered."

The Audit Report does not substantiate this statement. No showing is made that low- and moderate-income residents did not benefit from expended funds; indeed they were benefitted, including those who reside nearby or have a view of or who frequent or visit the waterfront. Also no showing is made that the expenditure of the subject funds for other purposes could have or would have benefitted a greater number of such persons or in a more substantial manner. The basis and methodology of the Audit Report must again be questioned.

**Recommendations from the Report:**

- 1A: Enforce the loan provisions on the Front Street Marina within 90 days and reimburse the CDBG program from nonfederal funds the \$449,817 used for Section 108 debt repayment.

City Response:

**Comment 8**

The City of Newburgh has filed a claim in Supreme Court, Orange County, New York seeking damages in the amount of the unpaid loan plus allowable interest and penalties to recoup losses to the City's CDBG entitlement program. It is not expected that this legal matter will be resolved within 90 days.

As stated, prior to enforcement proceedings being commenced, prior actions in the nature of enforcement were taken, although unsuccessfully. The demand for \$449,817 reimbursement for Section 108 debt repayment is unsubstantiated and not justified by the facts or by applicable law or rule.

**Comment 17**

Both the City and the auditor would benefit from further clarification of the definition of "nonfederal funds," particularly as that term applies to monies recovered from the developer.

- 1B: Provide HUD with evidence that all funding sources for the Front Street Marina project have been received or reduce the Section 108 and EDI loans proportionately and repay the funds to HUD.

City Response:

**Comment 6**

Documentation related to the construction of the marina proper were provided at the time of the on-site audit. No requests were made to review documents related to the State grants or City match during that time frame. Those documents are available for review upon request.

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**Comment 18**

City documentation has and will continue to show that funding sources have been identified, documented and used properly.

**1C: Take appropriate action against the developer and ensure that nonfederal funds are used to repay HUD the \$1,322,568 in future Section 108 program loan obligations (\$865,968 due for the Section 108 loan and \$456,600 due for the EDI loan) so that future CDBG funds can be safeguarded and put to better use.**

City Response:

Please see response to item 1A and 1B above. However, the City questions whether repayment of the EDI loan can impact the future use of CDBG funds. EDI loan repayments are available to the City for future eligible uses and are independent of any considerations related to CDBG program funds.

**Comment 11**

**1D: Reimburse the EDI Program from nonfederal funds the \$144,341 related to the ineligible duplicate payments paid to the developer for marina-related expenses.**

City Response:

Please see response to item (4) above. It is the City's contention that this was not, in fact, a duplicate payment.

**Comment 19**

**1E: Implement policies and procedures to ensure that all future Section 108 projects are administered in accordance with all approved application, loan agreements, and program requirements.**

City Response:

No showing has been made that the City's administrative policies, practices and/or procedures are inadequate to ensure compliance with all requirements pertaining to Section 108 projects, including but not limited to applications, loan agreements, support and documentation, fiscal procedures and program requirements.

Current City policies require that copies of all loan documents and a repayment schedules for current and future Section 108 loans are provided to the Comptroller's Office. The Comptroller's Office is charged with managing the loan and issuing payment invoices for all outstanding loans and reports same to the City's Director of Community Development who is charged with administering the City's CDBG entitlement funds. These reports facilitate the inclusion of such financial and program income data into the HUD's reporting systems. The Comptroller establishes a 'loan payable CD account' which is monitored on a monthly basis. Any missed payments or non payments are addressed in a timely fashion through coordination with and notice to the Community Development Director for further action in consultation with the City's Corporation Counsel.

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**Comment 19**

Should HUD wish to consult with and advise the City as to any additional and/or different fiscal procedures or policies which HUD would recommend the City consider, the City would welcome such consultation.

**Finding 2: The City's Crystal Lake Project Remained Incomplete and Failed to Achieve Program Objectives**

- (1) The City did not ensure that the commercial site was feasible for commercial development and job creation.

City Response:

The City diligently and professionally assessed the site under the business, economic, environmental and commercial circumstances which prevailed at the time. HUD was advised and provided written proposals and analysis describing the feasibility of the proposed development. These are circumstances which can and do change, often unpredictably, due to micro- and macro-economic forces and trends. The evaluation protocols employed by the City were appropriate and sound, and conducted according to the standards set forth in OMB Circular A-33 and other regulations.

**Comment 20**

The use of the subject funds was in compliance with applicable requirements. The Audit Report makes no showing that the expected feasibility of the project was based upon improper analysis or unsupported projections; and no objections from HUD were made at the time of the Section 108 loan application.

**Comment 21**

- (2) The City did not amend its Section 108 loan program to reduce the funds needed; see City response to (3) below.
- (3) The City did not pursue collateral or program income for loan repayment.

City Response:

The Audit Report apparently misapprehends the nature of this project. There was no actual or prospective developer who had been identified or retained for this site. Therefore there could not have been the opportunity to identify or pursue collateral from any such developer. The property to be improved and developed was and still is owned by the City of Newburgh.

**Comment 22**

**Comment 23**

The funds which were expended were used for the improvement of public infrastructure, i.e. Temple and Ellis Avenues. Such use is authorized under the program, and benefits those who are the target beneficiaries of the program. The Audit Report makes no reference to any rule or practice referenced in law or code which prohibited or discouraged such use of funds. The actual expenditure did in fact reasonably and factually result in

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**Comment 23**

benefits to the targeted population, even though the ultimate project was not completed. Since the funds expended were used for eligible and approved purposes and the improvements did benefit a targeted population and area. No need or indication existed for the City to amend its 108 loan program to reduce the funds needed.

**Comment 24**

Indeed, on page 13, lines 7-11 the Report indicates that HUD confirmed that further analysis disclosed that commercial development of the proposed site was properly reconsidered.

**Comment 25**

**General Comments in Narrative & City Response:**

p. 12: "...the City did not pursue possible collateral or program income...as required by the loan agreement between the city and the project developer."

There is no such loan agreement in place between the City of Newburgh and any real or prospective developer for this site.

p. 14: "...the City did not provide evidence that collateral was pursued or used to repay the Section 108 debt."

It is the City's contention that the identification of collateral to guarantee repayment of Section 108 debt is a HUD requirement which is not applicable in this case. Apparently the auditors did not understand the factual background of this project.

**Recommendations from the Report:**

2A: Reimburse the CDBG program, from nonfederal funds, the \$752,302 in unused Section 108 funds to reduce the CDBG funds already used to repay part of the Section 108 loan.

City Response:

**Comment 26**

As recommended in the narrative, the City of Newburgh has established a loan repayment account and will be making future Section 108 loan repayments from that fund. All payments for this grant will be deducted from that account, rather than from the City's entitlement funds, until the funds are exhausted.

2B: Establish a plan for the Crystal Lake industrial park site within 90 days or reimburse the CDBG program from nonfederal funds the \$1,002,849 used to repay the Section 108 loan debt (\$1,755,151 less \$732,302 in unused Section 108 funds and interest).

City Response:

**Comment 27**

This site presents numerous challenges for redevelopment - some of which were itemized in the narrative of this report. In the completed position of the project, expenditures were

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**Comment 27**

made for eligible purposes to a benefit low- and moderate-income area. The City intends to apply for approval to modify the scope of the project to continue to serve such a purpose in lieu of further construction of infrastructure.

- 2C: Pursue the loan collateral and use those funds to repay the \$1,690,177 required for future Section 108 loan repayments. This would allow the City to reprogram the \$1,690,177 in CDBG funds scheduled to be used for future repayments of the industrial park project loan and put these funds to better use for other CDBG-eligible activities.

City Response:

**Comment 28**

24 CFR 85.22 was satisfied in that funds expended were used for necessary improvements, that such improvements and the costs thereof were reasonable and harmonious with prevailing standards of sound business judgment, and were adequately documented. The allegation that the use of CDBG funds was "unreasonable and unnecessary" is a non sequitur and conclusory, without support in the record or in contravention of any applicable law or rule, which in any event is not identified in the record.

- 2D: Establish and implement policies and procedures to ensure that all future Section 108 projects are administered in accordance with all approved applications, loan agreements, and program requirements.

City Response:

**Comment 29**

No showing has been made that the City's administrative policies, practices and/or procedures are inadequate to ensure compliance with all requirements pertaining to Section 108 projects, including but not limited to applications, loan agreements, support and documentation, fiscal procedures and program requirements.

Current City policies require that copies of all loan documents and a repayment schedules for current and future Section 108 loans are provided to the Comptroller's Office. The Comptroller's Office is charged with managing the loan and issuing payment invoices for all outstanding loans and reports same to the City's Director of Community Development who is charged with administering the City's CDBG entitlement funds. These reports facilitate the inclusion of such financial and program income data into the HUD's reporting systems. The Comptroller establishes a 'loan payable CD account' which is monitored on a monthly basis. Any missed payments or non payments are addressed in a timely fashion through coordination with and notice to the Community Development Director for further action in consultation with the City's Corporation Counsel.

Should HUD wish to consult with and advise the City as to any additional and/or different fiscal procedures or policies which HUD would recommend the City consider, the City would welcome such consultation.

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**Comment 30**

Conclusions:

City Response:

The City contends that its administration of its Section 108 loan program has in fact complied with program goals and that expenditures were properly made to benefit program objections.

The Draft Report fails to define or substantiate that the City's supporting documentation was incomplete or unreliable as to the marina project. However, the recitations in the Draft Report were themselves not accurate, and the conclusions contained therein are not soundly reached.

The general statement that the City did not have adequate controls over compliance with applicable laws and rules is not supported by the record. Those laws and rules which the Draft Report contends were violated are not referenced in the Draft Report, nor does it show how the City's actions were in specific violation. As such the allegations in the Draft Report cannot be addressed with a view to amending any specific City policy or practice. As such the purpose of such audit cannot be fulfilled.

The conclusory statement that "ineligible and unsupported costs were charged to the program" is not sustained by the record. All expenditures have been shown to be in harmony with applicable law and rules and with program goals and requirements. The use of City resources was appropriate and authorized, and were properly allocated, documented, reported and safe-guarded. There is also no showing anywhere in the Draft Report that the alternative uses of City assets and resources would have bestowed greater or more appropriate benefits to the intended beneficiary population.

We hope this response clarifies and corrects the content of the Draft Audit Report. We can only address the City's actions in light of the applicable laws, rules and advisory publications promulgated by OMB and others. The Draft Report is replete with statements which are inaccurate, undefined and unsupported. These statements raise questions about the methodology and basis used to compose and support the findings and recommendations contained therein.

The Report fails to articulate the standards and criteria used to support the characterizations describing City actions and procedures. The City hopes that the final report makes significant revisions to correct factual inaccuracies and eliminate subjective conjecture which lacks an appropriate context and is unsupported by the documented record.

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**Comment 30**

Based upon the City's response and corrections to the audit findings referenced hereinabove, the City submits what there is insufficient basis for the audit report to find or conclude that these significant weaknesses actually exist or existed at the critical times mentioned in the report .

The City's responses demonstrate that:

- its Section 108 Loan Program did not meet program objectives;
- that the City did have controls in place to ensure that data relating to the marina project was valid and reliable and that supporting documentation was complete and property part of the City's records;
- that the City did have controls in place and in fact the City did comply with all applicable laws and regulations, as well as prevailing standards and protocols described in various circulars and advisory directives published by HUD;
- that the City administrative systems did ensure that resources were safeguarded such that no ineligible or unsupported costs were charged to the program; and
- that supporting documentation for chargeable costs was provided at all relevant times.

This response assumes that it will be attached to any final report issued as well as any and all documentation of the facts and circumstances stated herein.

Sincerely,



JEAN ANN McGRANE  
City Manager

JAM/ee

Cc: Lourdes Zapata-Perez, Community Development Director  
Robert McKenna, Planning and Development Director  
Charles Emberger, City Comptroller  
Geoffrey E. Chanin, Corporation Counsel  
Lucille Velez, HUD CPD Representative



## OIG Evaluation of Auditee Comments

### **Comment 1**

Officials for the City assert that the report does not conform to Government Auditing Standards and does not include criteria, condition, causes, effect, and recommendations. The officials request the redrafting of the report based upon their overall comments. The audit report complies with Government Auditing Standards and clearly states the criteria, condition, cause, effect, and recommendations for each finding. Moreover, the official's overall comments and assertions are contrary to the facts and conclusions contained in the audit findings. The draft report is based on evidence obtained from interviews with City officials, review of Section 108 files, and our extensive knowledge of both the Section 108 Loan Guarantee and Community Development Block Grant (CDBG) Programs. Thus, the officials have attempted to refute the audit report with extraneous language and terminology that do not address the core issues and conclusions of the report, which is that the City needs to improve its administration of its Section 108 Loan Guarantee Program. Accordingly, the report will not be modified.

### **Comment 2**

Officials for the City state that a lawsuit was commenced on August 26, 2008 against Marina Ops to enforce the loan agreement provisions and seek collection of the debt. Prior to initiating legal action, officials for the City assert that it pursued remedies by employing methods which are consistent with principles of standard commercial dealings of this kind. Such methods included formal demands, proposed payment plans, and negotiations of terms. The City's actions are responsive to our findings; however, this action is not timely as mentioned in the finding. The lawsuit did not commence until over five years after the borrower first neglected to make loan payments and only after we began the audit and raised these issues with the City. Further, audits by the City's Independent Public Accountant (IPA) also disclosed that the City failed to safeguard HUD assets by not requesting repayment from the third party marina developer in a timely manner.

### **Comment 3**

Officials for the City state that the draft report is not accurate as to the amount owed by Marina Ops. They assert that the audit report states that \$2.85 million is owed on the marina loan. Officials also contend that the language of the draft report seems to overlook or ignore that the City got a personal guarantee from the developer. The draft report clearly states that the total HUD funding for the project is \$1.5 million; nevertheless, we added additional language to the report to clear any confusion. In addition, the draft report clearly states on page 6 that the City was required to obtain a personal guaranty from the developer; however, this does not appear to be relevant as the issue discussed in this section of the finding pertains to the City's failure to adequately pursue loan collection and available collateral.

**Comment 4** Officials for the City assert that they have supported and documented all funding sources, in harmony with applicable Federal laws and rule. They state that their files have been audited as part of the City's annual auditing process and are available for further inspection. Further, officials assert that they expended in excess of \$1.5 million on the Marina project and provided a table detailing that over \$3.2 million in total was invested in the Marina project, including the \$1.5 million of HUD funding. However, our audit work found that the City was unable to fully support the \$1.5 million of HUD funding and provided no evidence of additional funding sources that would total \$2.85 million. Further, in a March 2008 email, we requested an accounting for all of the \$2.85 million of Marina costs and made repeated requests during the audit for all supporting documentation involving the total project costs of \$2.85 million. Nevertheless, the requested documentation was never provided to us. If supporting documents are now available, it will be reviewed by the field office during the audit resolution process.

**Comment 5** Officials for the City contend that there was a miscommunication regarding our request for project documentation, as the request for additional documentation was not clear. They contend that separate records were maintained by the City for various elements of the project. Nevertheless, as the finding stated, the City did not properly document and support all Marina project costs. However, the actions of the City to now have all files contain cross-references so that the necessary information is included and accessible, is responsive to our report.

**Comment 6** Officials for the City assert that the developer did provide the required \$300,000 of developer equity and that no violation of the loan provisions requiring a 2-to-1 ratio of Section 108 and EDI funds occurred. Further, the officials assert that the data on the Marina costs is attached directly to the vouchers and may have been overlooked by the auditor. The data on project-related costs was not overlooked by the auditor; the City never provided any evidence of developer equity. As such, since the City was unable to adequately support HUD funds and provide support for the leveraged funds, we have no assurance that the 2-to-1 ratio requirement was followed. Additional evidence, if available will be considered during the audit resolution process.

**Comment 7** Officials for the City claim that they followed OMB Circular A-87 when paying costs and supporting the project activities and that all loan documents were submitted to, reviewed, and approved by HUD. However, the official's claim of adherence to OMB Circular A-87 is not supported by the facts. The City failed to safeguard assets by not enforcing the loan agreements, and failed to obtain proper supporting documentation before disbursing all HUD funds. The audit report does not refute the fact that all loan documents were submitted to, reviewed,

and approved by HUD. The core issue raised in the report is that the City failed to abide by and enforce their own loan agreements; thus, the response from the officials has not addressed the facts.

**Comment 8**

Officials for the City state that there was no statutory or regulatory prohibition against the use of CDBG funds for Section 108 loan repayment and other municipal awardees of CDBG funds have used CDBG funds for similar purposes. The officials assert that our use of the terminology not reasonable or necessary is relative and not defined or placed in context. Consequently, the officials disagree with recommendation 1A. OIG fully recognizes and understands that regulations allow CDBG funds to be used for Section 108 loan repayments. This is not the issue raised in the report. The issue, as provided for in 24 CFR 85.22, is that the use of CDBG funds to repay the Marina loan was not necessary or reasonable. Specifically, the use of CDBG funds would not have been necessary had the City exercised their fiduciary responsibility to safeguard HUD assets. The Marina loan agreements executed by the City were clear in stating that the Marina developer would provide the loan repayment monies necessary to amortize the Section 108 debt, however, the City failed to adequately administer the loan and enforce loan provisions. In fact, even though the marina was earning income, the City allowed the developer to ignore nearly all of the loan conditions for many years, without any substantive action by the City to enforce the loan agreement. As such, our use of the terminology not reasonable or necessary is justified in the context presented, thus our conclusion that \$449,817 in CDBG funds could have been used for other purposes had they not been used to repay the Section 108 debt that should have been paid by the developer. Accordingly, we recommend that the City enforce the loan provisions within 90 days and reimburse the CDBG program from nonfederal funds the \$449,817 used for the Section 108 debt repayment.

**Comment 9**

Officials for the City state that CDBG expenditures were in fact necessary and adequately documented, and that HUD OIG's inspection disclosed that the Marina was open and successful. The officials are apparently confused about the issue discussed in the finding, whereas, the fact that the Marina is open has nothing to do with the requirement for the City to enforce their loan agreements with the developer. Further, if the Marina is successful, this lends credence to the fact that the City should have aggressively enforced loan collection from the developer, rather than using CDBG funds to repay the debt.

**Comment 10**

Officials for the City state that Section 108 repayments are required to be made on a semi-annual basis, irrespective of whether program income is being received to support the payment. We agree with this fact, however, the official's response does not address the issue discussed in the finding,

that the City could have avoided using CDBG funds, if it had properly managed and enforced their own loan agreements with the developer.

**Comment 11** In disputing a duplicate payment made to benefit the developer; officials for the City describe their disbursement procedures, whereas the City is the payer to the developer and not the City's Community Development Office. However, during the audit we were provided documentation which supports that a duplicate payment in the amount of \$144,341 was made to the developer for the same project costs, which should be repaid.

**Comment 12** Officials for the City question the audit statements pertaining to inaccurate and incomplete loan repayment requests sent to the developer. The officials contend that their notices sent to the developer were accurate and question the audit methodology followed. They further state that they were not informed of this concern. Our audit work found that the City provided inaccurate and incomplete information in their loan repayment requests and notices sent to the developer. For example, in December 2005 the City informed the developer that \$25,000 and \$75,000 were due and payable for the years 2004 and 2005, respectively. However, the notice failed to mention the 2003 EDI payments due that were not made, the monthly interest only payments (at 3.75 percent) that were due during the first year, as well as the year 2 and year 5 monthly payments that are due on the Section 108 loan for the next 10 years, etc. The notices from the City to the developer do not address these required payments or the requirement for the developer to submit annual financial statements. Since the officials should have been able to review their own loan documents and compare them to the notices sent to the developer, we question the official's contention that their notices sent to the developer were accurate.

This information was brought to City officials' attention during our audit. As such, our audit report statements are supported by detailed audit work, review, and analysis, such as noted in the examples above.

**Comment 13** Officials for the City appear to be confused. They seem to think that we believe the entire \$2.85 million is for the marina only and not the surrounding walkway. As such, to clarify the issue, when we refer to the total \$2.85 million we have added the words marina redevelopment project. As discussed in the audit report, the total marina redevelopment project costs are \$2.85 million. HUD funding towards the marina redevelopment project totaled \$1.5 million.

**Comment 14** Officials for the City contend that the Agreement between the City and HUD does not require that funding sources (other than HUD) be provided prior to disbursing Section 108 and EDI funds. However, the Section 108 agreement with the Marina developer, executed on March 22, 2002, detailed that no disbursement of the Section 108 and EDI loan funds shall

be made until the developer has expended or deferred not less than \$300,000 of equity funds for eligible costs of the project. Further, the agreement specified that in the event that total project costs were less than \$2.85 million, the HUD funding shall be reduced on a ratio of 2:1 by \$1.00 for each \$1.00 of such shortfall. Despite numerous documented requests by the auditor, no evidence was provided during our audit to support that the developer provided the \$300,000 of equity funds.

**Comment 15**

Officials for the City state that all communications between the City and HUD pertaining to the loan default reflect an accurate understanding of the situation at the time and that the City did not intentionally mislead HUD officials of the status of the loan. Nowhere in the audit report do we accuse the City of intentionally misleading HUD. However, our review of file evidence disclosed that on May 1, 2007, the City informed the developer that the first loan payment of \$46,250 was due on May 14, 2007 and a second payment on \$25,000 was due on July 6, 2007. These payment requests by the City do not agree with the signed loan agreement terms. On July 16, 2007, the City wrote to HUD and stated that the first payment of \$27,500 was made in May 2007 and that the next payment to the City is due in July. The City's letter to HUD omitted the fact that the first payment in May, as per their request letter, was supposed to be in the amount of \$46,250. An internal City memo, dated July 16, 2007, shows that the City was aware of the fact that the \$27,500 paid in May was only a partial payment of the total \$46,250 due. Thus, the City contemplated asking for the remainder of the first loan payment due, but did not. Also omitted in the July 16, 2007 letter to HUD is the fact that the due date for the second loan payment of \$25,000 had elapsed on July 6, 2007, 10 days prior. In fact, the developer never made this second payment. The facts as we have presented are readily available to the officials and are indicative of how the City has consistently failed to properly administer the Marina Redevelopment Project and loan.

**Comment 16**

Officials for the City question the basis and methodology of the audit report stating that it does not substantiate that the City's ability to provide maximum benefit to low- and moderate-income residents was hindered. The officials contend that the actual use of Section 108 proceeds and EDI grant funds for the Marina project benefitted low-and moderate-income residents, including those who reside nearby or have a view or visit the waterfront. However, the facts presented by City officials do not address the core issues and conclusions of the report. The report clearly states that the City's ability to provide maximum program benefit is hindered by the fact that \$449,817 of CDBG funds has been used for Section 108 loan repayments and another \$865,968 may be needed to repay future Section 108 debt. Obviously, had the City properly administered its Section 108 loan as described to HUD and memorialized in agreements with the developer, then the use of \$449,817 would not have been necessary. We recognize that development projects occasionally fail and that sometimes

CDBG funds are needed to repay Section 108 debt that was intended to be repaid by a private developer. However, the City failed to adequately safeguard the asset (loan receivable) and failed to enforce the loan agreement provisions and collateral. If the City had successfully administered the loan, then CDBG funding for loan repayment would not have been needed and the City could have used CDBG funds to accomplish additional worthy projects.

**Comment 17** In response to the request for further clarification of nonfederal funds, particularly in relation to monies recovered from the developer, we provide that any monies recovered from the Marina developer would constitute nonfederal funds.

**Comment 18** Officials for the City state that EDI loan repayments are available to the City for future eligible uses and are independent of any considerations related to the CDBG program funds. However, unless the EDI loan repayments are needed as security for the repayment of the Section 108 Loan debt, the EDI repayments will constitute program income under CDBG regulations.

**Comment 19** Officials for the City assert that no showing has been made that the City's administrative policies and procedures are inadequate to ensure compliance with all requirements of the Section 108 projects, including applications, loan agreements, support and documentation, fiscal procedures and program requirements. The assertion of the officials is contrary to the instances of noncompliance reported in the finding related to their Section 108 Marina Redevelopment loan project. The City did not comply with Section 108 program requirements and related agreements.

**Comment 20** Officials for the City contend that they diligently and professionally assessed the Crystal Lake project site under the conditions which prevailed at the time and provided analysis describing the feasibility of the proposed development. The facts presented in the finding lead to the conclusion that the site was not feasible. The Section 108 application provided that the City would complete necessary infrastructure improvements and attract commercial development at Crystal Lake to create jobs. Approximately \$1.6 million was targeted to complete this activity, but the City only expended \$911,330 and suspended the extension of the Temple Avenue infrastructure to Crystal Lake until a suitable commercial developer could be identified. Thus, no jobs were created and more than seven years later, no commercial developer has been identified, and almost half of the targeted Section 108 loan funds remain unexpended. During the audit, it was explained to us that several proposed projects did not pan out, primarily because of the difficulty of designing and constructing commercial buildings on narrow parcels wedged in between the lake and Snake Hill. However, we remind the officials that these physical constraints at the project site existed before the City applied for Section

108 funding and should have alerted the City as to the difficulties of commercial development at the site.

**Comment 21** Officials for the City state that they did not amend their Section 108 loan program to reduce the funds needed. While it is true that the City did not amend their Section 108 program, it is also true that the City violated their Section 108 Loan Contract by allowing \$652,800 of unused proceeds plus \$99,502 in interest to remain in the project bank account for over seven years.

**Comment 22** Officials for the City state that the audit report misapprehends the nature of the project, in regards to the City not pursuing collateral or program income for loan repayment. We refer the officials to the City's approved Section 108 loan application which provides that revenues generated by the sale of the used fire apparatus and the commercial development parcels will be placed in a secure account to be used to make subsequent loan payments. We were never provided evidence to support that the city exercised any of these options as promised. This is despite the fact that the City acknowledges that the Crystal Lake land parcels are owned by the City, and thus represent available collateral.

**Comment 23** Officials for the City state that the \$911,000 was used on eligible infrastructure improvements even though the ultimate project was not completed. Further, such use of funds is authorized under the program, and benefits those who are the target beneficiaries of the program. The officials contend that the audit report does not refer to any rule or practice referenced in law or code which prohibits such use of funds. The issue is not necessarily the use of the \$911,000. The issue, as presented in the finding, is that the City violated their Section 108 agreement by not utilizing all of their loan proceeds as promised. After which, the City failed to pursue its collateral to repay the Section 108 loan and instead used CDBG funds. Further, it should be noted that the Section 108 contract required the unused Section 108 loan proceeds of \$652,800 to be used as loan repayment collateral, instead, the City allowed the proceeds to remain unused for over seven years, despite acknowledging that completion of the project is not feasible.

**Comment 24** Officials for the City cite page 13, lines 7-11 of the audit report as confirmation that the commercial development of the proposed site was properly reconsidered. However, the section of the audit report cited actually states that an OIG inspection of the site confirmed the City's concerns that the Crystal Lake area was not feasible for commercial development. Specifically, there is no road access, and the land tract is very narrow along the lake area. Thus, the conclusions reached should have been apparent to the City prior to the Section 108 loan application, which promised development and job creation.

- Comment 25** Officials for the City contend that there is no loan agreement in place between the City and any developer for this site. Also, they contend that collateral for this Section 108 debt was not required by HUD and assert that the auditor apparently did not understand the factual background of this project. We corrected the report to state the City did not use funds to repay the debt as required by the loan application and contract agreement with HUD. The loan application and contract agreement provide that revenues generated by the sale of the used fire apparatus and the commercial development parcels will be placed in a secure account to be used to make subsequent loan payments. We were never provided evidence to support that these funds were pursued as promised.
- Comment 26** The actions of the City officials are responsive to our recommendation; however, they did not address what they will do with the balance of Section 108 funds not expended.
- Comment 27** Officials for the City intend to apply for approval to modify the scope of the Crystal Lake industrial park project. The modified project will be taken under consideration and addressed during the audit resolution process.
- Comment 28** Officials for the City state that 24 CFR 85.22 was satisfied in that, the funds were expended for necessary improvements and that the audit allegation regarding the use of CDBG funds as unnecessary and unreasonable is without support. We wish to make it clear that although collateral or other sources of income was promised to be used to repay the Section 108 loan related to the industrial park project, the City used CDBG funds instead. This was despite the fact that over \$750,000 of unused Section 108 proceeds is available for repayments. It is based on these facts that we concluded that the use of CDBG funds may not have been necessary or reasonable.
- Comment 29** Officials for the City assert that no showing has been made that the City's administrative policies and procedures are inadequate to ensure compliance with all Section 108 projects. Officials also express openness toward different fiscal procedures or policies that may be recommended by HUD during consultation. Officials are reminded that the report findings show that the City did not comply with Section 108 program requirements and related agreements, as it relates to pursuing collateral or other sources of income to repay the loans instead of using CDBG funds. In addition, the projects were not completed as described to HUD in the approved application, and the City allowed over \$752,000 of loan proceeds to remain unused for over seven years. Nevertheless, the officials desire to consult with HUD will be taken under consideration and addressed during the audit resolution process.



**Comment 30**

Officials for the City reiterate that they have complied with the requirements of the Section 108 loan program and that the report is inaccurate, undefined, and unsupported. Further, officials state that the report fails to articulate the standards and criteria used to support the characterization of the City's actions and procedures. The officials summarize many of their previous statements; however, their disagreement to the report is presented in general terms with little specifics or facts to support their position. In contrast, our report clearly provides the facts, criteria and documented evidence to support that contrary to the loan agreement and regulations, the City failed to ensure that all Section 108 Loan Guarantee funds and related project costs pertaining to the Front Street Marina redevelopment project were proper, necessary, and fully supported. In addition, the City did not achieve the primary objective of job creation for the industrial park project, loan proceeds remained unused in a bank account for more than seven years, possible collateral or program income for loan repayment was not pursued, and the City did not ensure that the industrial site was feasible for commercial development and job creation. As a result, the City's CDBG program was deprived of funds that could have been used for other activities and will be hindered from effectively using future CDBG funds to provide maximum benefit to low-and moderate-income residents.