October 10, 1997

Audit Related Memorandum
98-NY-112-0801

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

FROM: David J. Niemiec, Acting District Inspector General for Audit, 2AGA

SUBJECT: Proposed Financing Plan for Jose De Diego Beekman Houses

It has recently come to our attention that HUD is finalizing an expansive refinancing package for eight Section 236 projects, known as the Jose De Diego Beekman Houses (Beekman Houses), located in the City of New York. This package provides for HUD expenditures of nearly $181 million over the next 15 years to rehabilitate and stabilize the developments, over 80 percent of whose units do not meet basic housing quality standards (HQS), while holding harmless the parties who own and manage the properties. Under the package, substantial benefits can accrue to these owners, while only a nominal contribution for their continued participation is required. We must express our concern that:

- The plan is a poor deal for HUD and the taxpayers;
- The plan rewards a landlord who may bear responsibility for the deplorable conditions of the projects; and
- HUD's agreements with the landlord may undermine HUD's enforcement ability.

We strongly recommend that the proponents of this deal be required to provide a detailed analysis of how this plan constitutes the best alternative available to HUD. Alternatively, we recommend that this deal be renegotiated to better represent the interests of the Department and the taxpayers, while still providing affordable housing for low income tenants.

1. <u>The Plan is a Poor Deal for HUD and the Taxpayers</u>

The Beekman Houses consist of some 1238 units located in the South Bronx of New York City. The buildings were constructed around 1910 and were substantially rehabilitated in the early 1970s. The developments are owned by eight limited partnerships whose general partners are affiliated corporations. Until recently the developments were managed by an affiliated management agent. HUD became Mortgagee in Possession (MIP) in December 1996 after replacing the management agent. As of December 1996, some 80 percent of the units failed to meet HQS, and there are serious health and safety problems requiring immediate repairs. HUD expects to spend approximately $11 million on such repairs while MIP, and an additional $6 million in emergency repairs.

The proposed financing package, developed by representatives of HUD, the New York City Housing Partnership, New York State Housing Finance Agency, New York City Housing Development Corporation (HDC), and the owners, would essentially forgive the outstanding mortgages while maintaining subsidy payments pursuant to Section 236 and Section 8.[1] In return, the owners will renovate and maintain the Beekman Houses as Section 236 projects for the remainder of the terms of the mortgages (Years 2012-2017), with the program to be administered by HDC.[2]

While the law certainly permits HUD to negotiate the sale of mortgages to local agencies, that law sets as a condition that the sale price be the best obtainable consistent with the intention that the projects be retained for use under the applicable mortgage program for the life of the initial mortgage. See 12 U.S.C. § 1701z-11(k)(3). Although the plan appears to have accomplished retention of the developments as Section 236 projects, the plan does not justify why this is the best bargain HUD could have obtained.[3] In fact, this plan appears to be the best bargain for the owners, not HUD.

For your convenience, a chart is attached listing the proposed expenditures by, and the benefit accruing to, the parties to the agreement. As the chart indicates, the contrast between who funds the rehabilitation and who benefits from it is striking. Over the next 15 years, HUD is being asked to expend approximately $181 million, as follows:

$45.0 million (by selling 8 mortgages for $1 apiece)
$24.8 million (in Section 236 Interest Reduction Payments)
$<u>111.2</u> million (in Section 8 subsidies and fees)

---

1 Technically, HUD will sell the mortgages to HDC, which has agreed to forbear on payments and forgive the mortgages on maturity.

2 The plan does not address the age of the buildings and whether rehabilitation is feasible.

3 Although this package is technically a mortgage sale, it is effectively a long term work-out of the mortgage in which the mortgage is never reinstated. It is worth noting that HUD would have been prohibited from structuring such a work-out had it retained the mortgage. See HUD Handbook 4350.1, Rev-1, Multifamily Asset Management and Project Servicing (January 23, 1996), ¶11-26. This plan extends well beyond the 9-year limit imposed by the handbook. In addition, the handbook contemplates that the longer it takes to stabilize a mortgage through work-out, the larger the investment expected from the owners. The owner contribution on this project is approximately 4% of the current outstanding mortgage, without considering the additional amounts expended by HUD for emergency renovations. This percentage is substantially less than the handbook would have required for HUD-held mortgages. HUD Handbook 4350.1, ¶ 11.23.

$**181.0** million (in total)

In addition, New York City will provide a $750,000 loan and $7.5 million in tax abatements. These federal and local funds, including forgiving the mortgage debt, will be used to rehabilitate the developments, operate the developments, and create a contingency fund to be used should Congress fail to make Section 8 appropriations. The owners will apparently control the Section 8 payments and Interest Reduction Payments (IRPs), and will establish the contingency fund.

The required owner contribution toward the rehabilitation and maintenance of these properties is approximately **$1 million**. However, the benefits which will accrue to these owners are substantially higher. At the end of 15 years, these owners will have:

- mortgage-free rehabilitated properties;
- millions of dollars of tax benefits; and
- a windfall of surplus cash amounting to $43 million should the contingency fund not be needed (i.e., should Congress continue to appropriate funds in conjunction with Section 8.)

In addition, the plan is silent as to owners' rights to distributions during the 15 years. The project is expected to have a substantial positive cash flow almost immediately. Even assuming the owners do not pay distributions during the 15-year period, under the current Regulatory Agreement they have a right to accrue distributions annually and pay them at a later date. In fact, the projects' latest financial statements show an accrued liability to the owners of $4,735,475 in unpaid distributions.[4]

HUD, while it will have maintained some 1238 units of affordable housing, will have no share in the substantial cash flow of this project. The proposed plan contains no provision requiring the owner to remit any portion of the contingency fund, other surplus cash, or proceeds from the sale of the property.

This plan is not the first of its kind. HUD executed a similar plan in Missouri for a large number of loans purchased by the Missouri Housing Development Commission ("MHDC"). A comparison of benefit/expense between these plans further confirms OIG's concerns about the advisability of the Beekman plan. Like Beekman, the Missouri Loan Sale Agreement contemplates the sale of HUD-held mortgages for a nominal price while continuing IRPs and Section 8 payments. In addition, many of the developments in the Missouri sale also required substantial repairs. In Missouri, however, it is MHDC which controls the IRP funds and the

[4] In addition, three of the projects' financial statements list as accrued fees payable "management incentive fees" accruing to the general partners in amounts totalling $853,534. While these fees may only be paid from distributions, these amounts appear to be in addition to the $4.73 million of unpaid distributions. OIG is reviewing the agreement on which these fees are based to determine whether it violates HUD requirements.

excess income. The Missouri Loan Sale Agreement requires IRPs to be deposited in an account administered by the MHDC. The agreement also requires debt service payments in excess of estimated returns to be placed in this account. While the fund may be used for activities similar to those in Beekman, e.g., repairs, tenant assistance, etc., MHDC must provide HUD a detailed annual accounting of the fund. In addition, it is HUD which receives any residual amounts from this fund at the end of the mortgage term. It is our understanding that, in hindsight, HUD may consider the Missouri deal to have been too expansive in the benefits it provides to the purchaser and mortgagor, and yet it provides far greater safeguards and fewer owner incentives than the Beekman deal.

2. <u>The Plan Rewards a Landlord Who May Bear Responsibility for Existing Conditions and Undermines HUD's Enforcement Ability</u>

A particularly troubling aspect of this deal is the fact that the current general partners will become limited partners in the new ownership structures, thus entitling those entities to equity, dividends, and tax benefits. These entities and their affiliated management agent are arguably responsible for the condition of the units during the period which led to this refinancing. The financing plan indicates that the conditions in these developments at the time of MIP were not simply poor, but dangerous. A report, entitled "Life, Health, and Safety Conditions Report, Recommendations for Immediate Repair Work, which is appended to the financing packages, states that there are " . . . major life threatening, health and safety conditions that exist at Diego Beekman Houses" which pose "immediate health and safety risks to residents." See Report, p. 1.

The financing plan holds the general partner and affiliated management agent harmless as to these conditions. Moreover, the interim workout agreement currently in effect states, at ¶ 5.5, that HUD will not take any adverse action under any previous participation review or clearance with respect to the owners, their principals and affiliates, or the management agent as a consequence of the developments if they have complied with the interim workout agreement. Given the physical condition of these developments, there is reason to be concerned that the owners may have contributed to the condition of the projects, and that the possibility of mismanagement exists. The interim workout agreement effectively provides a safe harbor to these landlords to participate in future HUD programs regardless of whether a HUD audit determines that the landlords are liable civilly or criminally for the condition of the developments.

<u>Recommendations</u>

We strongly recommend that this plan be reconsidered in light of the concerns discussed above. While the retention of affordable housing is an important goal, this plan fails to make the case for why provision of such expansive benefits by HUD to the owners is required in order to meet that goal. Absent additional safeguards, this plan will provide a substantial windfall to the owners and a substantial drain on limited HUD resources.

At a minimum, the Beekman financing plan should provide accountability by the parties receiving these benefits similar to that provided for in the Missouri deal. To the extent that the extensive funds being provided by HUD do not directly benefit the development and its tenants, those funds should be recouped by HUD. In addition, the owners' contribution to this plan should more accurately reflect the long term investment by HUD and the benefits to these owners. Finally, we strongly recommend that HUD not curtail its enforcement ability before it has time to fully evaluate the facts of a given case.

Should you have any questions, please contact me or Alexander C. Malloy, Assistant District Inspector General for Audit, on 212-264-8000, extension 3976.

Attachments

cc: Gary Eisenman, CM, Room 10216

BEEKMAN HOUSES

CHART ON REFINANCING PLAN

OUTLAYS	Federal	Owner	State/Local
Current Mortgages	$ 45,000,000 [5]		$ 8 [6]
IRPs ($1.67M annually	24,867,000 [7]		
Section 8 Payments/Fees	111,200,007		
OTHER			
Article VIII(A) Loan			750,000
Other Capital		$1,000,000	
Tax Abatement	**** [8]		7,500,000
TOTALS:	$181,067,007	$1,000,000	$8,250,008

Note: During the 20 years prior to becoming Mortgagee in Possession (MIP), HUD made $118 million in Section 8 payments and $38 million in Interest Reduction Payments (IRP) on the projects.

5 This amount includes the current mortgages of $28M, plus an additional $17M in repairs to be expended by HUD.

6 The New York City Housing Development Corp. will pay $1 per mortgage.

7 The transferred mortgages will be deemed to be state-financed, uninsured mortgages, making the owners eligible for continued IRPs.

8 Because the forgiveness of the mortgages will not occur for 15 years, the federal tax payments to the government are also affected. However, the plan does not quantify this figure.

BEEKMAN HOUSES

CHART ON REFINANCING PLAN

POSSIBLE FINANCIAL BENEFITS	Federal	Owner	State/Local
Contingency Fund		$43,000,000	
Tax Benefits		7,500,000	
Section 8 Admin fees ($600,000 per year)			$9,000,000
Property Value [9]		25,750,000	
Replacement Reserve		2,500,000	
TOTALS		$78,750,000	$9,000,000

NOTE: These figures do not include the following financial benefits which cannot presently be quantified:

1. Federal Tax benefits to the owners resulting form deferment of mortgage forgiveness.
2. Distributions available to the owners. The current Regulatory Agreement permits the owners to accrue 6% of their initial equity investment, per year.

[9] This figure represents the value of the properties after renovation, according to the financing plan. It does not appear to include appreciation over 15 years. Accordingly, we believe it understates the value of the properties.

ATTACHMENT 2

DISTRIBUTION

Secretary's Representative, New York/New Jersey, AS (2)
Director, Office of Housing, 2AH (2)
Assistant to the Deputy Secretary for Field Management, SDF (Room 7106)
(Acting) Deputy Assistant Secretary, HM, Room 6106 (2)
Director, Office of Multifamily Housing Development, HMD, Room 6134 (2)
Director, Office of Assistant Management & Disposition, HMM, Room 6160 (2)
Office of the Housing-FHA Comptroller, HF (Attention: Comptroller, Room 5132) (5)
(Acting) Chief Financial Officer, F (Room 10166) (2)
Director, Housing and Community Development Issue Area, U.S. GAO, 441 G Street, NW, Room 2474, Washington, DC 20548 (2)
Field Comptroller, Midwest Field Office, 5AF
CFO, Mid-Atlantic, Field Office, 3AFI
Inspector General, Z (Room 8256)