

U.S. Department of Housing and Urban Development

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February 26, 1997

*Audit Related Memorandum
No. 97-BO-111-0803*

MEMORANDUM FOR: Nicholas P. Retsinas, Assistant Secretary for Housing, Federal
Commissioner, H

FROM: William D. Hartnett, District Inspector General, Office of Audit, 1AGA

SUBJECT: Review of Multifamily Enforcement Actions
Connecticut State Office
West Street Apartments
New Haven, Connecticut

INTRODUCTION

We conducted a review of the Connecticut State Office's (CSO) Multifamily enforcement actions pertaining to West Street Apartments, a 65-unit, multifamily insured project in New Haven, Connecticut. The owner defaulted on the mortgage in August 1995, violated numerous provisions of the Regulatory Agreement, did not cooperate with the CSO staff, and still remains in control of the project.

With respect to this one project, it paints a grim picture of HUD's enforcement actions and illustrates how an owner can continue to reap financial benefits without cooperating with HUD. While we recognize HUD has a major Multifamily Enforcement Strategy under way, we believe that HUD can strengthen its process by developing procedures to avoid the pitfalls experienced by the CSO staff.

This report contains one finding detailing the CSOs enforcement efforts.

Within 60 days, please give us for each recommendation made in the report, a status report on: (1) corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Also, please furnish us copies of any correspondence or directives issued because of the audit.

Should your staff have any questions, please have them call me at (617) 565-5259.

SUMMARY

This review should not be construed as a negative assessment of HUD's overall progress in taking enforcement actions. As illustrated by this one project, it shows where the HUD Asset Managers need to be trained in how to diagnose problems and negotiate with owners to secure cooperation and change behavior. The problem the Connecticut State Office (CSO) experienced was that they did not recognize that this owner was not going to live up to his agreements with HUD.

The CSO tried to negotiate with the project Owner because both Headquarters and CSO staff wanted to avoid the mortgage assignment. The CSO staff advised us that they generally do not implement enforcement actions during negotiations. This decision was made even though the Owner was under a HUD imposed debarment, and HUD's Contract Servicer was advising that the Owner was removing project funds, violating provisions of the Regulatory Agreement, and was unresponsive to requests for corrections and information.

This Owner has years of experience in dealing with HUD during which the Owner usually found that HUD would grant concessions to resolve problems rather than take enforcement actions or foreclose on the mortgage. Armed with this knowledge, the Owner continuously made worthless promises which delayed HUD's implementation of enforcement actions by approximately 16 months. During the 16 months, the Owner consistently violated provisions of the Regulatory Agreement, ignored HUD instructions to take corrective actions and diverted funds of over \$347,000 while the mortgage was delinquent.

At a December 16, 1996 meeting, the Deputy Assistant Secretary for Housing, stated that the Office of Housing has done an admirable job of improving multifamily enforcement in recent years. He agreed that a lot more needs to be done and provided us with Housing's latest Multifamily Enforcement strategy. The goal of the Multifamily Enforcement strategy is to remove every troubled property from the FHA portfolio in the next four years. An equally important goal is to ensure that the rest of the portfolio remains in good condition. Meeting these two goals will require that HUD sanction owners who do not live up to their business agreements which is no easy task as evidenced by this case. HUD will also have to make the best use of their existing staff and data systems by making the right decision as to when to start enforcement actions. Headquarters will need to be more directly involved in providing assistance with tough property owners, such as this one, if the strategy to improve enforcement is going to work.

The key strategy elements are to remove bad owners; encourage property owners to compete for residents; identify, diagnose and resolve troubled properties; train, energize and support Asset Managers; enhance computer hardware and software capacity; increase travel and contractor dollars; continue to expand the notes sales program; change the bankruptcy laws, and change the tax laws.

We furnished a draft report to the Assistant Secretary for Housing on January 9, 1997, for comment. In his February 20, 1997 response, the Assistant Secretary stated, "*While it is difficult to draw concrete conclusions from this one-project report, we agree that the items discussed in the report can assist the Office of Housing over the long term. The discussions also reinforce the fact that the*

actions that this Office has been taking to improve overall asset management results are the right actions."

While we acknowledge that this report details only one case, we believe that this case does serve as a useful learning tool for the Department's Asset Managers. Accordingly, we are recommending that HUD analyze the servicing actions on this project and develop specific training guidance for Asset Managers to deal with uncooperative owners by taking timely enforcement actions.

We have evaluated and incorporated the Assistant Secretary's comments into the finding as we considered appropriate. We have included a copy of the Assistant Secretary's comments in Appendix A of this report.

BACKGROUND

West Street Apartments is a 65-unit project located in New Haven, Connecticut which was constructed in 1982 and was originally known as Columbus-West Townhouses. Michael C. Kantrow was involved in the development and ownership of the project. Premier Management Company, owned by Mr. Kantrow, has been the Management Agent since September 1982. In 1984, Mr. Kantrow (Owner) became the General Partner of the Project.

In October 1988, the Mortgage was refinanced in the amount of \$4,364,600 and insured under Section 207 of the Act pursuant to Section 223 (f) under the Co-insurance Program. Puller Mortgage Associates processed the refinancing. The name of the project was changed to West Street Apartments. The Project receives Section 8 project based subsidy assistance (contract CT26-0028-013) from the New Haven, Connecticut Housing Authority. In April 1991, the loan servicing responsibility was transferred to the CSO. The Owner defaulted on the \$4.2 million West Street Apartments mortgage on August 1, 1995 and as of September 20, 1996, the mortgage arrearage is \$684,424.

The Owner is also involved in HUD's Section 8 Program in two cities, New Haven and Norwalk, Connecticut. The Norwalk Housing Authority and the CSO are currently having problems with the Owner's performance at Monterey Village, a non-insured Section 8 subsidized project. The Owner's Identity-of-Interest Management Company was recently removed as the Management Agent because of continuous noncompliance with Housing Quality Standards.

Mr. Kantrow is involved in New Hill Homes Associates Limited Partnership as the Management Agent and guarantor of the mortgages. These single-family properties were insured in 1984, under a pilot 203k program combined with the Section 8 Moderate Rehabilitation program which provided long term project-based subsidies. Three years ago, New Hill Homes Associates Limited Partnership, defaulted on all 48 mortgages valued at over \$2.7 million. Since the default, the Owner has collected over \$2.4 million in rents, of which \$1.9 million was from Section 8 subsidies, without making any mortgage payments and managed the properties until December, 1996. It is estimated that the potential loss to HUD could approximate \$1.5 million. The Mortgagee is currently obtaining these properties through foreclosure.

OBJECTIVE, SCOPE AND METHODOLOGY

Our examination was made to determine why the CSO did not take timely and decisive action to protect HUD's interest on West Street Apartments. We wanted to identify the problems that occurred with this project to help HUD understand the difficult task that the Asset Managers face when servicing these troubled multifamily projects. To achieve the objective, we reviewed HUD's oversight of the West Street Apartments project operations, we interviewed appropriate HUD staff in the CSO, Headquarters, and Ervin and Associates staff, HUD's Contract Asset Manager.

We began this review on May 6, 1996. Our audit generally covered HUD's and the Owner's actions from August 1995 to November 1996. We met with the Headquarters Multifamily Housing Staff on October 10, 1996 and obtained preliminary comments on October 24, 1996. In addition, on December 16, 1996 a meeting was held with the Deputy Assistant Secretary for Housing to discuss HUD's Multifamily Enforcement strategies and the results of this review.

A revised draft report was furnished to the Assistant Secretary for comment on January 9, 1997 and we received a response on February 20, 1997.

Results of Review

Finding - Need to Recognize Uncooperative Owners

The Connecticut State Office (CSO) needs to recognize when to take enforcement actions against owners who continuously fail to comply with the fundamental requirements of the Regulatory Agreement. The CSO Staff was not able to effectively deal with the Owner of West Street Apartments and did not seek timely assistance of specialized trained staff available to assist them with enforcement actions. As a result, HUD enforcement actions have been delayed at least 16 months.

Problems and barriers to overcome

Our review of West Street Apartments identified problems and barriers that HUD will have to overcome in order to meet its goal of removing every troubled property from the FHA portfolio. Until the HUD staff can develop the capacity to take prompt and appropriate action, uncooperative owners will continue to delay enforcement actions.

The following events illustrate a need to examine why the CSOs enforcement actions on this project were not timely and effective and what can be done to assure aggressive actions are taken in the future.

Project owner in control for 16 months

The Identity of Interest Owner/Management Agent, (Owner), of West Street Apartments ceased making payments on the insured loan on July 12, 1995. The mortgage was declared in default as of August 1, 1995 and subsequently assigned to HUD on March 27, 1996. During this period, HUD tried to negotiate with the Owner to bring the loan current without implementing any definite enforcement actions. It was not until approximately 16 months after the default, on November 14, 1996, that the CSO sent a letter to the Owner stating that foreclosure procedures were initiated. At this time the Owner filed for protection under the Bankruptcy laws for the Limited Partnership. This action further delays HUD enforcement actions because the Department must now deal with the Bankruptcy Court before proceeding with any sanctions.

If the CSO decided to take enforcement actions sooner, they may have prevented this owner from taking over

\$347,000 of improper diversions. The longer an owner delays turning the property over to HUD the more intensive day-to-day staff work is required.

Red flag - Owner has history of questionable integrity

At the time of default, the Owner was already under a three year HUD imposed debarment pertaining to HUD's Public and Indian Housing Program. The debarment was scheduled to expire on February 24, 1996. Although aware of this situation, the CSO continued to attempt to negotiate with the Owner to refinance the project and save the assignment of the mortgage.

Idle threats by HUD

From the date of the default (August 1, 1995), the CSO continuously advised the Owner of the potential enforcement actions HUD could take for Regulatory Agreement violations and provided target dates for the Owner's compliance. Because the CSO did not follow-up on its warnings, the Owner ignored HUD's instructions to take appropriate corrective actions. HUD waited until May 22, 1996 to take its first attempt at enforcement, when the CSO made a request to Headquarters for civil money penalties against the Owner for failure to submit monthly accounting reports and audited financial statements. However, this request was not promptly acted upon and subsequent follow up disclosed the request had been misplaced. It was not until August 8, 1996, over one year after the default, that HUD sent the Owner the notice of default under the Regulatory Agreement and indicated that HUD would proceed with enforcement actions.

Better coordination needed

Since the project was formerly co-insured, Headquarters staff and Ervin and Associates, HUD's Asset Management contractor, were involved in the asset management functions. From August 1, 1995 to January 31, 1996, the Owner and his Attorney dealt primarily with the Mortgagee, Headquarters staff and Ervin's staff in trying to refinance the project. The involvement of these groups caused the CSO staff to be confused over who was responsible for resolving the problem and resulted in a lack of decision making.

HUD unable to stop Owner from taking \$293,589 after default

The Owner has taken project funds in violation of the Regulatory Agreement. Of the \$347,824 in unauthorized disbursements, \$293,589 was withdrawn after the Owner stopped making the mortgage payments. The Owner continued to make unauthorized payments in 1996. On numerous occasions, the CSO and the HUD Contract Asset Management Agent advised the Owner about the improper disbursements and instructed the Owner to repay the funds to the project. The Owner ignored these instructions and continued to make unauthorized disbursements even though the Owner advised HUD staff that he stopped taking Project funds.

Regulatory violations

In addition to the financial default on the mortgage and the unauthorized distributions, the CSO was aware that the Owner violated other provisions of the Regulatory Agreement.

The Owner:

- failed to submit required monthly accounting reports in a timely manner and turn over any excess cash;
- failed to obtain HUD approval for project loans and repayments;
- failed to submit the annual audited financial statements within 60 days;
- failed to maintain accounting records as required by HUD;
- failed to account for and fund tenant security deposits;
- failed to comply with HUD instructions to dismiss the identity of interest management agent and contract with an agent acceptable to HUD; and
- ignored HUD's requests for information; when replies were sent, incomplete information was provided.

CSO reluctant to take action

Despite numerous indicators that the Owner continuously disregarded the Regulatory Agreement, HUD regulations, and HUD's requests for documentation, the CSO was reluctant to implement enforcement actions because the Owner indicated that he would file for bankruptcy. The Owner continued to make promises to resolve the problems and repay the unauthorized disbursements. The CSO believed imposing sanctions might impede their negotiations with the owner to solve the problems. The CSO was hoping for an amicable resolution of the problems. Therefore, enforcement actions were delayed.

Owner delays HUD

This Owner knows how the HUD process works. The Owner delayed HUD through the use and knowledge of HUD's process. The Owner, directly or through his attorney and consultants, eventually provided responses to HUD. Even when HUD management established various dates for the Owner to take corrective actions, the Owner avoided action by not responding timely, then contacting HUD and requesting a meeting to discuss the problem and offering other alternatives without addressing the issues raised by HUD.

Specific examples of how the Owner delayed HUD follow:

Unauthorized distributions while the project was in non-surplus cash position

The December 1993 and 1994 audited financial statements, signed by the Owner, showed that although the project had negative surplus cash, distributions were taken in violation of the Regulatory Agreement. The CSO detected these violations and requested repayment in January and June 1995. The Owner did not respond to these letters and never repaid the improper distributions.

After the August 1995 default, the project was assigned to HUD's contractor under the Asset Management contract. On August 29, 1995, the contractor sent a letter to the Owner citing HUD's requirements including describing allowable expenses, disbursements not allowed, and the criminal statues and penalties involved with misuse of project funds. The Owner ignored this letter and continued withdrawing project funds and violating the Regulatory Agreement provisions.

The Owner advised HUD staff that he stopped taking unauthorized distributions beyond the amount shown in the FY 1994 Annual Financial Statements (approximately \$52,700) and the funds would be repaid at refinancing. The Headquarters' Coinsurance staff considered the amount of the unauthorized distributions to be insignificant because the Owner's equity value in the property was greater than the unauthorized distributions. Because they accepted the Owner's comments that no additional unauthorized distributions were being made, they determined that it would be beneficial to HUD to deal with the Owner. This proved to be an incorrect decision.

The Owner continued to take unauthorized distributions. As of August 26, 1996, the Owner improperly disbursed \$347,824 to himself or on his behalf. This occurred despite numerous written and verbal notifications from HUD to stop the unauthorized distributions and repay the funds. The Owner was able to take unauthorized withdrawals from the cash made available from not paying the HUD mortgage.

In addition, the Owner delayed the submission of monthly accounting reports and never remitted any of the excess cash on hand at month end. The CSO did not take aggressive action to obtain the monthly accounting reports and the month end cash balances. These reports when finally submitted disclosed additional cash diversions.

Finally, in September 1996, HUD requested the U.S. Attorney's Office to file a complaint under the equity Skimming statute to recover the funds. On August 7, 1996, the CSO requested the Assistant Secretary for Housing to suspend the Owner. On September 30, 1996, the Department issued a suspension notice to the Owner and his affiliate companies preventing them from doing any new business with HUD pending a debarment hearing.

Replacement of the
Management Agent

The Regulatory Agreement states that HUD may terminate the management contract without penalty and with or without cause, with a 30 day notice. The CSO waited until nine months after the default before requesting the replacement of the Management Agent. The Owner was advised to hire a competent professional management company acceptable to HUD by May 17, 1996. Over eight months later, the Owner still had not replaced the Identity of Interest Management Agent.

The Owner ignored HUD's letters and did not replace the Management Agent. On August 22 the Owner submitted a proposal to replace the current management agent with a firm with no experience headed by the present management agent's maintenance director. The CSO notified the Owner on November 5, 1996, that the proposed management agent was unacceptable. HUD, through the U.S. Attorney's Office has filed a complaint in U.S. District Court to remove the Management Agent.

Causes for delays

We believe that the delays in taking timely enforcement actions can be attributed to the following barriers:

- The belief that enforcement actions will result in owners not working with HUD to prevent assignment of the mortgage and foreclosure.
- The lack of expertise on how to implement enforcement actions. Although the CSO staff are aware of enforcement actions available, few people know the specific procedures of how to implement them.
- The inability to negotiate with an uncooperative Owner.
- Workload problems - the CSO staff were not able to devote sufficient resources to service this troubled project in a timely manner and to provide adequate follow-up, especially in dealing with this uncooperative Owner. This caused the CSO to be reactive rather than proactive.
- Not involving the Office of General Counsel early in the process to assure that the proper legal steps were taken at the proper time in order to prevent any lost time in the enforcement process.

HUD enforcement strategy

At the December 16, 1996 meeting, the Deputy Assistant Secretary for Housing provided us with HUD's Multifamily Enforcement strategies. One of the goals is to remove every troubled property from the FHA portfolio in the next four years. HUD also has a goal of ensuring the rest of the FHA portfolio is properly maintained and operated. In order to meet this strategy, HUD will be required to sanction owners who do not live up to their obligations under the various programs. This will not be an easy task, as evidenced by transactions involving this Project.

The key strategy elements are to remove bad owners; identify, diagnose and resolve troubled projects; train, energize and support Asset Managers; enhance computer hardware and software; increase travel and contractor dollars; continue to expand the note sales program, and change the bankruptcy and tax laws.

Actions needed

To make timely decisions as to when enforcement actions will be started, HUD will have to make the best use of their existing staff and data systems. Headquarters staff and legal counsel will need to be more directly involved in providing assistance to deal with uncooperative owners, such as this one, if the Multifamily Enforcement strategy is going to work. In order to do the job right, Asset Managers need to be trained, provided the proper tools, and given the appropriate support in taking decisive enforcement actions to protect HUD's interest in the property.

Assistant Secretary's response

The Assistant Secretary for Housing agreed that the lessons learned through real life experience with cases like West Street Apartments, can be used to strengthen the Department's enforcement strategy and capacity of HUD staff to carry out enforcement actions. The Assistant Secretary agreed that training and guidance provided to Asset Managers should stress the importance of concluding negotiations with project owners in as little time as possible. Timely asset management processing, and enforcement actions where necessary, have been guiding principles of asset management and enforcement strategies and will continue to be so.

The Assistant Secretary also agreed with the recommendation that specific procedures be developed to assist asset managers in dealing with uncooperative owners be developed. He advised that in the past few years, the Office of Housing has worked to develop support systems to strengthen asset management and enforcement capability. The Special Workout Assistance Team (SWAT), financial and technical assistance contracts, the upcoming Multifamily Asset Management Technical Assistance contract, and the database warehouse were cited as examples. The field offices and the multifamily offices in Headquarters were reorganized to maximize flexibility to meet workload demands despite ever-shrinking staff resources. However, the Assistant Secretary notes that although they have invested heavily in getting the asset managers enough of the right kind of tools to do a job, a report, such as West Street notes so well the asset managers have to be well-trained in the use of the tools that have been provided. Negotiation skills, especially in dealing with uncooperative owners, have figured prominently in our training and development of the asset management staff and will continue to be stressed.

Recommendations

We recommend that your staff:

- 1A Analyze the servicing actions on this project and use it as a case study to provide guidance for Asset Managers.
- 1B Develop specific procedures to assist Asset Managers in dealing with uncooperative owners.

Auditee Comments

Distribution

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