U.S. Department of Agriculture

Office of Inspector General
Southwest Region

Audit Report

Multi-Family Housing Loans in Texas

Report No. 04099-212-Te
August 2009

UNITED STATES DEPARTMENT OF AGRICULTURE
OFFICE OF INSPECTOR GENERAL
Southwest Region - Audit
101 South Main Street, Suite 324
Temple, Texas 76501
TEL: 254-743-6565 FAX: 254-298-1373

August 25, 2009

REPLY TO
ATTN OF: 04099-212-Te

TO: Francisco Valentin, Jr.
State Director
Rural Development
Texas State Office

FROM: Timothy R. Milliken /s/
Regional Inspector General
for Audit

SUBJECT: Multi-Family Housing Loans in Texas

SUMMARY:

Rural Development's Rural Rental Housing (RRH) Program provides affordable housing for low- and moderate-income people in rural areas by providing loans for construction or rehabilitation of multi-family housing. At the request of the Texas State Rural Development Office, the Office of Inspector General (OIG) initiated this audit to determine if there was an unidentified identity-of-interest relationship—essentially, two businesses acting as if they are distinct when they, in fact, are sharing common ownership interests—between the borrower and the general contractor for three rehabilitation projects in Texas.

Our review determined that there was not an identity-of-interest relationship between the borrower and the general contractor. There was, however, an unidentified identity-of-interest relationship between the borrower and a subcontractor (company C). The general contractor, who was paid directly for the construction, passed at least $83,000 in program funds to this undisclosed identity-of-interest company.

Project payments were calculated on a percentage-of-completion basis and certified by the general contractor, the borrower's project architect, and approved by Rural Development officials before being paid. Because actual cost documentation was not submitted with the payment requests, we did not determine whether the unidentified identity-of-interest relationship resulted in the misuse of the borrowers' projects assets.

We recommend that Rural Development obtain a certification of the actual costs of completing the project directly from an independent certified public accountant (i.e., one who has not acted as the borrower's accountant) when the rehabilitation work is complete. Based on the results of the cost certification, Rural Development should determine if the borrower's failure to disclose its identity-of-interest relationship with company C warrants further action, including determining if the borrower should be suspended or debarred.

In a letter dated August 11, 2009, Rural Development generally concurred with the finding and recommendations and provided proposed corrective actions. Rural Development's written response is included as exhibit A of the report, with excerpts and the OIG position incorporated into the relevant sections of the report. Your response contained sufficient justification to reach management decisions on all the recommendations contained in the report.

BACKGROUND:

The purpose of the multi-family housing program is to provide adequate, affordable, decent, safe, and sanitary rental units for very low-, low-, and moderate-income households in rural areas. In particular, the multi-family housing program supports the development of rental units in rural areas where this housing is unlikely to be provided through other means. These loans can be used to build, acquire and rehabilitate, or improve dwellings in rural areas.

On March 30, 2005, loans for the transfer and assumption of three multi-family housing properties in West Texas were closed between the Texas State Rural Development Office and the borrower. On that same date, Rural Development made rehabilitation loans through an interim lender totaling $954,000 to three properties: $234,000 to Marfa Villa, Ltd.; $350,000 to Alpine Mountainview, Ltd.; and $370,000 to Fort Stockton Oasis, Ltd. Even though the rehabilitation loans were made in March 2005, rehabilitation construction did not begin on the properties until after the preconstruction hearing was held on April 20, 2006.

On April 23, 2008, the Texas State Rural Development Office requested that OIG conduct an audit of these three properties. In its request, Rural Development alleged that an undisclosed identity of interest existed between the borrower and the general contractor. The borrower indicated to Rural Development staff that the general contractor had ceased working directly on the projects and was now paying subcontractors to complete the work.

On March 26, 2009, Rural Development conducted the final inspections on each of the three properties and determined that the rehabilitation work was complete. On May 17, 2009, the interim lender notified the borrower that it was 2 months past due and planned to foreclose on the properties if the rehabilitation loans were not brought current or closed with Rural Development.

OBJECTIVE:

Our objective was to determine whether there were undisclosed identity-of-interest relationships[1] at three multi-family housing properties in Texas, and, if so, whether this has resulted in equity skimming of project funds.

SCOPE AND METHODOLOGY:

The scope of our review included the loan portfolios for three multi-family housing loans: Marfa Villa, Ltd.; Alpine Mountainview, Ltd.; and Fort Stockton Oasis, Ltd. Fieldwork began in June 2008 and ended in May 2009. The fieldwork was performed at the Texas State Rural Development Office in Temple, Texas; Rural Development's Area Nine field office located in Fort Stockton, Texas; and the borrower's office in Austin, Texas. We also visited the interim lender's bank in Corpus Christi, Texas; the project architect's office in Hondo, Texas; and the borrower's banks in Austin, Texas.

To accomplish our audit objective, we:

1. Reviewed laws, regulations, and agency policies and procedures.
2. Reviewed and analyzed the loan portfolios for the three loans.
3. Interviewed Rural Development personnel responsible for servicing the projects, the borrower, the general contractor, the executive vice president at the interim lender, the management agent, the project architect, and personnel at the borrower's banks.
4. Reviewed information obtained from Rural Development personnel, the borrower, the general contractor, the interim lender, and the project architect. The information included bank records, business records, annual agreed-upon procedures engagements, and inspection documents for the three projects.
5. Analyzed data obtained to determine whether undisclosed identities of interest existed at three multi-family housing properties in Texas.

We conducted this performance audit in accordance with generally accepted Government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

FINDINGS AND RECOMMENDATIONS

FINDING 1: BORROWER DID NOT DISCLOSE AN IDENTITY-OF-INTEREST RELATIONSHIP

The borrower did not disclose an identity of interest in a subcontractor named company C, which was rehabilitating three of the borrower's RRH projects. The borrower believed that, since it had disclosed an identity of interest in company C's parent company, company B, it had done what

[1] Relationships where the borrower and the supplying entity (subcontractor) share a financial interest.

was necessary. The borrower further stated that, since it knew that all identity-of-interest relationships would be fully disclosed when the cost certification was completed, it was not concealing this relationship. As a result, the general contractor was able to pass at least $83,000[2] to company C without the borrower disclosing to Rural Development its identity of interest in the company.

Federal regulations and Rural Development procedures[3] state that borrowers must disclose to the agency all identity-of-interest relationships they have with firms and must receive agency approval prior to entering into any contractual relationship with such entities that involve agency funds. In addition to disclosing all situations where there is identity of interest, the borrower, contractor and any subcontractor, material supplier, or equipment lessor having an identity of interest must each provide certification as to the actual cost of the work performed in connection with the construction contract. If an identity of interest exists or comes into being, the contractor agrees to have construction costs audited by a certified public accountant who will provide an opinion as to whether the construction costs have been presented fairly in conformity with eligible construction costs. The construction costs must also be audited in accordance with governmental auditing standards. In some cases, the cost certification will be obtained by Rural Development through direct contract with the certified public accountant. Any certified public accountant who acts as the borrower's accountant will not be the same certified public accountant who cost-certifies the project. Failure to disclose such an identity-of-interest relationship may subject the borrower, the management agent, and the other firms or employees found to have an identity-of-interest relationship to suspension, debarment, or other remedies available to the agency.

The Texas State Rural Development Office requested this audit because officials there believed that the borrower might have an identity-of-interest relationship with the general contractor. We found that this was not the case—the general contractor was an independent business that the borrower did not own or have a personal or financial interest in.

We did, however, find that the borrower had not disclosed its ownership interest in company C. After the general contractor received $83,000 in project funds, it passed that sum on to this undisclosed identity-of-interest company. When we questioned the borrower about this transaction, he explained that company C was only used to pay yet another subcontractor. The borrower reasoned that a disclosure was not needed for company C since it was a wholly owned subsidiary of company B, an identity-of-interest company that had been disclosed on June 26, 2006. Company B's disclosure was needed because Rural Development authorized it to do a minimum amount of work on the projects under a separate contract. The borrower further explained that this relationship would be disclosed when costs were certified.

Given the undisclosed identity-of-interest relationship between the borrower and the subcontractor, we are recommending that Rural Development take additional steps to ensure that the borrower spent program funds appropriately. Specifically, Rural Development needs to

[2] Payments totaling $83,085 were made as follows: $18,394 on May 23, 2007; $41,833 on July 12, 2007; and $22,858 on May 19, 2008.
[3] Title 7, *Code of Federal Regulations* (CFR), part 3560, section 11, January 1, 2005, edition.; 7 CFR part 3560, section 72(b), January 1, 2005, edition; 7 CFR part 1924, section 13(e)(1)(v)(F), January 1, 2006, edition.; 7 CFR part 3560, section 102(g), January 1, 2005, edition. Rural Development *Handbook* HB-1-3560, paragraphs 9.4 and 9.8, dated February 24, 2005.

obtain a cost certification directly from a certified public accountant who has not acted as the borrower's accountant.

RECOMMENDATION 1:

Upon completion of the rehabilitation work, obtain a certification of the actual costs of construction directly from a certified public accountant who has not acted as the borrower's accountant.

AGENCY RESPONSE:

Rural Development's written response, dated August 11, 2009, stated the rehabilitation construction is complete; however, the borrower has been nonresponsive to our requests for documents which are needed for loan closing. In addition, it has come to our attention that the borrower's limited partnership's right to conduct affairs was forfeited on July 31, 2009, by the State of Texas Office of the Secretary of State. The borrower's corporation charter was also forfeited as of July 24, 2009. If the borrower does not clear the loss of privileges with the State of Texas and does not provide the necessary documents and information needed for loan closure by August 14, 2009, we intend to proceed with acceleration and foreclosure action. As a result of aforementioned actions, we are unable to obtain cost certification from an independent certified public accountant. We plan to complete the proposed servicing actions by August 1, 2010.

OIG POSITION:

We accept the management decision for Recommendation 1.

RECOMMENDATION 2:

Upon completion of the cost certification and review, determine if the borrower's failure to disclose its interest in company C warrants further action, including determining if the borrower should be suspended or debarred.

AGENCY RESPONSE:

Rural Development's written response, dated August 11, 2009, stated if the borrower does not cure the loss of privileges with the State of Texas and does not provide the necessary documents and information needed for loan closure by August 14, 2009, we intend to proceed with acceleration and foreclosure action. As a result of aforementioned actions, we anticipate the borrower will be suspended and debarred. We plan to complete the proposed action to suspend and debar the borrower by August 1, 2010.

OIG POSITION:

We accept the management decision for Recommendation 2.

Please follow Departmental and your internal agency procedures in forwarding final-action correspondence to the Office of the Chief Financial Officer, Director, Planning and Accountability Division. Final action on the management decisions should be completed within 1 year of the date of the management decisions to preclude being listed in the Department's annual Performance and Accountability Report.

We appreciate the courtesies and cooperation extended to us by members of your staff during the audit.

Exhibit A – *Agency Response*

USDA Rural Development

United States Department of Agriculture
Rural Development

AUG 1 1 2009

SUBJECT: Official Draft - Multi-Family Loans in Texas
Audit No. 04099-212-TE)

TO: Robert Young
Assistant Inspector General
For Audit

Attached for your review is the response from the Texas State Director, Francisco Valentin, Jr., concerning a response to the recommendations the above subject audit. The Discussion Draft was elevated to an Official Draft on July 1, 2009.

This response is being submitted to reach management decision on the two recommendations in the Official Draft Report.

If you have any questions, please contact Arlene Pitter Bell of my staff at 202-692-0083.

John M. Purcell

JOHN M. PURCELL
Director
Financial Management Division

Attachment

Exhibit A – Page 2 of 3

USDA Rural Development

United States Department of Agriculture
Rural Development
Texas State Office

AUG 7 2009

TO: Evan J. Segal
Chief Financial Officer
Whitten Building, Room 143-W
1400 Independence Avenue SW
Washington D.C. 20250

SUBJECT: 04099-212-Te
Multi-Family Housing Loans in Texas

We have reviewed the above referenced official draft audit report, and are providing the following response which describes the corrective actions planned and timeframes for implementation of the recommendations.

Recommendation #1 – The rehabilitation construction is complete; however, the borrower has been non-responsive to our requests for documents which are needed for loan closing. Please see attached copies of our letters to the borrower requesting necessary documents and information. In addition, it has come to our attention that the borrower's limited partnership's right to conduct affairs was forfeited on July 31, 2009, by the State of Texas Office of the Secretary of State. Please see attached copies of the Secretary of State's letters dated July 31, 2009. The borrower's corporation charter is also forfeited as of July 24, 2009. Please see attached "Forfeiture pursuant to Section 171.309 of the Texas Tax Code."

If the borrower does not cure the loss of privileges with the State of Texas and does not provide the necessary documents and information needed for loan closure by August 14, 2009, we intend to proceed with acceleration and foreclosure action. As a result of afore mentioned actions, we are unable to obtain cost certification from an independent certified public accountant.

Timeframe: We plan to complete the proposed servicing actions by August 1, 2010.

Recommendation #2 – If the borrower does not cure the loss of privileges with the State of Texas and does not provide the necessary documents and information needed for loan closure by August 14, 2009, we intend to proceed with acceleration and foreclosure action. As a result of afore mentioned actions, we anticipate the borrower will be suspended and debarred.

Timeframe: We plan to complete the proposed action to suspend and debar the borrower by August 1, 2010.

If you have any questions concerning our response, please contact Donna Freytag, Management Control Officer at 254-742-9704 or by email at Donna.Freytag@tx.usda.gov.

FRANCISCO VALENTIN, JR.
State Director

Attachment

cc: John Purcell, Director, Financial Management Division
Donna Freytag, Management Control Officer