



U.S. Department of Housing and Urban Development

Office of Inspector General

Region IX

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December 22, 2011

Mr. Greg Nyhoff
City Manager
City of Modesto
1010 Tenth Street, Suite 6100
Modesto, CA 95353

Dear Mr. Nyhoff:

Enclosed is our audit report resulting from our recently completed review of the City of Modesto's Neighborhood Stabilization Program 2 (NSP2). We performed the review because it was part of the Office of Inspector General's (OIG) audit plan to conduct audits of NSP2 under the American Reinvestment and Recovery Act of 2009. If you have any questions, please contact me at (213) 534-2471 or Helen Sparks, Assistant Regional Inspector General for Audit, at (415) 489-6697.

Sincerely,

Tanya E. Schulze
Regional Inspector General for Audit

Enclosure

Cc: Marcia Bradshaw, CPD Specialist, 9AD
Rebecca Blanco, NSP Specialist, 9AD
Maria F. Cremer, Acting Director, Community Planning and Development, 9AD
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Craig T. Clemmensen, Director, Departmental Enforcement Center, CACB

AUDIT REPORT



THE CITY OF MODESTO, CA, DID NOT ALWAYS COMPLY
WITH NEIGHBORHOOD STABILIZATION PROGRAM 2
REQUIREMENTS

MODESTO, CA

2012-LA-1003

December 22, 2011

OFFICE OF AUDIT
REGION IX
LOS ANGELES, CALIFORNIA



Issue Date	December 22, 2011
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Audit Report Number	2012-LA-1003
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TO: Maria F. Cremer, Acting Director, San Francisco Office of Community Planning and Development, 9AD

Craig T. Clemmensen, Director, Departmental Enforcement Center, CACB

Tanya E. Schulze

FROM: Tanya E. Schulze, Regional Inspector General for Audit, Region IX, 9DGA

SUBJECT: The City of Modesto, CA, Did Not Always Comply With Neighborhood Stabilization Program 2 Requirements

HIGHLIGHTS

What We Audited and Why

We completed a review of the City of Modesto's Neighborhood Stabilization Program 2 (NSP2). We performed the review because it was part of the Office of Inspector General's (OIG) audit plan to conduct audits of NSP2 under the American Reinvestment and Recovery Act of 2009. We selected the City because it received \$25 million and HUD's San Francisco Office of Community Planning and Development requested that OIG consider a review of the City.

Our objective was to determine whether the City administered its NSP2 grant in accordance with HUD requirements. Specifically, we focused on whether the City administered the program to ensure that developers used program funds for eligible acquisition and rehabilitation costs. The audit scope did not include tenant or homeowner eligibility and occupancy.

What We Found

Program funds were not always used for eligible costs to acquire and rehabilitate properties. Specifically, the City approved ineligible project management fees and unsupported expenditures totaling \$56,130 during rehabilitation. In addition, a city council member and a principal of one developer violated HUD's and the City's requirements when a company they co-own collected a commission of \$62,500 in an NSP2 property purchase transaction. Lastly, the City used program funds of \$51,936 to pay inappropriate real estate commissions based on unsigned addenda to purchase agreements.

What We Recommend

We recommend that the Acting Director of HUD's San Francisco Office of Community Planning and Development require the City to (1) adjust the loan amounts and developer contribution amounts for each of the properties affected by the \$47,976 in ineligible project management fees and the \$8,154 in unsupported rehabilitation costs and (2) reimburse its NSP2 grant \$51,936 using non-Federal funds for the ineligible real estate commissions paid based on unsigned addenda to purchase agreements.

We also recommend that the Director of HUD's Departmental Enforcement Center take administrative action against the city council member for the conflict-of-interest violation.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-4. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided the City a discussion draft report on November 28, 2011, and held an exit conference with appropriate officials on December 1, 2011. The City provided written comments on December 12, 2011, and generally agreed with our findings.

The complete text of the City's response, along with our evaluation of that response, can be found in appendix B of this report. The City also provided numerous attachments, which were too voluminous to include in the report; however, they are available upon request.

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BACKGROUND AND OBJECTIVE

The Neighborhood Stabilization Program 2 (NSP2) was authorized under Title XII of Division A of the American Recovery and Reinvestment Act of 2009 and provided 56 grants nationwide on a competitive basis totaling \$1.93 billion. The grants went to one State, local governments, nonprofits, and consortia of public or private nonprofit entities. This program was established to stabilize neighborhoods, the viability of which had been damaged by the economic effects of properties that were foreclosed upon or abandoned.

The U.S. Department of Housing and Urban Development (HUD) awarded \$25 million in NSP2 funding to the City of Modesto and executed the grant agreement with the City on February 11, 2010. The grant agreement requires the City to expend 50 percent of the grant by February 11, 2012, and expend 100 percent of the grant by February 11, 2013.

According to the City’s action plan, NSP2 funding will be used to purchase and rehabilitate foreclosed-upon or abandoned residential properties and then rent or resell these properties to income-eligible households. The City expected to accomplish three major objectives: (1) stabilize the housing market in the City, (2) create jobs through the rehabilitation work, and (3) provide an opportunity for home ownership to many who might not have that opportunity otherwise.

Activity	Responsible entity	NSP2 funds
Buying and rehabilitating residential properties for rental or home ownership by households with incomes of up to 120% of the area median income	For-profit and nonprofit developers	\$10,500,000
	Stanislaus Community Assistance Project	\$4,500,000
Buying and rehabilitating residential properties for rental or home ownership by households at or below 50% of the area median income	Housing Authority of the County of Stanislaus	\$6,000,000
	Stanislaus Community Assistance Project	\$1,500,000
Program administration	City	\$2,500,000
Total		\$25,000,000

Our objective was to determine whether the City administered its NSP2 grant in accordance with HUD requirements. Specifically, we focused on whether the City administered the program to ensure that developers used program funds for eligible acquisition and rehabilitation costs. The audit scope did not include tenant or homeowner eligibility and occupancy.

RESULTS OF AUDIT

Finding 1: The City Approved Ineligible and Unsupported Costs During Rehabilitation

The City used NSP2 funds for ineligible project management fees and unsupported rehabilitation costs for one developer and its affiliated general contractor. This deficiency occurred because the City did not follow HUD's or its own requirements. As a result, the rehabilitation costs and corresponding loans to the developer were inflated, and \$56,130 in NSP2 funds was not available for other eligible expenditures.

The City's NSP2 Program Design

Although the City attempted to design its program in accordance with HUD requirements and guidelines for acquisition and rehabilitation of NSP2 properties, there were ineligible and unsupported costs during rehabilitation. One of the for-profit developers, Trinity Ventures RE II, used a company owned by one of its principals, Trinity Renovation, Inc., as its general contractor. HUD has no requirement that specifically prohibits such an arrangement. However, the conflict-of-interest clause in the City's memorandum of understanding with developers prohibits this arrangement. It states, "No board member, officer, owner or employee of *Developer* shall have any personal interest, direct or indirect, in this MOU [memorandum of understanding]. No board member, officer or employee of *Developer* shall have, receive, accept or derive any pecuniary interest, direct or indirect, from this MOU or any CDBG [Community Development Block Grant] NSP2 Loan made to purchase eligible property" (see appendix C). When we identified the issue, the City stated that it believed that the conflict-of-interest clause was written incorrectly in the for-profit developer memorandums of understanding and it was inconsistent with the regulatory and loan agreements; thus, the clause could not be enforced. As a result, the City planned to amend the memorandum to remove and replace the conflict-of-interest clause to conform to HUD requirements.

HUD allows grantees to engage subrecipients and developers to assist in the acquisition and rehabilitation of eligible properties under NSP2. Developers are distinctly different from subrecipients in that developers may earn a developer fee. Developers are also not held to the same level of procurement, record-keeping, or audit requirements as subrecipients. Because of this flexibility, HUD put the burden on the grantees to structure programs to avoid undue enrichment of developers. For instance, grantees were encouraged to

structure assistance to developers that undertook acquisition or rehabilitation as loans rather than grants (see appendix C).

The lack of an arm's-length transaction led to Trinity Ventures RE II and Trinity Renovation, Inc., having collectively received undue enrichment for eight of the developer's nine rental properties. This enrichment included a developer fee that amounted to 5 percent of the rehabilitation budget, a project management fee, a project supervision fee, and a 20 percent markup for subcontractors' rehabilitation work.

Ineligible and Unsupported Costs

While developers are permitted to charge a developer fee, HUD's NSP Policy Alert, dated August 27, 2010 and updated on November 16, 2011, prohibited developers from double-dipping by both collecting a developer fee and charging a project management fee (see appendix C). The City approved ineligible project management fees for eight of nine Trinity Ventures RE II properties. The project management fees amounting to \$47,976 were ineligible because the City had already paid a developer fee that equaled 5 percent of the rehabilitation budget for each of eight properties (see appendix D). For instance, Trinity Ventures RE II received \$6,340 in project management fees for one property for which it had previously collected a \$1,712 developer fee.

The City also approved rehabilitation invoices from Trinity Ventures RE II without requiring adequate supporting documentation. Invoices showed rehabilitation costs charged by Trinity Renovation, Inc., but did not always include adequate documentation to support the rehabilitation costs invoiced. For instance, there were invoices showing project supervision costs and other subcontractors' work with a 20 percent markup by Trinity Renovation, Inc., but no documentation other than the invoice was provided.

The City's NSP2 loan agreement required the developer, as the borrower, to "...prepare and retain all pertinent books, records, and documents sufficient to reflect all costs incurred by Borrower for which funds are sought in accordance with HUD and NSP2 Program requirements. City and/or HUD may inspect such writings and carry out such monitoring and evaluation which will, at minimum, ensure that Borrower is in compliance with the terms of this NSP2 Loan Agreement." It further required that the borrower (developer) "...maintain complete books of accounts and other records for expenses incurred under this NSP2 Loan Agreement, including personal property, personnel and financial records. Borrower's records shall accurately and fully show the date, amount, purpose, and payee of all expenditures incurred" (see appendix C).

Conclusion

The City did not follow HUD's or its own requirements when it approved \$47,976 in ineligible project management fees and \$8,154 in unsupported rehabilitation costs. As a result, the rehabilitation costs and corresponding rehabilitation loans for Trinity Ventures RE II's eight properties were inflated by these questioned costs, and the developer received undue enrichment (see appendix D).

Recommendations

We recommend that the Acting Director of HUD's San Francisco Office of Community Planning and Development require the City to:

- 1A. Adjust the loan amount and developer contribution amount for each property affected by the \$47,976 in ineligible project management fees and ensure that the City only draws down the appropriate amounts from its NSP2 grant from HUD.
- 1B. Provide documentation to support the \$8,154 rehabilitation costs incurred by Trinity Ventures RE II and Trinity Renovation, Inc., or adjust the loan amount and developer contribution amount for each property affected by the unsupported rehabilitation costs and ensure that the City only draws down the appropriate amounts from its NSP2 grant from HUD.

Finding 2: One NSP2 Developer and a City Council Member Violated the Conflict-of-Interest Requirements in an NSP2 Property Purchase Transaction

A city council member and one of the developers violated conflict-of-interest requirements of both HUD and the City in one multifamily property acquisition. Specifically, the real estate company co-owned by the city council member and a principal of the developer collected a real estate commission from the purchase transaction. This condition occurred because the city council member and the developer did not disclose the relationship with the real estate company. This deficiency resulted in the real estate company's collecting an inappropriate \$62,500 in commissions from the seller.

Conflict of Interest

HUD's conflict-of-interest regulations at 24 CFR (Code of Federal Regulations) 570.611 state that no persons who are employees, officers, or elected or appointed officials of the recipient, who are in a position to participate in a decision-making process or gain inside information with regard to such activities, may obtain a financial interest or benefit from a CDBG-assisted activity or have a financial interest in any contract, subcontract, or agreement with respect to a CDBG-assisted activity, either for themselves or those with whom they have business ties, during their tenure or for 1 year thereafter. In addition, the City's memorandum of understanding with the developer specifically stated that no board member, officer, or employee of the developer could have, receive, accept, or derive any pecuniary interest, direct or indirect, from that memorandum of understanding or any CDBG NSP2 loan made to purchase an eligible property (see appendix C).

The city council member and a principal of the developer, Trinity Ventures RE II, ignored the conflict-of-interest requirements when the real estate company they co-owned, Benchmark Commercial Real Estate Services, collected a \$62,500 broker's commission from the seller, Delta Bank, when Trinity Ventures RE II purchased a multifamily property (see appendix D). While the city council member recused himself from discussions related to NSP2 at city council meetings, both before and after the purchase transaction as required, his real estate company chose to accept the broker's commission in this transaction. The City was unaware of the conflict-of-interest violation because both the city council member and the principal of Trinity Ventures RE II failed to disclose their ownership interests in Benchmark Commercial Real Estate Services.

Corrective Action Taken

Soon after we brought this matter to the City's attention, the City took corrective action and sent a letter to the principals of Trinity Ventures RE II demanding that the \$62,500 commission be returned to the City. In response to the City's demand, Sentinel Rock Realty Trust¹ wrote a check to the City for \$62,500. However, since the commission was not originally paid by the City using NSP2 funds, the City did not retain these funds in its NSP2 grant. Instead, it returned the \$62,500 commission to Delta Bank.

Conclusion

A conflict-of-interest violation occurred because there was no disclosure of the ownership interest of Benchmark Commercial Real Estate Services. This omission resulted in an inappropriate real estate commission of \$62,500. Had the relationship been disclosed to the City, it would have disallowed the payment.

Recommendation

We recommend that the Director of HUD's Departmental Enforcement Center:

- 2A. Take appropriate administrative action, up to and including debarment², against the city council member for his part in the violation that resulted in the inappropriate \$62,500 commission.

¹ According to California's Department of Real Estate, Sentinel Rock Realty Trust is doing business as Benchmark Commercial Real Estate Services.

² A debarment sanction means that an individual, organization and its affiliates are excluded from conducting business with any Federal Agency government-wide. Debarment is the most serious compliance sanction and is generally imposed for a three-year period. However, debarment can be imposed for a longer period of time, if the debarring official determines this action is necessary to protect the public interest.

Finding 3: The City Approved Ineligible Real Estate Commissions

In addition to the seller-paid commissions, the City approved and financed ineligible real estate commissions that equaled six percent of the property purchase price for one developer. This condition occurred because the City did not verify with the seller or the buyer the appropriate amount of real estate commissions. As a result, NSP2 funds were used to pay \$51,936 in ineligible real estate commissions.

Real Estate Commissions Paid by Buyer

Financed by the City's NSP2 funds, the developer, Mission Housing Development Corporation, purchased 12 properties. Mission used the same real estate agent for all 12 acquisitions. In 11 of those transactions, an unsigned addendum to the purchase agreement stated that Mission, as the buyer, would pay all closing costs above those stipulated by the seller in the contract and would also pay commissions totaling 6 percent (half for the seller's agent and the other half for the buyer's agent) of the purchase price at closing.³

When the offers to purchase were accepted by the sellers, the sellers prepared the purchase agreements and emailed them to Mission's real estate agent for signature. The seller, Bank of America, stipulated in its nine purchase agreements that it would pay commissions to both agents, while the seller, Wells Fargo's purchase agreements for two transactions were silent on the commissions. The verbiage that stipulated the additional closing costs and commissions to be paid by the buyer was added to each addendum by Mission's real estate agent, who then collected half of the additional commissions based on the unsigned addendum.

The City paid a total of \$51,936 for ineligible real estate commissions based on the unsigned addenda in 11 property acquisitions (see appendix D). Upon receiving the unsigned addenda, the City raised concerns about the additional closing costs and commissions to be paid by Mission. In response, the buyer's real estate agent verbally informed the City that, through negotiation, the sellers had demanded that the buyer pay all closing costs, including the real estate agents' commissions. The ineligible real estate commissions occurred because the City did not further verify with the seller or buyer regarding commissions that benefited the real estate agent. Instead, the City relied on the

³ One of the twelve transactions had an addendum with the same language, stipulating that the buyer would pay the additional closing costs and commissions, and it was signed by both the seller, JPMorgan Chase, and the buyer, Mission.

explanation from the buyer's agent although his explanation conflicted with the written terms in the purchase agreements and unsigned addenda. In addition, Old Republic Title Company allowed escrow funds to be disbursed based on unsigned purchase agreement addenda for 11 transactions.

Recommendation

We recommend that the Acting Director of HUD's San Francisco Office of Community Planning and Development require the City to:

- 3A. Repay, using non-Federal funds, \$51,936 in ineligible real estate commissions to its NSP2 grant.

SCOPE AND METHODOLOGY

Our review generally covered the period July 1, 2009, to March 31, 2011, and was expanded to other periods when necessary. We performed our onsite audit work at the City's office located in Modesto, CA, from May to October 2011.

To accomplish our audit objective, we

- Reviewed applicable HUD requirements;
- Reviewed relevant background information related to the City and its NSP2 grant;
- Reviewed the City's policies and procedures for administering NSP2;
- Interviewed HUD staff, City staff, developers, and real estate agents, as appropriate;
- Reviewed the City's records pertaining to property acquisition, rehabilitation, and expenditures and disbursements;
- Reviewed escrow files; and
- Visited properties that were purchased and rehabilitated under NSP2.

We chose a survey sample from a universe of 66 properties with more than \$10.3 million in NSP2 funds drawn down and attributed to four activities⁴ as of March 31, 2011. Based on the Disaster Recovery Grant Reporting system drawdown reports, we selected a nonstatistical sample of draws from three activities.⁵ The draws selected in the survey sample totaled more than \$5 million for 12 property acquisitions and 8 rehabilitations. In the audit phase, we expanded the nonstatistical sample to include an additional 22 property acquisitions with purchase prices that totaled more than \$2.1 million and 19 property rehabilitations with rehabilitation budgets that totaled more than \$1.2 million (see appendix E for a summary of property information). We used computer-processed data to select the nonstatistical sample and, through our testing, determined that the computer-processed data were adequate for our purposes.

We conducted the 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.

⁴ The four activities shown in the Disaster Recovery Grant Reporting system drawdown reports were entitled AR Developers, AR Special Needs, LH 25% Special Needs, and Administrative.

⁵ We did not select from the administrative activity because as of March 31, 2011, the amount drawn down for this activity was less than 3 percent of the total amount drawn for all four activities.

INTERNAL CONTROLS

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

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

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

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

- Policies and procedures implemented to reasonably ensure that program activities comply with applicable laws and regulations.
- Policies and procedures implemented to reasonably ensure that program funds are used for eligible activities.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Significant Deficiency

Based on our review, we believe that the following item is a significant deficiency:

- The City did not always ensure that program expenditures were eligible and adequately supported.

APPENDIXES

Appendix A

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

Recommendation number	Ineligible <u>1/</u>	Unsupported <u>2/</u>	Funds to be put to better use <u>3/</u>
1A	\$47,976		
1B		\$8,154	
2A			\$62,500
3A	\$51,936		
Totals	\$99,912	\$8,154	\$62,500

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 policies or regulations. In this case, the ineligible costs included the \$47,976 in project management fees paid to Trinity Ventures RE II and the \$51,936 in real estate commissions paid based on the unsigned purchase addenda for the Mission properties.

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 the 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. In this instance, the unsupported costs represented the \$8,154 in rehabilitation costs charged by Trinity Ventures RE II and Trinity Renovation, Inc., which the City approved but did not provide supporting documentation.

3/ Recommendations that funds be put to better use are estimates of amounts that could be used more effectively if an Office of Inspector General (OIG) recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified. In this case, the funds to be put to better use refer to the \$62,500 real estate commission paid by the seller, Delta Bank, to Benchmark Commercial Real Estate Services based on nondisclosure of a conflict of interest.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments



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TDD 209/526-9211*

December 12, 2011

Tanya E. Schulze
Regional Inspector General for Audit
U.S. Department of Housing & Urban Development
Office of Inspector General, Region IX
611 West Sixth Street, Suite 1160
Los Angeles, California 90017-3101

Dear Ms. Schulze:

This letter transmits the City of Modesto's response to the Office of the Inspector General (OIG) draft Audit Report dated November 28, 2011.

The City of Modesto has carefully reviewed the OIG's findings and recommendations and appreciates the opportunity to provide comments on the OIG Draft Audit report. Further we are grateful for the cooperation of the OIG staff in working with the city both during the audit process and in the completion of the Audit Report.

As we understand it, the OIG audit included property acquisitions, appraisal procedures, the reasonableness and cost effectiveness of property rehabilitations, billing procedures and reimbursements to developers, as well as overall policies and procedures set in place by the City of Modesto. After reviewing all these activities, the OIG identified three audit findings, none of which the city disputes.

At this point, the City of Modesto has distributed approximately \$11 million of the funding allocated through the NSP2 grant. The city, in its analysis, finds that the total monetary amount cited in the draft findings equals \$253,888 (including the \$153,305 for which the city is now providing documentation). These findings amount to only a very small amount of the grant expended thus far and less than 1.0% of the total grant allocated to the City of Modesto. We appreciate the OIG's thorough study and review of the NSP 2 files and consider the limited findings representing a small percentage of error a testament to the city's attention to regulations, procedures and overall appropriate grant management.

The city's comments follow:

OIG Finding #1: The city approved ineligible and unsupported costs during rehabilitation.

City Response for Finding 1A: With regard to the \$47,976 in ineligible property management fees, the city concurs with the OIG finding and has adjusted the developer contributions to ensure that the NSP2 drawdowns reimburse only eligible expenses.

Citizens First!

Comment 1

Comment 2

City Response for Finding 1B: The city agrees that there was incomplete documentation in the office files to support the \$91,476 rehabilitation costs incurred by Trinity Ventures RE II and Trinity Renovation, Inc. However, the documentation and paperwork has been obtained and is provided in Attachment A except for a small amount totaling \$670.37. We believe that this documentation supports the reimbursement of \$90,805.63

OIG Finding #2: One NSP2 developer and a City Councilmember violated the Conflict-of-Interest Requirements in an NSP2 property purchase transaction.

City Response: The city concurs with the OIG finding regarding a conflict-of-interest violation by Trinity Ventures RE II during the purchase of one multi-family unit. This violation resulted in the improper payment of a real estate commission to Benchmark Commercial Real Estate Services. As noted in the draft Audit Report, the city did request repayment of the commission and has since returned the commission to the seller, Delta Bank.

OIG Finding #3: The city approved ineligible real estate commissions.

City Response: The city concurs with the OIG finding that these commissions should not have been paid and that Old Republic Title Company allowed escrow funds to be disbursed based on unsigned addenda for 11 property transactions. We further concur with the OIG recommendation that the city adjust the developer fees for these 11 properties to account for the \$51,936 in ineligible real estate commissions or repay these fees using non-Federal funds.

Comment 3

Thank you again for the opportunity to provide comments on the draft Audit Report. If you have any questions, please contact Cynthia Shallit at (209) 341-2941.

Sincerely,



Greg Nyhoff
City Manager

Cc: Jim Ridenour, Mayor
Dee Williams-Ridley, Deputy City Manager
Susana Alcala-Wood, City Attorney
Julie Hannon, Director of Parks, Recreation, & Neighborhoods

OIG Evaluation of Auditee Comments

- Comment 1** We reviewed the City's policies and procedures to obtain an understanding of the program design. We made no attestation to the effectiveness of appraisal procedures, billing procedures by developers, the City's overall policies and procedures, and the reasonableness and cost effectiveness of property rehabilitations. Our audit focused on whether the City ensured program funds were used for eligible acquisition and rehabilitation costs.
- Comment 2** The final report has been revised. After reviewing the documentation provided by the City, we determined that \$8,154 in rehabilitation costs remained unsupported.
- Comment 3** The City approved the payment of the real estate commissions based on the explanation of the buyer's agent even though his explanation conflicted with the written terms in the purchase agreements and unsigned addenda. The ineligible real estate commissions were paid because the City did not verify with the seller or buyer regarding the commissions that benefited the real estate agent. Therefore, the recommendation remains the same, for the City to repay, using non-Federal funds, \$51,936 in ineligible real estate commissions to its NSP2 grant. While we had discussed the possibility of adjusting the developer fees, we evaluated this further, and do not agree that the City adjust the developer fees for the ineligible real estate commissions.

Appendix C

CRITERIA

The Notice of Fund Availability (NOFA) for the NSP2 under the American Recovery and Reinvestment Act, 2009 states, “The Recovery Act repealed Section 2301(d)(4) of HERA [Housing and Economic Recovery Act of 2008], which set requirements for the disposition of revenues generated by NSP assisted activities. Therefore, regular CDBG rules governing program income shall apply. Recipients are strongly encouraged to avoid the undue enrichment of entities that are not subrecipients.”

HUD NSP Policy Alert, dated December 11, 2009, states that developers “are not subject to recordkeeping or audit requirements that do apply to subrecipients. This flexibility creates a burden on the grantee to underwrite all such transactions to avoid undue enrichment.”

HUD NSP Policy Alert, dated August 27, 2010 and updated on November 16, 2011, states, “Grantees and subrecipients may not earn a developer’s fee. An entity may charge developer’s fees only under 24 CFR 570.202(b)(1), which allows a grantee to provide CDBG funds (or NSP funds) to assist in the acquisition and rehabilitation/reconstruction of property by private individuals or entities. The right to charge a developer’s fee is available only to an entity that receives assistance from the grantee or the subrecipient and assumes some of the risk of the project, which the developer does by investing some of his/her own money in the project.”

The same HUD NSP Policy Alert states that “if a developer’s budget called for directly paying a project manager and also a developer fee that would be double-dipping and would not be allowed. Direct costs or indirect costs of a developer related to project management should be paid only through the fee.”

HUD’s conflict of interest requirements in 24 CFR 570.611 specify that no persons (who are employees, agents, consultants, officers, or elected or appointed officials of the recipient or of any designated public agencies or of subrecipients), who exercise or have exercised any functions or responsibilities with respect to CDBG activities assisted under this part or who are in a position to participate in a decision-making process or gain inside information with regard to such activities, may obtain a financial interest or benefit from a CDBG-assisted activity or have a financial interest in any contract, subcontract, or agreement with respect to a CDBG-assisted activity or with respect to the proceeds of the CDBG-assisted activity, either for themselves or those with whom they have business or immediate family ties, during their tenure or for 1 year thereafter.

The City’s memorandum of understanding with developers includes a conflict-of-interest clause that states, “No board member, officer, owner or employee of *Developer* shall have any personal interest, direct or indirect, in this MOU. No board member, officer or employee of *Developer* shall have, receive, accept or derive any pecuniary interest, direct or indirect, from this MOU or any CDBG NSP2 Loan made to purchase Eligible Property.”

The City's NSP2 loan agreement with developers, section 9, paragraphs d and e, states:

Borrower shall prepare and retain all pertinent books, records, and documents sufficient to reflect properly all costs incurred by Borrower for which funds are sought in accordance with HUD and NSP2 Program requirements. City and/or HUD may inspect such writings and carry out such monitoring and evaluation activities which will, at minimum, ensure that Borrower is in compliance with the terms of this NSP2 Loan Agreement.

Borrower shall maintain complete books and accounts and other records for expenses incurred under this NSP2 Loan Agreement, including personal property, personnel and financial records. Borrower's records shall accurately and fully show the date, amount, purpose, and payee of all expenditures incurred for a period of not fewer than five (5) years after the date the expenditure is incurred. The same shall be available for audit, inspection and copying by City upon reasonable notice to Borrower.

The City's NSP2 loan agreement with developers further states in Section 33 that the "Borrower shall maintain complete books of accounts and other records for the Project and for the use of Loan Funds; including, but not limited to, records of preliminary notices, lien releases, invoices, receipts and certificates of insurance pertaining to the contractor and each subcontractor, and the same shall be available for inspection and copying by City upon reasonable notice to Borrower."

Paragraph 24 in the purchase agreements for the nine Bank of America properties and paragraph 30 in the purchase agreements for two Wells Fargo properties state, "Modification: No provision, term or clause of this Agreement shall be revised, modified, amended or waived except by an instrument in writing signed by Purchaser and Seller."

Appendix D

SCHEDULE OF INELIGIBLE AND UNSUPPORTED COSTS

	Developer	Ineligible project management fees (finding 1)	Unsupported rehabilitation costs (finding 1)	Ineligible real estate commissions (finding 2)	Ineligible real estate commissions (finding 3)
1	Trinity Ventures RE II	-	-	\$62,500	-
2	Trinity Ventures RE II	\$6,340	\$3,531	-	-
3	Trinity Ventures RE II	5,149	1,424	-	-
4	Trinity Ventures RE II	4,710	-	-	-
5	Trinity Ventures RE II	4,295	426	-	-
6	Trinity Ventures RE II	4,063	896	-	-
7	Trinity Ventures RE II	4,037	170	-	-
8	Trinity Ventures RE II	4,218	276	-	-
9	Trinity Ventures RE II	15,165	1,432	-	-
10	Mission Housing Development Corporation	-	-	-	\$7,080
11	Mission Housing Development Corporation	-	-	-	6,750
12	Mission Housing Development Corporation	-	-	-	6,210
13	Mission Housing Development Corporation	-	-	-	5,760
14	Mission Housing Development Corporation	-	-	-	5,760
15	Mission Housing Development Corporation	-	-	-	4,950
16	Mission Housing Development Corporation	-	-	-	4,440
17	Mission Housing Development Corporation	-	-	-	3,621
18	Mission Housing Development Corporation	-	-	-	3,150
19	Mission Housing Development Corporation	-	-	-	3,105
20	Mission Housing Development Corporation	-	-	-	1,110
	Total	\$47,976*	\$8,154*	\$62,500	\$51,936

* The totals are off by \$1 due to the rounding of each line item to the nearest dollar.

Appendix E

SUMMARY OF PROPERTY INFORMATION

	Developer	Purchase price	Approved budget for rehabilitation, construction, and miscellaneous property costs
1	RSJS	\$ 133,650	\$ 37,350
2	Trinity Ventures RE II	146,520	47,832
3	Verterex Investments	193,050	94,460
4	Trinity Ventures RE II	1,250,000	465,753
5	Stanislaus Community Assistance Project	227,700	27,320
6	Stanislaus Community Assistance Project	135,000	95,170
7	Stanislaus Community Assistance Project	1,465,200	1,014,500
8	Stanislaus Community Assistance Project	110,000	144,670
9	Stanislaus Community Assistance Project	255,000	76,820
10	Stanislaus Community Assistance Project	70,000	6,800
11	Stanislaus Community Assistance Project	115,899	47,700
12	Stanislaus Community Assistance Project	229,900	43,650
13	Stanislaus Community Assistance Project	229,900	67,170
14	Stanislaus Community Assistance Project	247,000	75,470
15	Stanislaus Community Assistance Project	180,000	161,860
16	Stanislaus Community Assistance Project	155,000	77,570
17	Stanislaus Community Assistance Project	199,900	77,570
18	Borges Construction	145,000	37,445
19	Global Acres	66,500	56,150
20	Mission Housing Development Corporation	118,000	65,564
21	Mission Housing Development Corporation	112,500	56,916
22	Mission Housing Development Corporation	103,500	85,008
23	Mission Housing Development Corporation	98,877	96,432
24	RSJS	144,540	14,545
25	RSJS	118,800	3,545
26	RSJS	113,850	47,845
27	RSJS	113,850	30,045
28	RSJS	104,000	11,445
29	Stocktonians Taking Action to Neutralize Drugs	123,750	54,625
30	Thompson Construction	127,500	50,395
31	Thompson Construction	68,400	42,170
32	Thompson Construction	63,360	23,370
33	Trinity Ventures RE II	143,550	29,689
34	Trinity Ventures RE II	73,000	22,977
35	Trinity Ventures RE II	70,000	12,636
36	Trinity Ventures RE II	64,350	21,339

Developer		Purchase price	Approved budget for rehabilitation, construction, and miscellaneous property costs
37	Trinity Ventures RE II	\$ 64,350	\$ 19,031
38	Trinity Ventures RE II	64,350	20,706
39	Trinity Ventures RE II	60,390	106,982
40	Mission Housing Development Corporation	82,500	88,006
41	Mission Housing Development Corporation	74,000	99,916
42	Mission Housing Development Corporation	51,755	93,883
Total		\$7,714,391	\$3,752,330