U. S. Department of Housing and Urban Development

Office of Inspector General for Investigation

Inspections and Evaluations Division

Inspection of the Assignment and Assumption of Mark-to-Market Loans Lakeshore Village Apartments Cleveland, OH

November 2009
IED-09-005

Executive Summary

The Office of Inspector General, Inspections and Evaluations Division, conducts independent, objective examinations of U.S. Department of Housing and Urban Development (HUD) activities, programs, operations, and organizational issues.

We conducted an inspection of the post-Mark-to-Market (M2M) restructuring of mortgage debt of Lakeshore Village Apartments (Lakeshore Village), Cleveland, OH, to determine the validity of an informal complaint from HUD's Multifamily Office of Asset Management (OAM). OAM staff was concerned that, in approving the assignment and assumption of the restructured debt instruments, HUD's Office of Affordable Housing Preservation (OAHP) was not sufficiently verifying information provided from purchasers and sellers and stated that OAHP

- Allowed the nonprofit purchaser to retain approximately $400,000 that should have been remitted to HUD,
- Failed to provide timely information to OAM during the decision-making process, and
- Ignored questions raised by OAM staff about the amount of proceeds due HUD at loan closing.

We examined official records of the post-M2M restructuring, including the mortgage notes, the related low-income housing tax credit application, and the settlement documents. We interviewed staff of HUD's Office of General Counsel, the Multifamily HUB at Columbus, OH, the Cleveland field office, and current and former OAM and OAHP staff. We also reviewed the issues in question with key third parties involved in the transaction.

Our inspection did not substantiate any of the allegations in the informal complaint. OAHP did not allow the purchaser to retain funds that should have been remitted to HUD and required the purchaser to pay $426,432 to HUD in compliance with existing guidelines. OAHP also took into consideration questions raised by OAM staff during the loan approval process and did not ignore OAM's concerns as evidenced by interoffice e-mails and related correspondence. Nevertheless, OAHP and OAM could not reach full agreement on some of OAM's concerns. Going forward, better communications between the two offices will be needed to adequately resolve questions raised during the loan approval process.

Apart from our inspection objective, we observed three other matters which warrant further review by HUD's Office of Housing concerning (1) certified source and use of funds statement, (2) voting rights on the Assumption/Subordination Loan Committee, and (3) safe harboring certification. We made four recommendations to address the observations in this report.

We discussed our observations with OAM and OAHP staff during the inspection and provided a copy of the draft report to the Assistant Secretary for Housing – Federal Housing Commissioner on October 15, 2009. We received the Assistant Secretary's written comments on November 6, 2009. The Assistant Secretary agreed with recommendations 1, 2, and 4 and is willing to amend current HUD guidelines in response to recommendation 3. The complete text of the Office of Housing's response is included in appendix A of this report.

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Introduction

Mark-to-Market Program

Pursuant to the Multifamily Assisted Housing Reform and Affordability Act (MAHRA) of 1997, as amended, the Mark-to-Market (M2M) program allows the U.S. Department of Housing and Urban Development (HUD) to restructure Federal Housing Administration (FHA)-insured or HUD-held debt on multifamily subsidized housing that operate with above-market, project-based Section 8 contract rents. The primary objective of the M2M program is to reposition a property financially and physically so that the low-to-moderate-income tenants can continue to have access to affordable housing and owners can undertake needed repairs. At the conclusion of the rent and debt restructuring, the above-market rents are reduced to comparable-market rents for the area, the project owner generally obtains a new first mortgage loan, and the loan is amortized on a schedule that can be supported by the lower market rents. HUD pays off the existing FHA-insured first mortgage through a claim on behalf of the owner. The owner's obligation to repay the claim is evidenced by a second mortgage note (called an MRN or mortgage restructuring note) and/or a third mortgage note (called a CRN or contingent repayment note). These notes have periodic payment obligations to HUD, which are to be met solely from future surplus cash from the property, with full repayment expected from property refinancing at maturity or disposition. To ensure that the claim payments are ultimately repaid to HUD, the repayment terms of the second and third subordinate notes include a "due-on-sale or refinance" clause.

Within the Office of Housing, the M2M program and the post-M2M assignment and assumption transactions are administered by the Office of Affordable Housing Preservation (OAHP), formerly the Office of Multifamily Housing Assistance Restructuring. The Office of Asset Management (OAM), also within the Office of Housing, is responsible for the oversight of all multifamily project assets after their development. This responsibility includes oversight of ownership and management of HUD's multifamily properties, mortgage default servicing, and the acquisition and disposition of loans and properties.

Assignment and Assumption of M2M Program Loans

HUD Guidelines

HUD Notice H 08-04, issued July 31, 2008, by the Assistant Secretary for Housing (recently reissued under Notice H 09-06), provides that HUD has the discretionary flexibility to waive the "due-on-sale" requirements of the M2M debt when it is determined that such a waiver may be in the best interests of HUD. These guidelines describe the waiver request process for multifamily project owners who wish to refinance or sell a property that has received the benefits of a debt restructuring under the M2M program and for which the loans evidenced by an MRN or CRN will be assumed or subordinated. It also outlines HUD's criteria for determining whether the proposed transaction is in the best interests of HUD and how the amount of proceeds due to the parties, if any, is calculated. The guidelines also relate to cases in which HUD will approve debt assignment, modification, or forgiveness of the subordinate notes to a qualifying nonprofit purchaser. Pursuant to Section 517(a)(5) of MAHRA, the HUD Secretary may modify, assign,

or forgive all or part of the second mortgage if the project is acquired by a tenant organization or community-based nonprofit entity or public agency.

HUD Notice H 08-04 also states that "OAHP has the delegated responsibility to review and approve assumptions and subordinations involving proceeds and/or requested modifications to the existing note(s) or any first mortgage," and "all qualified nonprofit transactions involving assignment, modification or forgiveness of note(s) without exception, will be reviewed and approved by OAHP."

Pursuant to the same HUD notice, OAM has the authority to review and approve assignment and assumption requests when there are no modifications to the notes or no proceeds due to the seller and/or purchaser. OAM also has the authority to process and approve requests for transfers of physical assets in accordance with the established procedures.

Appendix C of the Mark-to-Market Program Operating Procedures Guide provides details on how purchasers can qualify for and receive mortgage relief for second and third mortgages and outlines the criteria and process for OAHP to follow in determining the eligibility of the nonprofit purchasers.

Lakeshore Village Apartments

M2M Transaction

Lakeshore Village is a 108-unit garden style complex located in Cleveland, OH. Built in 1982, Lakeshore Village went through its first phase of preservation in August 2004 with the HUD-approved M2M rent and debt restructuring. As a result of this M2M restructuring, the former owner, Beach House Development Company, LP, obtained a new first HUD-insured mortgage in the amount of $777,100, a second mortgage (MRN) of $1,875,000, and a third mortgage (CRN) of $1,537,219, with HUD holding both subordinate notes.

Post-M2M Transaction

In July 2008, Cleveland Leased Housing Associates I, LP (purchaser), entered into a contract with Beach House Development, LP, to acquire Lakeshore Village Apartments. To facilitate the sale and financing, the purchaser requested HUD to waive the "due-on-sale" clause of the M2M subordinate debt and provide debt relief through the assignment of the HUD-held second and third mortgage notes to a qualified nonprofit. The purchaser also proposed to assume the HUD-insured first mortgage and attain State and Federal low-income housing tax credits to accomplish extensive rehabilitation of the project.

To meet the HUD eligibility requirements, the purchaser sought qualified nonprofit status through a request for debt relief submitted to OAHP. In September 2008, OAHP approved the request based on the nonprofit status of CRS Housing Preservation, Inc., as the sole managing member of Cleveland Leased Housing Associates I, LLC (the sole general partner of the purchaser). In November 2008, the assignment of the subordinate debt was approved by OAHP; and on December 31, 2008, the Lakeshore assignment and assumption transaction was

completed. According to OAHP, the subordinate debt will be further assigned at a later date to the qualified nonprofit, CRS Housing Preservation, Inc.

Scope and Methodology

In evaluating the concerns of OAM, we reviewed the documents and communications related to the M2M restructuring and the assignment and assumption of the Lakeshore Village Apartments, including but not limited to mortgage notes, OAHP restructuring documents, settlement documents, HUD interdepartmental communications, and the low-income housing tax credit application.

We met with employees of OAM and OAHP, and spoke with staff of HUD's Office of General Counsel, the Multifamily HUB at Columbus, OH, and HUD Cleveland field office. We also spoke with the purchaser's attorney, the developer, and employees of the Ohio Housing Finance Agency (the agency that provided the low-income housing tax credit financing).

We conducted the inspection in accordance with the *Quality Standards for Inspections* issued by the President's Council on Integrity and Efficiency.

Observations

OAM's primary concerns regarding the Lakeshore Village assignment and assumption transaction and our evaluation of these concerns are detailed below.

Concern 1

OAHP did not sufficiently verify information provided by the purchaser or seller when analyzing requests for assignments of M2M loans. In the case of Lakeshore Village, this deficiency may have resulted in OAHP's allowing the purchaser to retain approximately $400,000 that should have been remitted to HUD.

<u>OIG Evaluation</u>

OAHP did not allow the purchaser to retain funds that should have been remitted to HUD and required the purchaser to pay $426,432 to HUD in compliance with existing guidance. OAM staff mistakenly believed that the purchaser intended to pay down $775,000 of the subordinate debt owed to HUD, but OAHP instead allowed the purchaser to pay down a lesser amount calculated to be $426,432.[1] OAM incorrectly based its $775,000 pay-down amount on the difference between the amount of subordinate debt OAHP used for its calculations in the assignment and assumption computer model and the lower subordinate debt amount filled in on the Ohio Housing Finance Agency's low-income housing tax credit application form. The calculation of the $348,568 total underpayment using OAM's methodology is shown in the following table.

[1] The difference of $348,568 (or approximately $400,000 according to OAM) was the amount OAM believed was improperly retained by the purchaser.

Second mortgage balance according to purchaser[2]	$1,951,133		
Third mortgage balance according to purchaser	1,599,636		
Total subordinated debt owed to HUD		$3,550,769	
Less: total subordinate debt on low-income housing tax credit application		2,775,769	
Amount due to HUD according to OAM			$775,000
Less: proceeds due HUD according to OAHP			426,432
Amount of underpayment to HUD according to OAM			$348,568

Based on the lower mortgage balances for the subordinate debt shown on the low-income housing tax credit application, OAM staff presumed that a larger pay down of $775,000 was due from the purchaser. OAHP responded to OAM's concern by obtaining an explanation from the purchaser's law firm. The attorney certified in a letter, dated December 1, 2008, that after exhaustive discussions with the parties that prepared the low-income housing tax credit application, the discrepancy in mortgage amounts was not a result of a projection of any pay down at closing but was caused by some combination of poor information provided by the seller, bad assumptions of amortization that would occur between the time of application and closing, and human error. Further, the attorney stated that any differences in these mortgage amounts had no effect on the acquisition basis or purchase price of the project and no effect on the amount of equity to be provided by the investors. We confirmed that these errors did not result in an improper calculation of the funds due HUD from the Lakeshore Village transaction. OAHP correctly calculated the proceeds due to HUD in the amount of $426,432, as set forth in Housing Notice H 08-04, and applied the amount to the outstanding subordinate CRN note. Additionally, the purchaser did not retain any funds due to HUD.

Concerns 2 and 3

OAHP did not provide timely information to OAM in assisting it in the decision-making process and ignored concerns raised by OAM which affect the amount of funds due HUD.

OIG Evaluation

OAHP took into consideration questions raised by OAM staff during the loan approval process and did not ignore OAM's concerns as evidenced by interoffice e-mails and related correspondence. Nevertheless, OAHP and OAM could not reach full agreement on some of OAM's concerns. Going forward, better communications between the two offices will be needed to adequately resolve questions raised during the loan approval process.

After reviewing the documents of the transaction, we contacted the former OAHP employee responsible for the Lakeshore Village assignment and assumption as well as other OAHP employees with knowledge of the Lakeshore Village transaction. The former employee indicated that the concerns raised by OAM were adequately addressed by OAHP before closing. As mentioned in our evaluation of concern 1, OAM's primary concern regarding the discrepancy

[2] The balances of the second and third mortgages are the amounts which appear on the purchaser's sources and uses statement and were also included in the OAHP post restructuring model.

in the subordinate loan balances was addressed in the letter from the purchaser's attorney. Other OAM issues brought to the attention of OAHP were addressed in e-mails between the two divisions. The record shows that the assignment and assumption of Lakeshore Village was approved by OAHP on November 14, 2008; however, OAM staff continued to have questions regarding this transaction up to December 18, 2008. OAHP considered its primary concerns addressed, and the settlement occurred on December 31, 2008.

We recognize that both OAHP and OAM bring their own unique expertise into the evaluation of these transactions. As the two offices work through their concerns and questions, we believe a more complete record of the decisions made during the process should be established. During our review, we discussed the need for OAHP and OAM to better coordinate the assignment and assumption process. We were advised by the OAHP Director that staff of both offices met during a more recent assignment and assumption transaction, during which both OAHP and OAM sought to better their working relationship before the formal loan committee meeting. We recommend that both offices continue to hold these pre-loan committee meetings and appropriately document their concerns.

Other Matters

During our review we also noted the following other matters, which warrant attention by the HUD Office of Housing:

(A) Certified Source and Use of Funds Statement

The nonprofit purchaser did not provide a certified source and use of funds statement to OAHP as required in HUD's letter to the purchaser, dated November 14, 2008, granting approval of the Lakeshore Village assignment and assumption of M2M debt. This statement is necessary for OAHP's determination of the financial viability of the proposed transaction. We believe that the assignment and assumption process should not be completed until OAHP obtains a certified source and use statement from the purchaser.

(B) Voting Rights on the Assumption/Subordination Loan Committee

While OAHP has the delegated responsibility to review and approve assumptions and subordinations involving proceeds, HUD Housing Notice H 08-04 states, "…OAHP and the Multifamily Office of Asset Management will meet as an Assumption/Subordination Loan Committee to review and approve, reject or modify all Requests with Proceeds or Modifications…."

In the Lakeshore Village transaction, OAHP invited OAM staff to attend the loan committee meeting but did not allow OAM to vote on the approval of the transaction, as implied in the HUD guidelines. Previously, the Director of OAM made a request to the Director of OAHP to revise the guidelines to specifically allow OAM one of the three existing votes on the loan committee. The guidelines were reissued in July 2009 (Notice H 09-06) without revisions. Since OAM will have the continued responsibility of monitoring the physical and financial stability of the project, we believe that OAM's input and voice in the loan approval process is essential. Accordingly,

the existing guidelines should be revised to clarify the responsibilities of both OAHP and OAM during this process.

(C) Safe Harboring Certification

A nonprofit purchaser requesting debt relief must demonstrate to OAHP that it is independent from and not controlled by any for-profit entity. The Mark-to-Market Program Operating Procedures Guide, appendix C, section IV (E), states that certain "safe harbored" purchasers can demonstrate that they are independent without the need for any transaction-specific review by OAHP. To qualify under the safe harbor standard, a purchaser must certify to OAHP, in a form acceptable to OAHP, that it is independent from any for-profit entity.

Assignment and assumption transactions such as Lakeshore Village often represent the forgiveness of a significant amount of debt due to HUD at the time of sale. If OAHP is relying on the assertions of the purchaser and/or its agents to determine safe harbor status, those assertions should be subject to a certification containing a prohibition against false or misleading information. To better protect the interests of HUD, we suggest that along with the required documentation, the purchaser also provide a certification stating, "Under the penalty of perjury, the information contained in these documents is true and correct."

Recommendations

We recommend that the Office of Housing ensure that

1. OAM and OAHP continue their pre-loan committee meetings and provide a comprehensive record of the concerns raised and the decisions arrived at during the assignment and assumption approval process.

2. The assignment and assumption approval process not be completed until such time as a certified source and use of funds statement is received by OAHP.

3. Existing HUD guidelines are amended as soon as possible to clarify OAHP's and OAM's responsibilities during the assignment and assumption approval process.

4. Nonprofit purchasers who intend to qualify for safe harboring status include a certification of their independence from any for-profit entity by declaring, "the information contained in these documents is true and correct under the penalty of perjury."

Office of Housing's Comments and OIG Response

We discussed the observations with OAM and OAHP staff during the inspection and provided a copy of the draft report to the Assistant Secretary for Housing – Federal Housing Commissioner on October 15, 2009. The Assistant Secretary agreed with recommendations 1, 2, and 4 of this report and has already taken or will take corrective action as stated in a memorandum, dated November 6, 2009 (see appendix A).

Regarding recommendation 3, the Assistant Secretary stated that it was not OAHP's intention to imply in the HUD housing notice that OAM was a voting member of all loan committees, but only that it would be a participant in all transactions. Further, he stated that OAHP has final approval authority on all qualified nonprofit transactions involving the assignment, modification, or forgiveness of notes. The Assistant Secretary advised us that to eliminate the confusion in the language of the current Housing Notice H 09-06, the Office of Housing would amend the notice now or upon its expiration in July 2010. Since OAM concurs with this response, we have revised our draft results and this recommendation accordingly.

OIG agrees with the planned corrective actions indicated in the Assistant Secretary's memorandum cited above. To clarify OAHP's and OAM's responsibilities in all post-M2M transactions, we believe that Housing Notice H 09-06 should be amended as soon as possible.

Appendix A – Office of Housing's Comments

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

NOV 6 2009

MEMORANDUM FOR: Jennifer L. Sorenson, Director for Inspections and Evaluations
Office of Investigation, GIH

FROM: David Hiyatt Stevens, Assistant Secretary for Housing-
Federal Housing Commissioner, H

SUBJECT: Response to Draft Report – Inspection of the Assignment and Assumption of Mark-to-Market (M2M) Loans, Lakeshore Village Apartments, Cleveland, Ohio - File: IED-09-005

HUD's Office of Inspector General provided HUD's Office of Housing with a Draft Report dated October 15, 2009, detailing findings and recommendations from its inspection of the above referenced case, and its underlying policy. The Draft Report asked for the Office of Housing's written response to the recommendations.

The October 15 Draft Report includes four specific recommendations, involving two offices within the Office of Housing: Multifamily Housing Programs' Office of Asset Management (OAM), and the Office of Affordable Housing Preservation (OAHP). The OIG recommendations (*italicized*), and Office of Housing responses follow.

1. *Multifamily Housing Programs' Office of Asset Management, and OAHP should continue the practice of holding pre-Loan Committee meetings to discuss cases, and maintain a comprehensive record of concerns raised and decisions arrived at during the assignment and assumption approval process.*

   The Office of Housing agrees, and has modified the Draft Assumption/Subordination Transaction Procedures guidelines to reflect this recommendation as a matter of internal policy.

2. *The assignment and assumption approval process should not be completed until such a time that a certified source and use of funds statement is received (from the parties to the transaction) by OAHP.*

   The Office of Housing agrees. OAHP has historically required a certified statement of sources and uses during the underwriting review, updated when the transaction terms are materially changed, and given the ever-changing nature of the numbers up until the closing table, has relied upon the Settlement Statement from closing as the final sources and uses statement. However, a current certified statement of sources and uses is the requirement, and this requirement is included in the Due Diligence Checklist used in reviewing transactions for compliance.

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3. *OAM should be granted a vote on the Loan Committee as implied in the existing HUD guidelines.*

The Office of Housing respectfully disagrees. The existing HUD guidelines, Housing Notice H-09-06 (and prior, Notice H-08-04), were developed and published to give owners and potential purchasers of M2M-restructured properties guidance on the policies and procedures used by HUD when reviewing requests to waive the due on sale or refinance clause of M2M Notes. The underlying Notes that are the subject of this Notice and policy, are underwritten and originated by OAHP, and the primary responsibility for reviewing and approving requests to waive the due on sale or refinance clause therefore rests with OAHP; in the case of *assumption and/or subordination* of the M2M Notes, the delegated authority for these decisions rests with both OAHP and OAM, and in the case of *assignment or forgiveness* of M2M debt to qualified, safe-harbored non-profit purchasers, the delegated authority rests solely with OAHP.

The Loan Committee structure mirrors these delegated authorities, granting OAM voting participation for cases involving assumption and/or subordination, and giving OAM non-voting participation for cases involving debt assignment or forgiveness to qualified, safe-harbored non-profit purchasers. This brings OAM concerns to these cases, but leaves the ultimate decision to the office with the delegated authority for such decisions, OAHP. Indeed, the subject of this OIG inspection was just such a case, and as the Draft Report findings indicate, OAHP followed the HUD guidelines, and took OAM's questions and concerns into consideration in developing the final, approved transaction.

The Notice was not intended to imply that OAM was a voting member of all Loan Committees, but only that it would be a participant in all transactions. While the Notice reads, "OAHP and OAM will meet as a Loan Committee to review and approve, reject or modify requests. . ." it also states in multiple places that, "all qualified nonprofit transactions involving assignment, modification or forgiveness of note(s) without exception, will be reviewed and approved buy OAHP." We believe this clearly informs the public that the authority rests with, and will be exercised, solely by OAHP, albeit with consideration of OAM input. If this language creates room for confusion, and if OIG believes that the public needs more detailed information on the voting makeup of each type of Loan Committee, the Office of Housing can either amend the current Notice, or amend the Notice upon its expiration and potential renewal in July 2010. Please advise.

4. *Nonprofit purchasers who intend to qualify for safe harboring status should include certification of their independence from any for-profit entity, by declaring, "the information contained in these documents is true and correct under the penalty of perjury.*

Appendix C of the Operating Procedures Guide, "Qualified Tenant Organizations, Non-Profit and Public Agency Purchasers" requires certain certifications from a safe-harbor

nonprofit purchaser, "in a form acceptable to OAHP." Appendix C is used as the review checklist in ensuring proposed transactions are compliant with the definition of independence from a for-profit entity that must be met by a nonprofit, safe-harbor purchaser. The OIG-recommended language will be added to the certifications required prior to closing any nonprofit transaction involving assignment, modification or forgiveness of M2M debt.

For further information, please contact Theodore K. Toon, Deputy Assistant Secretary, Office of Affordable Housing Preservation, at 708-0001.