



# Lakeview East Cooperative, Chicago, IL

## Resident Home-Ownership Program

**Office of Audit, Region 5  
Chicago, IL**

**Audit Report Number: 2017-CH-1006  
September 5, 2017**

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**To:** Daniel J. Burke, Director of Multifamily Midwest Region, 5AHMLA

**From:** //signed//  
Kelly Anderson, Regional Inspector General for Audit, 5AGA

**Subject:** The Cooperative and Management Agent Lacked Adequate Controls Over the Operation of Lakeview East Cooperative, Chicago, IL

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of HUD's resident home-ownership program grant for Lakeview East Cooperative.

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

The Inspector General Act, Title 5 United States Code, section 8M, requires that OIG post its publicly available reports on the OIG website. Accordingly, this report will be posted at <http://www.hudoig.gov>.

If you have any questions or comments about this report, please do not hesitate to call me at 312-353-7832.



**Audit Report Number: 2017-CH-1006**

**Date: September 5, 2017**

**The Cooperative and Management Agent Lacked Adequate Controls Over the Operation of Lakeview East Cooperative, Chicago, IL**

## Highlights

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### What We Audited and Why

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We audited the U.S. Department of Housing and Urban Development's (HUD) resident home-ownership program grant for Lakeview East Cooperative (project) based on the results of a risk assessment of multifamily housing programs in Region 5's jurisdiction (States of Illinois, Indiana, Michigan, Minnesota, Ohio, and Wisconsin). The audit was part of the activities in our fiscal year 2017 audit plan. Our objective was to determine whether the Lakeview East Cooperative (Cooperative) and management agent operated the project in accordance with HUD's requirements and HUD's grant agreement with the 707 Tenants' Association.

### What We Found

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The Cooperative and management agent did not operate the project in accordance with HUD's requirements and the grant agreement. The Cooperative and management agent did not determine the fair market value of memberships to support that members did not pay more than the fair market value for their memberships and HUD's secured interest in the memberships was appropriately valued. Further, they could not provide sufficient documentation to support that (1) the payments to HUD from initial membership sales were accurate, (2) the Cooperative used its share of the proceeds from initial membership sales in accordance with the grant agreement, and (3) housing was affordable for all members. In addition, they did not ensure compliance with other requirements of the program. As a result, the Cooperative is at risk of having to reimburse HUD more than \$18.1 million.

### What We Recommend

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We recommend that the Director of HUD's Multifamily Midwest Region require the Cooperative to resolve the issues and implement adequate procedures and controls to address the weaknesses cited in this audit report and make a preliminary determination as to whether the Cooperative is in default of the grant agreement.

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# Background and Objective

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During the 1960s and 1970s, the U.S. Department of Housing and Urban Development (HUD) financed thousands of housing projects under its Federal Housing Administration (FHA) mortgage insurance programs, including Section 236 of the National Housing Act. HUD insured loans for the projects under Section 236 for up to 40 years. However, it allowed owners to prepay the FHA-insured mortgage after 20 years and convert the projects to market-rate housing, providing a powerful incentive for owners to prepay the FHA-insured mortgage, particularly if the property had appreciated in value. This early prepayment option, along with the expiration of project-based rental assistance contracts, resulted in the loss of several hundred thousand affordable housing units. To prevent further loss of affordable housing units, Congress enacted the Low-Income Housing Preservation and Resident Homeownership Act in 1990. The Act imposed a general prepayment limitation of federally insured mortgages and offered owners fair-market-value incentives to extend low-income affordability standards for the remaining useful life of the projects or transfer the projects to nonprofit organizations, tenant associations, or community-based organizations that would keep the housing units affordable for the remaining useful life of the projects.

In February 1973, HUD insured Lakeview East Cooperative's (project) mortgage under section 236(j)(1) of the National Housing Act to provide low-cost rental housing. The 707 Tenants' Association, an Illinois nonprofit corporation, was organized in 1992 to ensure that the project remained as quality, affordable housing for low- and moderate-income households. In December 1995, the Association submitted a resident home-ownership plan for the project to HUD to prevent the owner of the project from prepaying the HUD-insured mortgage and converting the building to market-rate use. In August 1996, HUD awarded the Association a grant of nearly \$18.8 million through its resident home-ownership program under the Low-Income Housing Preservation and Resident Homeownership Act.<sup>1</sup> The Association was required to use the funds to acquire and rehabilitate the project and transfer ownership of the building to the Lakeview East Cooperative, which would then sell memberships in the Cooperative to tenants in occupied units.<sup>2</sup> The Association transferred ownership of the project to the Cooperative in June 1998. The project is a 220-unit multifamily cooperative project located in Chicago, IL. As of May 2017, there were 210 units that were required to be occupied by Cooperative members, 6 rental units, and 4 vacant units. HUD disbursed more than \$18.6 million of the nearly \$18.8 million in funds from September 1996 through August 1999, and the Cooperative used the remaining nearly \$149,000 in undisbursed funds in the project's grant account in HUD's Line of Credit Control System to offset proceeds from initial membership sales due to HUD.

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<sup>1</sup> The grant agreement included more than \$12.2 and \$6.5 million in program and capital funds, respectively.

<sup>2</sup> Tenants were not required to purchase memberships. If the tenants did not purchase memberships, they could remain in their unit and were eligible to receive Housing Choice Voucher program housing assistance from the Chicago Housing Authority.

Realty and Mortgage Company has been the management agent for the project since November 2010. The records are at the project located at 707 West Waveland Avenue, Chicago, IL, and Realty and Mortgage's office located at 1509 West Berwyn Avenue, Chicago, IL.

The Cooperative was required to remit to HUD 50 percent of the proceeds from initial membership sales.<sup>3</sup> Further, initial members were required to enter into a 20-year nonrecourse promissory note payable to HUD for the difference between the fair market value and the purchase price of a membership. Upon the sale of a household's initial membership, the note became due.<sup>4</sup> If a subsequent member purchased the membership during the 20-year note period for less than the current fair market value of the membership, that member was required to enter into a note for the amount of the discount for the period remaining on the initial note. Further, members were required to maintain their units at the project as their principal residence for as long as they owned a membership. In addition, the Cooperative was required to ensure that members did not pay more than 35 percent of their monthly adjusted gross income toward mortgage payments and membership fees.

Our objective was to determine whether the Cooperative and management agent operated the project in accordance with HUD's requirements and the grant agreement with the Association.

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<sup>3</sup> Proceeds from initial membership sales consisted of members' downpayments and monthly mortgage payments to the Cooperative for the purchase of a membership. The Cooperative was required to remit to HUD 50 percent of the downpayments and principal portion of the mortgage payments it received.

<sup>4</sup> The amount due was payable to the City's HOME investment trust fund from the sales proceeds after deducting (1) amounts due for the purchase of a membership, (2) other amounts due in connection with the sale of a membership, and (3) the household's equity in a membership at the time of sale. Further, 6 years after the members entered into the notes with HUD, the amounts payable on the notes were to be reduced by 1/168 each month until the notes had a zero balance and were to be forgiven at the end of the 20<sup>th</sup> year.

# Results of Audit

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## **Finding: The Cooperative and Management Agent Did Not Operate the Project in Accordance With HUD's Requirements**

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The Cooperative and management agent did not operate the project in accordance with HUD's requirements and the grant agreement. The Cooperative and management agent did not determine the fair market value of memberships to support that members did not pay more than the fair market value for their memberships and HUD's secured interest in the memberships was appropriately valued. Further, they could not provide sufficient documentation to support that (1) the payments to HUD for initial membership sales were accurate, (2) the Cooperative used its share of the proceeds from initial membership sales in accordance with the grant agreement, and (3) housing was affordable for all members. In addition, they did not ensure compliance with other requirements of the program. These weaknesses occurred because the Cooperative and management agent lacked adequate procedures and controls to ensure that the project was operated in accordance with HUD's requirements and the grant agreement.<sup>5</sup> As a result, the Cooperative is at risk of having to reimburse HUD more than \$18.1 million.

### **Memberships Were Not Sold in Accordance With the Grant Agreement**

We reviewed the initial membership sales associated with 21 units, which occurred after August 2000,<sup>6</sup> and subsequent membership sales associated with 100 units, which had occurred as of October 15, 2016. Contrary to

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**The Cooperative did not determine the fair market value of memberships.**

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article IV(f) of the grant agreement, the Cooperative and management agent did not determine the fair market value of memberships when they were sold after the conversion period.<sup>7</sup> The fair market value was needed to support that members did not pay more than the fair market value for their memberships and HUD's secured interest in the memberships was appropriately valued. Further, the Cooperative generally required initial and subsequent members to enter into promissory notes payable to HUD consistent with the amounts on the HUD notes for memberships sold during the conversion period from August 1996 through August 2000. Therefore, the purchase prices of the memberships and the amount of the promissory notes payable to HUD may not have reflected the fair market value of the memberships. In addition, a representative of HUD was not signing the HUD notes.

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<sup>5</sup> See appendix C of this audit report for the applicable requirements.

<sup>6</sup> The last membership the Cooperative sold to an initial member was sold in February 2009.

<sup>7</sup> The conversion period was the 4-year period after the date of the use agreement when the Cooperative initially sold memberships to tenants in occupied units. The conversion period ended in August 2000. Subsequent membership sales associated with 97 of the 100 units occurred after August 2000.

The property manager for the Cooperative's management agent said that she recalled that the grant agreement required the fair market value of the memberships to be determined when the memberships were sold. However, she continued processing membership sales and requiring members to enter into promissory notes payable to HUD consistent with the prices and amounts on the HUD notes for memberships sold during the conversion period since that was the Cooperative's practice before she became the property manager in February 2011. Further, on August 3, 2012, an attorney for the Cooperative requested guidance from HUD's Chicago Multifamily Housing Regional Center regarding the purchase price of memberships and the promissory notes payable to HUD.

A Regional Center project manager responded that the Cooperative should sell memberships and require members to enter into promissory notes payable to HUD consistent with the prices and amounts on the HUD notes for memberships sold during the conversion period. Although the response was not dated, there was a hand-written note on the response stating that the response was provided to a Regional Center supervisory project manager on August 7, 2012. On August 24, 2012, the supervisory project manager instructed the project manager to revise the response to the attorney to state that before the Regional Center could respond to the attorney's request, the attorney would need to explain why the Cooperative wanted to sell memberships at the same prices as the memberships sold during the conversion period. However, neither the Regional Center staff nor the attorney could provide documentation to support that there was additional communication regarding the purchase price of memberships or the promissory notes payable to HUD.

As of May 2017, the Cooperative did not maintain a waiting list for rental units that met the requirements of its resident home-ownership plan or considered its tenant profile as stated in the resident income profile in paragraph 4.a. of HUD's use agreement with the Association. Therefore, the Cooperative would not be in a position to select rental households for units vacated by current tenants or that remained vacant for 6 or more months after the Cooperative acquired the membership associated with the unit.

In addition, we reviewed two units for which the Cooperative purchased the memberships associated with the units from members and which had been vacant for more than 6 months as of April 20, 2017. The Cooperative had not transferred ownership of the memberships or rented the units within 6 months of acquiring the units from members as required by article IV(e) of the grant agreement. The property manager said that she was not aware that the grant agreement required the Cooperative to rent units associated with memberships that it acquired from members if it was not able to sell the memberships to subsequent members within 6 months of the acquisitions.

#### **Documentation To Support Proceeds From Initial Membership Sales Was Not Sufficient**

We reviewed the proceeds from initial membership sales for fiscal years 1999 through 2016 to determine whether the Cooperative remitted 50 percent of the proceeds to HUD and used its share of the proceeds in accordance with the grant agreement. The Cooperative's audited financial statements through the fiscal year ended December 31, 2016, stated that the Cooperative accrued nearly \$1.3 million in proceeds from initial membership sales, of which nearly \$631,000 in proceeds was due to HUD. Further, the Cooperative had remitted more than



\$458,000 to HUD and used nearly \$149,000 in undisbursed funds in the project's grant account in HUD's Line of Credit Control System to offset proceeds due to HUD.

However, contrary to HUD's regulations at 24 CFR (Code of Federal Regulations) 248.173(h) and article IV(l) of the grant agreement, the Cooperative could not provide sufficient documentation to support that the amount due to HUD was accurate since the Cooperative did not provide complete records for membership sales and based its calculations of funds due to HUD on estimates rather than actual amounts collected.

The vice president of financial services for the Cooperative's management agent stated that the specific uses of the Cooperative's share of the proceeds from initial membership sales could not be determined since the Cooperative did not account for its share of the proceeds received from members' note payments separate from other funds and the proceeds could have been used for any expense paid from the Cooperative's operating account. The vice president of financial services also said that the Cooperative disbursed funds for eligible reserve for replacements expenditures in an amount that was at least equal to the Cooperative's share of the proceeds from initial membership sales.<sup>8</sup> We selected nearly \$628,000 of the Cooperative's capital expenditures to determine whether the Cooperative used an amount that was at least equal to its share of the proceeds from initial membership sales for eligible reserve for replacements expenditures. However, as of May 2017, the Cooperative had not provided sufficient documentation to support that it used its share of the proceeds in accordance with article IV(m) of the grant agreement.

We also reviewed whether the proceeds due to HUD that were offset by undisbursed funds, were accounted for in the reserve for replacements account or the Cooperative received HUD's approval before using the funds in accordance with article XIII of the grant agreement. The vice president of financial services said that the reserve for replacements account had a balance that was at least equal to the amount of proceeds offset by undisbursed funds and stated that the Cooperative had not used any of the proceeds. As of December 31, 2016, the Cooperative maintained a reserve for replacements account balance, which was greater than the amount of proceeds offset by undisbursed funds. However, the Cooperative's January through December 2016 general ledger did not include sufficient detail to determine which portion of the funds in the reserve for replacements account was restricted and subject to HUD's approval.

### **There Was No Assurance That Housing Was Affordable for All Members**

Contrary to paragraph 12 of the use agreement, the Cooperative and management agent did not ensure that monthly housing expenses did not exceed 35 percent of the members' monthly adjusted gross income other than upon membership sales. Further, since the Cooperative and management agent had not determined the members' household income after the membership sales, the Cooperative and management agent would not be able to support that they sold memberships to the same proportion of very low-, low-, and moderate-income households as

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<sup>8</sup> A reserve for replacements expenditure was an eligible use of the Cooperative's share of the proceeds from membership sales.

stated in the resident income profile in paragraph 4.a. and required by paragraph 10.b. of the use agreement. The president of the Cooperative's board of directors said that the Cooperative considered a household's income only at the time of application for membership in the Cooperative and it was her understanding that members' incomes needed to be considered only at the time of sale. However, the use agreement does not limit the requirement to only at the time of membership sales.

On March 27, 2017, HUD's Chicago Multifamily Housing Regional Center provided the Cooperative an amendment to the use agreement, which would require the Cooperative to ensure that monthly housing expenses did not exceed 35 percent of the members' monthly adjusted gross income only at the time of sale. However, the Cooperative had not returned the amendment to the Regional Center as of June 19, 2017.

### **Other Requirements of the Program Were Not Followed**

#### Members Did Not Live in Units at the Project

We reviewed the principal residency of 263 members associated with 210 units as of September 30, 2016, to determine whether the members maintained their units as their principal residence in accordance with 24 CFR 248.173(g)(4) and paragraph 7(a) of the Cooperative's occupancy agreement with members.

The property manager said that the remaining member associated with a unit had passed away in 2015 and the Cooperative had been trying to transfer the membership associated with that unit to one of the members in another unit.<sup>9</sup> However, the two members had not maintained the other unit as their principal residence since approximately January 2016 or informed the Cooperative that they were required to move outside the market area due to a change in employment or an emergency situation. Further, the unit was vacant as of May 2017. Therefore, the Cooperative had attempted to require the members to move into the units or transfer the memberships associated with the units to the Cooperative. As of April 2017, the Cooperative had issued the members notices to terminate membership associated with both units due to nonpayment of the mortgages and membership fees. However, the Cooperative had not terminated the memberships as of May 2017.

Further, the president of the board said that two members, one of whom was on the Cooperative's board, associated with another unit did not always maintain the unit as their principal residence. One member moved out of the unit around 2002, and the board member did not always maintain the unit as their principal residence since they purchased a property in 2006 and was required to maintain the property as their principal residence for at least 1 year to satisfy an occupancy requirement of the mortgage. However, as of March 2017, the board member considered the unit to be their principal residence.

In addition, the Cooperative could not provide sufficient documentation to support that the single occupant of another unit was a member of the Cooperative. The occupant said that he had

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<sup>9</sup> The members in the other unit were children of the member who passed away.

purchased the membership associated with the unit about 8 to 10 years ago from previous members who no longer resided in the unit. However, the Cooperative could provide only closing documents to support the sale of the membership to the members the occupant said he purchased the membership from. The property manager said that for as long as she had been the property manager at the project, she had believed that the occupant was a member of the Cooperative.

#### A Unit Was Used for Purposes Other Than Rental or Cooperative Housing

Contrary to paragraph 3 of the use agreement, the Cooperative used a unit to provide rent-free housing to two former maintenance employees of the management agent from October 2010 through January 2017.<sup>10</sup> The president of the board said that it was her understanding that the Cooperative was allowed to provide a unit to a maintenance employee. However, the Cooperative did not obtain approval from HUD to use a unit to provide rent-free housing. In June 2017, and as a result of our audit, the president of the board stated that the Cooperative would no longer provide a rent-free unit to an employee of the management agent and planned to rent the unit.

#### Reports Were Not Submitted to HUD

The Cooperative did not submit reports to HUD to show continued compliance with the program as required by article VII(d) of the grant agreement. The reports included but were not limited to

- (1) semiannual reports on vacancies,
- (2) semiannual reports of nonpurchasing tenants,
- (3) monthly reports on the status of resales,
- (4) monthly reports on the status of sales activity, and
- (5) reports on changes in closing costs.

The vice president of financial services said that HUD informed the Cooperative that it was not required to submit reports to HUD. However, as of June 2017, the Cooperative had not provided documentation to support that HUD informed the Cooperative that it was not required to submit the reports.

#### **Conclusion**

The weaknesses described above occurred because the Cooperative and management agent lacked adequate procedures and controls to ensure that the project was operated in accordance with HUD's requirements and the grant agreement. Further, the Cooperative's management agent did not have specific policies and procedures for managing a project under the program. The property manager stated that she relied on the bylaws of the Cooperative, guidance she had compiled to process membership sales, and the management agreement to manage the project. In addition, the property manager and the president of the board lacked an adequate understanding of HUD's requirements and the grant agreement. As a result, HUD and the Cooperative lacked assurance that the project was operated in accordance with HUD's

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<sup>10</sup> The unit was vacant as of May 30, 2017.

requirements and the grant agreement, and the Cooperative is at risk of having to reimburse HUD more than \$18.1 million as allowed by the grant agreement. In addition, the Director of HUD's Multifamily Midwest Region stated that based on the results of our review, he believed that there was a reasonable basis to conclude that the Cooperative may be in default of its grant and use agreements with HUD.

### **Recommendations**

We recommend that the Director of HUD's Multifamily Midwest Region require the Cooperative to

- 1A. Implement adequate procedures and controls to ensure that memberships are sold at or below the fair market value and HUD's secured interest in the memberships is appropriately valued.
- 1B. Have a representative of HUD at the closing for membership sales to sign the HUD notes.
- 1C. Develop and maintain a waiting list for rental units that meets the requirements of the resident home-ownership plan and considers the tenant profile.
- 1D. Implement adequate procedures and controls to ensure that any rental units vacated by current households or units associated with memberships which were repurchased by the Cooperative and then remained vacant more than 6 months, are rented to very low-, low-, or moderate-income households selected from a waiting list for rental units that meets the requirements of the resident home-ownership plan and considers the tenant profile.
- 1E. For the two units for which the Cooperative acquired the memberships associated with the units from members and which had been vacant for more than 6 months, rent the units to households that meet the tenant income profile.
- 1F. Provide sufficient documentation to support that HUD had received 50 percent of the proceeds from initial membership sales as of May 2017. If the Cooperative cannot do this, it should pay HUD half of the principal on the promissory notes payable to the Cooperative for all of the membership sales less the amount the Cooperative can support that it paid HUD for initial membership sales.
- 1G. Implement adequate procedures and controls to ensure that HUD receives its full share of the proceeds from future initial membership sales.
- 1H. Provide sufficient documentation to support that the Cooperative used its share of the proceeds from initial membership sales in accordance with the grant agreement. If the Cooperative cannot do this, it should transfer funds from its operating account, in an amount equal to half of the principal on the mortgages to the Cooperative for all membership sales less the amount the Cooperative can support that it used for eligible purposes, to a reserve account to be used in accordance with the grant agreement.

- 1I. Implement adequate procedures and controls to ensure that its share of the proceeds from initial membership sales is used in accordance with the grant agreement.
- 1J. Implement adequate procedures and controls to ensure that the Cooperative receives HUD approval before using the \$148,872 in proceeds from initial membership sales offset by undisbursed funds which was in the Cooperative's reserve for replacements account for the project.
- 1K. Sign the amendment to the use agreement which would require the Cooperative to ensure that monthly housing expenses did not exceed 35 percent of the members' monthly adjusted gross income only at the time of sale. If the Cooperative does not sign the amendment, it should verify the current household income for all members to determine whether the members are paying more than 35 percent of their households' monthly adjusted gross income for monthly housing expenses. For any members that are paying more than 35 percent of their households' monthly adjusted gross income for monthly housing expenses, it should determine the amount the household overpaid and reimburse the household that amount. It should also implement adequate procedures and controls to ensure that members do not pay more than 35 percent of their households' monthly adjusted gross income for monthly housing expenses.
- 1L. Implement adequate procedures and controls to ensure that it sells memberships to the same proportion of very low-, low-, and moderate-income households as stated in the resident income profile in paragraph 4.a. and required by paragraph 10.b. of the use agreement.
- 1M. Require the member for whom it tried to transfer the membership associated with a unit in which the remaining member passed away, to move into the unit or continue to pursue the release of the member's membership rights to the Cooperative.
- 1N. Require the members who did not maintain their unit at the project as their principal residence to move into the unit or continue to pursue the sale of their membership in the Cooperative.
- 1O. Provide sufficient documentation to support that the single occupant of a unit was a member of the Cooperative. If the Cooperative cannot do this, it should determine who has the right to membership associated with the unit, transfer the membership to that person if appropriate, and require him or her to move into or sell the unit.
- 1P. Implement adequate procedures and controls to ensure that members maintain their units at the project as their principal residence or sell their memberships.
- 1Q. Rent the unit that was used to provide rent-free housing to former employees of the management agent to a very low-, low-, or moderate-income household

selected from a waiting list for rental units that meets the requirements of the resident home-ownership plan and considers the tenant profile.

- 1R. Implement adequate procedures and controls to ensure that the project's units are used for rental or cooperative housing unless otherwise approved by HUD.
- 1S. Implement adequate procedures and controls to ensure that it submits the required reports to HUD to show continued compliance with the program.

We also recommend that the Director of HUD's Multifamily Midwest Region

- 1T. Ensure that the Cooperative's board members and responsible staff of the Cooperative's management agent are provided training on HUD's requirements and the grant agreement.
- 1U. Consider removing from the Cooperative's board the member who did not maintain their unit as their principal residence.
- 1V. Make a preliminary determination as to whether the Cooperative is in default of the grant agreement. If it is preliminarily determined that the Cooperative is in default, HUD should provide the Cooperative notice of the determination and propose corrective or remedial actions to address the default and prevent the Cooperative from repaying the remaining \$18,149,023, which HUD disbursed for the project (\$18,607,467 in funds disbursed for the project – \$458,444 in proceeds from initial membership sales the Cooperative remitted to HUD).

# Scope and Methodology

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We performed our onsite audit work from November 2016 through June 2017 at the project located at 707 West Waveland Avenue, Chicago, IL. The audit covered the period August 1996 through September 2016 and was expanded as necessary.

To accomplish our objective, we reviewed

- Applicable laws, regulations at 24 CFR Part 248, and HUD's files for the project and grant and use agreements with the Association.
- The Cooperative's audited financial statements from 1999 through 2016, financial records, resident home-ownership plan, bylaws, management agent agreement, and closing files.
- Realty and Mortgage Company's organizational chart.
- Data in HUD's Integrated Real Estate Management System, Line of Credit Control System, and Single Family Insurance System.

In addition, we interviewed the president of the Cooperative's board of directors, employees of Realty and Mortgage Company, and HUD staff.

As of September 2016, there were 210 units that were required to be occupied by Cooperative members, 7 rental units, 2 vacant units, and a unit the Cooperative used to provide rent-free housing to a maintenance employee of the management agent. Further, as of October 15, 2016, memberships associated with 212 units had been sold to initial members, and memberships associated with 100 of the 212 units had been sold to subsequent members.<sup>11</sup>

We selected a nonstatistical sample of the initial membership sales associated with 21 units, which occurred after August 2000, and all 165 subsequent membership sales associated with 100 units, which had occurred as of October 15, 2016, to determine whether memberships were sold in accordance with the grant agreement and HUD's secured interest in the memberships was appropriately valued. We used a nonstatistical sample since we knew enough about the population to identify items of interest that were likely to be misstated or otherwise have high risk and we were not projecting the results to the population that we did not review. We also selected the two units for which the Cooperative purchased the memberships associated with the units from members and which had been vacant for more than 6 months as of April 20, 2017, to

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<sup>11</sup> Forty-one of the memberships for the 100 units were sold more than once to subsequent members. There were at least 165 subsequent membership sales associated with the 100 units.

determine whether the Cooperative transferred ownership of the memberships or rented the units in accordance with the grant agreement.

Further, we selected the Cooperative's fiscal years 1999 through 2016 payments to HUD to determine whether HUD received its full share of the proceeds from initial membership sales. In addition, we selected a nonstatistical sample of nearly \$628,000 of the Cooperative's capital expenditures to determine whether the Cooperative used its share of the proceeds from initial membership sales for eligible reserve for replacements expenditures.<sup>12</sup> We used a nonstatistical sample since we knew enough about the population to identify a relatively small number of items of interest that were likely to be misstated or otherwise have high risk and we were not projecting the results to the population.

In addition, we reviewed all 210 units that were required to be occupied by Cooperative members as of September 30, 2016, to determine whether the Cooperative and management agent ensured that mortgage payments and membership fees did not exceed 35 percent of the members' adjusted gross monthly income and members maintained their units as their principal residence.

We did not rely on data maintained in Realty and Mortgage Company's MRI Software, LLC, system. We performed a limited assessment of the reliability of the data and found that the data was not adequately reliable 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(s). We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

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<sup>12</sup> The grant agreement allowed the Cooperative to use its share of the proceeds from initial membership sales to fund replacement reserves for expenses other than customary operating expenses.



# Internal Controls

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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:

- Effectiveness and efficiency of operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.
- Reliability of financial reporting – Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.
- Compliance with applicable laws and regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

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 Cooperative and management agent lacked adequate procedures and controls to ensure that the project was operated in accordance with HUD's requirements and the grant agreement (finding).

# Appendixes

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## Appendix A

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**Schedule of Funds To Be Put to Better Use**

<b>Recommendation number</b>	<b>Funds to be put to better use 1/</b>
1V	\$18,149,023
<b>Total</b>	<b>18,149,023</b>

- 1/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently 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 instance, implementation of our recommendations will ensure that the Cooperative takes corrective or remedial actions to prevent default of the grant agreement and does not have to repay the remaining more than \$18.1 million in funds HUD disbursed for the project.

# Appendix B

## Auditee Comments and OIG's Evaluation

### Ref to OIG Evaluation

### Auditee Comments

Comment 1

Comment 2

Comments 1 and 3

Comment 1

Comments 1, 3, and 4

July 24, 2017

Mr. Brent G. Bowen  
Asst. Regional Inspector General for Audit  
U.S. Dept. of H.U.D. – Office of Inspector General  
77 W. Jackson Blvd., Room 2201  
Chicago, IL 60604

Re: Lakeview East Cooperative Association  
Draft Audit Report Responses

Dear Mr. Bowen:

The Lakeview East Cooperative Association ("LECA") avails itself of the opportunity to respond to the draft audit report regarding the audit of the resident home-ownership program grant by the Office of Inspector General ("OIG").

Issue: Memberships Were Not Sold in Accordance With the Grant Agreement

We disagree and contend all membership sales complied with the Grant Agreement. We acknowledge that appraisals were not obtained for subsequent unit sales. An appraisal would be costly and does nothing more than add costs that would have to be borne by households of limited means. Units were sold for an amount equal to the amount the initial unit owner was entitled to receive under the cooperative documents, including the assumption of any existing debt.

Issue: Documentation To Support Proceeds From Initial Membership Sales Was Not Sufficient

We disagree and contend inaccurate conclusions have been drawn for LECA not having complete sales documentation going back to 1999. We retain documentation for at least seven (7) years. We believe record retention requirements for HUD grants are generally three (3) years. OIG's suggestion that LECA did not properly document sales proceeds and other information because it does not have records dating back to 1999 is contrary to HUD record retention requirements.

The operations of LECA were subjected to an annual certified audit and annual principal collected payments were paid to HUD. Since the term of the Grant, any documentation requested or required by HUD was provided. We believe it is fundamentally unfair and inconsistent with HUD record retention requirements to conclude LECA may not have made accurate payments to HUD (or the City of Chicago) simply because documentation from almost twenty years ago no longer exists.

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**Ref to OIG  
Evaluation**

**Auditee Comments**

Comment 5

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Issue: There Was No Assurance That Housing Was Affordable for All Members

We disagree and contend all initial membership sales complied with the Grant Agreement. OIG's incorrectly interprets LIHPRHA affordability requirements. The "35% test" is found at 24 CFR 173(g)(2), which provides that a resident homeownership plan must demonstrate that: "Prospective owner debt service payments, occupancy charges and utilities payable by the owners shall not exceed 35% of the monthly adjusted gross income of the owners." The Grant Agreement provides that: "An initial Owner will not qualify to purchase a unit if, during the first year of homeownership, it would spend more than 35% of its monthly adjusted gross income on monthly housing expenses." This is a one-time test, applicable solely to the time of purchase. There are no ongoing income certification requirements for cooperative unit purchasers and no HUD subsidies available for owners who may be financially challenged. The maximum percentage of income limit would be inconsistent with any other HUD program, especially Section 8 and Section 42, that HUD would impose an ongoing affordability requirement without a corresponding source of operating support like a subsidy. The limit would also serve as a disincentive for residents to seek better job opportunities or otherwise improve their economic standing, which appears contrary to the idea of creating homeownership opportunities for moderate and low income households.

Comment 6

Issue: Other Requirements of the Program Were Not Followed

Members Did Not Live in Units at the Project

On one unit, we disagree with the OIG's audit report that a member did not maintain their unit as their primary residence. We base our reply on the OIG's auditor incorrectly misinterpreting a statement regarding the member's primary residence. On two additional units the cooperative is currently investigating the unit owner's primary residency. However, we do agree and will work to enforce the requirement of the Grant Agreement as it relates to the primary residence stipulation

Comment 7

A Unit Was Used for Purposes Other Than Rental or Cooperative Housing

The use of a unit as an employee apartment has been disclosed to HUD in LECA's annual reports over many years. We will comply with a HUD directive to discontinue this use, and presently plan to offer the unit for sale or rental.

Comments 1  
and 8

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Evaluation**

**Auditee Comments**

Comment 9

Page 3

Reports Were Not Submitted to HUD

We believe to the best of our knowledge, we have submitted all reports required under the Grant Agreement. We will work with HUD if it seeks additional reporting regarding this property.

Comment 2

OIG Recommendations:

1A. Disagree. Article IV (f) of the grant agreement states, "At the time of the sale of the shares to the initial member, the Cooperative must determine share values so that the total of all unit values equals the project's transfer preservation value (TPV) or the purchase price of the project, if lower than the TPV." The purchase price of the shares must never exceed the fair market value of the shares. Initial members are the first purchasers of the units. Subsequent members are subsequent purchasers including persons who purchased from initial members or from the Cooperative after a member has sold his/her shares back to the Cooperative. These definitions are found in Article I (g) of the grant agreement.

Comments 2  
and 10

The grant agreement does not require a determination of the fair market value of the units which are sold after the sale to the initial members. A determination of the share value was done at the time of the sale to the initial members and such determination was approved by HUD.

Comment 11  
Comment 2  
Comments 2,  
10, and 12

Cooperative sales information has consistently been submitted to HUD and HUD has never suggested the need to determine the fair market value of memberships. Not only is this exercise not required by the regulatory agreement, it will further financially burden the Cooperative which receives no governmental assistance subsidies.

Comment 13

1B. Conditionally agree, subject to no closing will be delayed if a HUD representative does not appear at the closing, and we would desire one point of contact for scheduling.

Comment 14

1C. Disagree. Paragraph 4(a) of the use agreement does not require maintaining a waiting list for rental units. There is no requirement that the few rental units remaining be rented rather than sold when they become vacant. This is a home ownership program.

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**Auditee Comments**

Comment 15

Page 4

1D Disagree. Article IV(e) of the grant agreement pertains to the initial members. There is no indication that this provision pertains to anyone other than the initial members. Moreover, nowhere in the paragraph cited does it state that if the unit is transferred, within six months it must be rented. The paragraph reads if the Cooperative has a right to purchase the shares, the Cooperative must make a bona fide attempt to transfer the shares to a subsequent member within the time period specified in the RHP or within six months from the date of its acquisition of the shares, whichever is shorter. If the Cooperative is unable to transfer the unit, it shall rent the unit to a tenant that meets the applicable tenant profile. As stated above, this paragraph pertains to initial members and it says that the Cooperative must make a bona fide attempt to transfer the shares within the six-month period. It does not say if it fails to convey it within six months, that the unit must be a rental.

Comment 15

1E Disagree. Article IV(e) of the grant agreement pertains to the initial members. There is no indication that this provision pertains to anyone other than the initial members. Moreover, nowhere in the paragraph cited does it state that if the unit is transferred, within six months it must be rented. The paragraph reads if the Cooperative has a right to purchase the shares, the Cooperative must make a bona fide attempt to transfer the shares to a subsequent member within the time period specified in the RHP or within six months from the date of its acquisition of the shares, whichever is shorter. If the Cooperative is unable to transfer the unit, it shall rent the unit to a tenant that meets the applicable tenant profile. As stated above, this paragraph pertains to initial members and it says that the Cooperative must make a bona fide attempt to transfer the shares within the six-month period. It does not say if it fails to convey it within six months, that the unit must be a rental.

Comments 3  
and 16

1F Disagree. We believe HUD was paid in full its share of sales proceeds. We provided a schedule to their auditor of all owner notes. This schedule totaled the respective monthly note payment for each unit owner. This schedule provided principal and interest per unit owner and was relied on by the auditor. From this schedule the auditor determined the annual amount of sales proceeds due to HUD. However, we admit that HUD did not fully fund the Grant, shorting LECA. Over a number of years, proceeds due HUD were partially reduced by the amount of the Grant receivable.

Comments 1  
and 17

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Evaluation**

**Auditee Comments**

Comments 3  
and 16

Page 5

1G Disagree. We believe the current schedule of all owner notes is accurate and reliable and can continue to be used. We do admit this schedule assumes unit owners pay their note every month. However, if a unit owner is delinquent, the schedule still reflects the note payments being made. We believe that is what the OIG meant by estimates. Accordingly, HUD may have been overpaid sales proceeds but was not shorted.

Comments 3  
and 16

1H Disagree. We believe the current schedule of all owner notes is accurate and reliable and can continue to be used. We do admit this schedule assumes unit owners pay their note every month. However, if a unit owner is delinquent, the schedule still reflects the note payments being made. We believe that is what the OIG meant by estimates. Accordingly, HUD may have been overpaid sales proceeds but was not shorted.

Comment 18  
Comments 1  
and 18

1I Disagree. Neither the Act nor Regulations require segregated accounts for sales proceeds, if HUD changes the program requirements, LECA will work with HUD to establish segregated accounts for note payments on a prospective basis and will work with HUD to further enumerate approved purposes for use of such funds.

Comments 1  
and 19

1J Agree. HUD did not fully fund the grant and may still owe LECA. To prevent undue hardship, we offset this amount due against a portion of the annual sales proceeds remitted to HUD. We informed HUD in writing of what we were doing and HUD never informed us we could not make this offset. But, in the future we agree to obtain HUD's approval in writing before we unilaterally offset amounts due to HUD.

Comments 1  
and 5

1K Disagree. As previously stated, this recommendation is inconsistent with the Grant and without a HUD subsidy could put LECA in a future financial burden.

Comment 20

1.L. The audit report also recommends adequate procedures and controls to ensure it sells membership in the same proportion of very low, low and moderate income housing as required by paragraph 10(b) of the use agreement. Paragraph 10(b) of the use agreement states, "The owner shall, to the extent practicable, sell membership in the project to the same proportion of very low, low and moderate income families as indicated in the resident income profile set forth in paragraph 4(a) of this agreement." This requirement has never been imposed in the past and it is not practicable for the Cooperative to sell memberships to such a large amount of very low income and low income families. The only way for this to occur is to have HUD provide a subsidy to such individuals.

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Evaluation**

**Auditee Comments**

Comments 1  
and 7

Comments 1  
and 7

Comment 7

Comment 7

Comment 8

Comment 21

Comment 9

Comment 1

1M Agree. We will follow up on the deceased member's unit and have a family member move in or release the member's membership rights back to LECA.

1N. Agree. We agree that LIHPRHA regulations require that initial owners occupy their units for 15 years. In addition, LECA's occupancy agreement requires principal residency by subsequent owners, although such requirement is not required under LIHPRHA homeownership. Nonetheless, LECA does attempt to enforce this requirement within the limits of our resources.

1O. Agree. We will follow up on this situation, determine who has the right to membership associated with this unit and require that person to either move into or sell the unit.

1P. Agree. We will actively enforce the Occupancy Agreements requirement that unit owners maintain their units as their principal place of residence or have to sell their memberships.

1Q. Agree. We will either rent or sell the unit to a qualified person.

1R. Agree. We will ensure that the project's units are used for rental or cooperative housing unless otherwise approved by HUD in writing.

1S. Agree. We will ensure that we submit any reports to HUD to show compliance with the program.

Sincerely,



Esther Ohiku  
President  
Lakeview East Cooperative Association



## OIG Evaluation of Auditee Comments

- Comment 1 The president of the Cooperative's board referred to the Cooperative as the Lakeview East Cooperative Association. However, the Cooperative owns the project and is responsible for operating the project in accordance with HUD's requirements and the grant agreement. Therefore, we considered the president of the board to mean the Cooperative when she referred to the Lakeview East Cooperative Association.
- Comment 2 Although the president of the board stated that the Cooperative acknowledged that appraisals were not obtained for subsequent membership sales, the Cooperative disagreed that memberships were not sold in accordance with the grant agreement. The president also stated that appraisals would have been costly and done nothing more than add costs that would have been borne by households of limited means.
- As stated in the audit report, contrary to article IV(f) of the grant agreement, the Cooperative and management agent did not determine the fair market value of memberships when they were sold after the conversion period. The fair market value was needed to support that members did not pay more than the fair market value for their memberships and HUD's secured interest in the memberships was appropriately valued.
- Comment 3 The president of the board stated that the Cooperative disagreed that documentation to support proceeds from initial membership sales was not sufficient and stated that the Cooperative believed that records were generally required to be maintained for only a 3 year period and it was unfair to conclude that the Cooperative may not have made accurate payments to HUD because documentation from almost 20 years ago no longer existed.
- The historical records in question are generally needed to support the current circumstances. Regulations at 24 CFR 248.173(h) state that the entity that transfers ownership interests in or shares representing units to eligible households must return 50 percent of the proceeds to HUD for use under 24 CFR 248.157 and 248.161, subject to the availability of appropriations. Article IV(l) of the grant agreement states that at the time of the sales of memberships to the initial members, the Cooperative must remit to HUD 50 percent of all proceeds from the share sales. Both the regulations at 24 CFR 248.173(h) and article IV(l) of the grant agreement require the Cooperative to keep and make available to HUD all records necessary to accurately calculate the payments due to HUD. Without sufficient documentation to support the historical payments to HUD, the Cooperative would not be able to sufficiently support that the recent amounts due to HUD were accurate.
- Comment 4 The president of the board stated that the Cooperative believed that it was unfair to conclude that the Cooperative may not have made accurate payments to the

City of Chicago. We did not include, in the audit report, that the Cooperative could not provide sufficient documentation to support that an amount due to the City was accurate.

Comment 5 The president of the board stated that the Cooperative disagreed that it did not ensure that housing was affordable for all members and that it was required to ensure that monthly housing expenses did not exceed 35 percent of the members' monthly adjusted gross income other than upon membership sales. The president also stated that the regulations at 24 CFR 248.173(g)(2) state that prospective debt service payments, occupancy charges, and utilities payable by the owners must not exceed 35 percent of the monthly adjusted gross income of the owners.

However, regulations at 24 CFR 248.173(g)(2) do not limit the determination that debt service payments, occupancy charges, and utilities payable by owners must not exceed 35 percent of the monthly adjusted gross income to only at the time of membership sales. Paragraph 12 of the use agreement states that monthly carrying charges, including principal, interest, utility costs, taxes, property insurance, and home-ownership fees for all members must not exceed 35 percent of the member's monthly adjusted gross income. Further, paragraph 4.a. of the use agreement states that during the conversion period and for as long as any unit in the project continues to be operated as rental housing after conversion, the Cooperative must, to the extent practicable, maintain 68, 11, and 21 percent of the rental units in the project as affordable to very-low, low-, and moderate-income households, respectively. Paragraph 10.b. states that the Cooperative, to the extent practicable, must sell memberships in the project to the same proportion of the very-low, low-, and moderate-income households as indicated in the resident income profile set forth in paragraph 4.a. of the use agreement.

Therefore, contrary to paragraph 12 of the use agreement, the Cooperative and management agent did not ensure that monthly housing expenses did not exceed 35 percent of the members' monthly adjusted gross income other than upon membership sales. Further, the Cooperative would not be able to support that it sold memberships to the same proportion of very-low, low- and moderate-income households stated in the resident income profile in paragraph 4.a. and required by paragraph 10.b. of the use agreement. In addition, on March 27, 2017, HUD's Chicago Multifamily Housing Regional Center provided the Cooperative an amendment to the use agreement, which would require the Cooperative to ensure that monthly housing expenses did not exceed 35 percent of the members' monthly adjusted gross income only at the time of sale. However, the Cooperative had not returned the amendment to the Regional Center as of June 19, 2017. The Cooperative should work with HUD's Chicago Multifamily Housing Regional Center to resolve recommendations 1K and 1L, as applicable.

Comment 6 The president of the board stated that the Cooperative disagreed that a member associated with a unit did not maintain their unit at the project as their principal

residence and stated that we misinterpreted a statement regarding the member's principal residence.

On March 20, 2017, the president of the board said that she and her son did not always maintain their unit as their principal residence. The president also said that her son moved out of the unit around 2002, and she did not always maintain the unit as her principal residence since she purchased a property in 2006 and was required to maintain the property as her principal residence for at least 1 year to satisfy an occupancy requirement of the mortgage.

Comment 7 The president of the board stated that the Cooperative was investigating the members' principal residence for the two additional units. The Cooperative would work to enforce the principal residency requirements. The Cooperative should work with HUD's Chicago Multifamily Housing Regional Center to resolve recommendations 1M, 1N, 1O, and 1P as applicable.

Comment 8 The president of the board stated that the Cooperative had disclosed to HUD in its annual reports over many years that it used a unit as an employee apartment. The Cooperative planned to rent or sell the unit that was used to provide rent-free housing to former employees of the management agent to a qualified person.

However, contrary to paragraph 3 of the use agreement, the Cooperative did not obtain approval from HUD to use a unit to provide rent-free housing to two former maintenance employees of the management agent from October 2010 through January 2017. The Cooperative should work with HUD's Chicago Multifamily Housing Regional Center to resolve recommendation 1Q.

Comment 9 The president of the board stated that to the best of the Cooperative's knowledge, it had submitted to HUD all reports required under the grant agreement. Further, the Cooperative stated that it would work with HUD if HUD required additional reporting.

However, the Cooperative did not submit reports to HUD to show continued compliance with the program as required by article VII(d) of the grant agreement. The Cooperative should work with HUD's Chicago Multifamily Housing Regional Center to resolve recommendation 1S.

Comment 10 The president of the board stated that HUD's grant agreement with the Association does not require a determination of the fair market value of memberships that were sold after the memberships were sold to initial members.

Article IV(j) of the grant agreement states that if a subsequent member purchases a membership share for less than the then current fair market value, as determined by the Cooperative, the subsequent owner must execute a promissory note meeting the requirements of 24 CFR 248.173(j) for the amount of the difference between the purchase price and the fair market value.

- Comment 11 The president of the board stated that the Cooperative had consistently submitted sales information to HUD. However, the Cooperative did not provide sufficient documentation to support that it had consistently submitted sales information to HUD.
- Comment 12 The president of the board stated that the regulatory agreement did not require the Cooperative to determine the fair market value of memberships. However, the Cooperative did not have a regulatory agreement with HUD.
- Comment 13 The president of the board stated that if the closings for membership sales were not delayed, the Cooperative would agree to have a representative of HUD at the closing to sign the HUD notes, and it desired a single point of contact for scheduling. The Cooperative should work with HUD's Chicago Multifamily Housing Regional Center to resolve recommendation 1B.
- Comment 14 The president of the board stated that paragraph 4.a. of the use agreement does not require the Cooperative to maintain a waiting list for rental units. There is no requirement that the few rental units remaining be rented rather than sold when they become vacant.

Section IV.A of the resident home-ownership plan states that any rental units vacated by current households, either during the conversion period or after the conversion to home ownership, must be marketed and households must be selected in accordance with the affirmative fair housing marketing and tenant selection plan in tab 16 of the resident home-ownership plan. The affirmative fair housing plan in tab 16 states that the Cooperative will advertise the availability of rental units in newspapers or publications. Further, paragraph 4.a. of the use agreement states that during the conversion period and for as long as any unit in the project continues to be operated as rental housing after conversion, the Cooperative must to the extent practicable, maintain 68, 11, and 21 percent of the rental units in the project as affordable to very-low, low- or moderate-income households, respectively. The Cooperative did not maintain a waiting list for rental units that met the requirements of its resident home-ownership plan or considered its tenant profile as stated in the resident income profile in paragraph 4.a. HUD's use agreement with the Association. Therefore the Cooperative would not be in a position to select rental households for units vacated by current tenants.

- Comment 15 The president of the board stated that article IV(e) of the grant agreement applied to only initial members and it did not require the Cooperative to rent a unit if the unit was not transferred to a subsequent member within 6 months.

Article IV(e) of the grant agreement states that if the Cooperative has the right to purchase shares, it must make a bona fide attempt to transfer ownership of the shares to a subsequent member within 6 months from the date of its acquisition of the shares. If the Cooperative is unable to transfer a share, it must rent the unit to a tenant that meets the applicable tenant profile. Further, paragraph 3 of the use

agreement states that the project must be used solely as rental or cooperative housing, unless otherwise approved by HUD. Therefore, if a unit remains vacant for more than 6 months, the unit is not being used for rental or cooperative housing. In addition, HUD's Chicago Multifamily Housing Regional Center's position was that article IV(e) applied to memberships the Cooperative acquired from both initial and subsequent members and the Cooperative was required to rent any units for which it was not under a contract of sale with a potential buyer within 6 months from the date of its acquisition of the share.

- Comment 16 The president of the board stated that the Cooperative believed it paid HUD its full share of the proceeds from initial membership sales. The president stated that the Cooperative provided a schedule of the owners' notes that was accurate and reliable and could continue to be used to determine the amount of proceeds due to HUD even though the schedule assumed that the members paid their notes every month. The president also stated that the Cooperative relied on the schedule to determine the annual amount of proceeds due to HUD.

Contrary to regulations at 24 CFR 248.173(h) and article IV(l) of the grant agreement, the Cooperative could not provide sufficient documentation to support that the amount due to HUD was accurate since the Cooperative did not provide complete records for memberships sales and based its calculations of funds due to HUD on estimates rather than actual amounts collected. Further, we did not rely on the Cooperative's schedule of owners' notes to determine an amount of sales proceeds due to HUD.

- Comment 17 The president of the board stated that HUD did not fully fund the grant. However, HUD authorized the entire grant amount of nearly \$18.8 million in the project's grant account in HUD's Line of Credit Control System. Further, HUD disbursed more than \$18.6 million of the nearly \$18.8 million in funds from September 1996 through August 1999, and the Cooperative used the remaining nearly \$149,000 in undisbursed funds in the project's grant account to offset proceeds from initial membership sales due to HUD.

- Comment 18 The president of the board stated that neither the Act nor the regulations required that the Cooperative place its share of the proceeds from initial membership sales into a separate accounts. However, if HUD changed its program requirements, the Cooperative would work with HUD to establish segregated accounts for note payments and it would work with HUD to determine the approved purposes for these funds.

Article IV(m) of the grant agreement states that the portion of the proceeds from the sale of the shares, which is not paid to HUD, along with interest paid by the member on the debt, must fund a reserve to be used for specific purposes.

The vice president of financial services for the Cooperative's management agent stated that the specific uses of the Cooperative's share of the proceeds from initial membership sales could not be determined since the Cooperative did not account

for its share of the proceeds from members' note payments separate from other funds and the proceeds could have been used for any expense paid from the Cooperative's operating account. The vice president of financial services also said that the Cooperative disbursed funds for eligible reserve for replacement expenditures in an amount that was at least equal to the Cooperative's share of the proceeds from initial membership sales. We selected nearly \$628,000 of the Cooperative's capital expenditures to determine whether the Cooperative used an amount that was at least equal to its share of the proceeds from initial membership sales for eligible reserve for replacements expenditures. However, as of May 2017, the Cooperative had not provided sufficient documentation to support that it used its share of the proceeds in accordance with article IV(m) of the grant agreement. We recommended that the Cooperative transfer funds from its operating account to a reserve account to be used in accordance with the grant agreement if it was unable to provide sufficient documentation to support that it used its share of the proceeds in accordance with the grant agreement. The reserve account could be a separate bank account or a separate account within the Cooperative's accounting system.

- Comment 19 The president of the board stated that the Cooperative agreed to implement adequate procedures and controls to ensure that the Cooperative received HUD approval before using the \$148,872 in proceeds from initial membership sales offset by undisbursed program funds which was in the Cooperative's reserve for replacements account for the project. The president also stated that HUD may still owe the Cooperative program funds.

The Cooperative should work with HUD's Chicago Multifamily Housing Regional Center to resolve recommendation 1J. HUD does not owe the Cooperative additional program funds.

- Comment 20 The president of the board stated that it was not practicable for the Cooperative to sell memberships to the same proportion of very-low, low-, and moderate-income households as indicated in paragraph 10.b. of the use agreement.

Paragraph 4.a. of the use agreement states that during the conversion period and for as long as any unit in the project continues to be operated as rental housing after conversion, the Cooperative, must to the extent practicable maintain 68, 11, and 21 percent of the rental units in the project as affordable to very-low income households, low-income households, moderate-income households, respectively. Paragraph 10.b. states that the Cooperative, to the extent practicable, must sell memberships in the project to the same proportion of the very-low, low-, moderate-income households as indicated in the resident income profile set forth in paragraph 4.a. of the use agreement. The Cooperative should work with HUD's Chicago Multifamily Housing Regional Center to resolve recommendation 1L.

- Comment 21 The president of the board stated that the Cooperative would ensure that the project's units were used for rental or cooperative housing unless otherwise

approved by HUD in writing. The Cooperative should work with HUD's Chicago Multifamily Housing Regional Center to resolve recommendation 1R.

## Appendix C

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### Applicable Requirements

Section 226(b)(5)(a)(i) of the Low-Income Housing Preservation and Resident Homeownership Act of 1990 states that a homeowner under a home-ownership program may transfer the homeowner's ownership interest in or membership representing the unit except that a program may establish restrictions on the resale of units under the program.

Regulations at 24 CFR 248.173(g)(4) state that HUD must require that the form of home ownership impose the appropriate conditions to ensure that each initial owner occupies the unit the owner acquires for at least the initial 15 years of ownership, unless the resident council determines that the initial owner is required to move outside the market area due to a change in employment or an emergency situation. Section 248.173(h) states that the entity that transfers ownership interests in or shares representing units to eligible households must return 50 percent of the proceeds from the initial sale to HUD for use under 24 CFR 248.157 and 248.161, subject to the availability of appropriations. The entity must keep and make available to HUD all records necessary to accurately calculate payments due to HUD.

Regulations at 24 CFR 248.173(i)(3) state that at closing, the initial homeowner must execute a nonrecourse promissory note for a term of 20 years equal to the difference between the fair market value of the unit and the purchase price, payable to HUD, together with a mortgage securing the obligation of the note. Section 248.173(i)(3)(i) states that with respect to a sale by an initial homeowner, the note must require payment upon sale by the initial homeowner to the extent that proceeds of the sale remain after paying off other outstanding debt incurred in connection with the purchase of the property; paying any other amounts due in connection with the sale, including closing costs and transfer taxes; and paying the household the amount of its equity in the property, computed in accordance with 24 CFR 248.173(k). Section 248.173(i)(3)(ii) states that with respect to a sale by an initial homeowner during the first 6 years after acquisition, the household may retain only the amount computed under 24 CFR 248.173(k). Any excess is distributed as provided in 24 CFR 248.173(l). Section 248.173(i)(3)(iii) states that with respect to a sale by an initial homeowner 6 to 20 years after acquisition, the amount payable under the note must be reduced by 1/168 of the original principal amount of the note for each full month of ownership by the household after the end of the sixth year. The homeowner may retain all other proceeds of the sale.

Regulations at 24 CFR 248.173(j) state that when a subsequent purchaser during the 20-year period, measured by the term of the initial promissory note, purchases the property for less than the then current fair market value, the purchaser must also execute at closing such a promissory note and mortgage for the discount. The term of the promissory note must be the period remaining in the original 20-year period. Section 248.173(k) states that the amount of equity an initial homeowner has in the property is determined by computing the sum of (1) the contribution to equity paid by the household, if any, including any downpayment and any amount paid toward principal on a mortgage loan during the period of ownership; (2) the value of any improvements installed at the expense of the household during the household's tenure as owner, as determined by the resident council based on evidence of amounts spent on the improvements, including the



cost of material and labor; and (3) the appreciated value, determined by applying the consumer price index against the contribution to equity under 24 CFR 248.173(k)(1) and (2), excluding the value of any sweat equity or volunteer labor used to make improvements to the unit. Section 248.173(l) states that any net sales proceeds that may not be retained by the homeowner under the program approved under 24 CFR 248.173 must be paid to the HOME investment trust fund for the unit of general local government in which the project is located.

In HUD's grant agreement with the Association, dated August 29, 1996, the Association and Cooperative agreed to carry out grant activities under the grant agreement in compliance with the regulations, the terms of the resident home-ownership plan for the project, and any other applicable laws and regulations. Article I(a) of the grant agreement states that the Cooperative will assume ownership of the project from the Association and transfer ownership of shares to individual members.

Article IV(e) of the grant agreement states that the Cooperative must make a bona fide attempt to transfer ownership of the shares to a subsequent member within 6 months from the date of its acquisition of the shares. If the Cooperative is unable to transfer a share, it must rent the unit to a tenant that meets the applicable tenant profile. Article IV(f) states that at the time of the sale of the shares, the purchase price of the shares must not exceed the fair market value for the shares. Article IV(i) states that each initial member must execute a promissory note, secured by a mortgage or other document, which dictates the terms of the repayment of the promissory note, payable to HUD, which constitutes an agreement to pay HUD the difference between the fair market value of the share and the purchase price. The promissory note will be for a 20-year term, must not bear interest, and must not be amortizing. The promissory note will be repaid at the time the initial member sells his or her unit according to the formula specified in 24 CFR 248.173(i)(3). Article IV(j) states that if a subsequent member purchases a membership share for less than the then current fair market value, as determined by the Cooperative, the subsequent owner must execute a promissory note meeting the requirements of 24 CFR 248.173(j) for the amount of the difference between the purchase price and the fair market value.

Article IV(k) of the grant agreement states that all initial members must certify that their unit will be used as their principal residence. Initial members must also agree to occupy their unit for at least 15 years from the date of purchase unless the Cooperative determines that an initial member is required to move outside the market area due to changes in employment or for emergency reasons. The Cooperative may impose longer occupancy terms in its agreement with each initial and subsequent member if it deems it necessary.

Article IV(l) of the grant agreement states that at the time of the sales of memberships to the initial members, the Cooperative must remit to HUD 50 percent of all proceeds from the share sales. If cash is received from the initial member because the member receives a loan for the purchase price, 50 percent of the cash received must be remitted to HUD. If the Cooperative provides the mortgage loan to the member, the Cooperative must remit to HUD 50 percent of the principal paid by the member as it is paid to the Cooperative. If the initial member transfers the share to a subsequent purchaser who assumes the initial member's remaining debt, 50 percent of the principal amount collected will continue to be remitted to HUD. Article IV(m) states that the portion of the proceeds from the sale of the shares, which is not paid to HUD, along with interest

paid by the member on the debt, must be used to fund a reserve, the purposes of which will be to (1) provide loans to members who demonstrate short-term inability to make monthly occupancy payments due to loss of income resulting from medical or other emergencies, (2) ensure that the Cooperative can repurchase memberships for not less than the member's initial investment if the member is unable to secure a qualified buyer, (3) provide financing to prospective purchasers of low- or moderate-income means, and (4) fund a replacement reserve for expenses other than usual or customary operating expenses. HUD may approve additional uses for the funds. The Cooperative must keep and make available to HUD all records necessary to accurately calculate the payments due to HUD.

Article V(e) of the grant agreement states that any excess grant funds must be deposited into the reserve for replacements account for the project.

Article VII(d) of the grant agreement states that the Association or Cooperative must submit reports to HUD to show continued compliance with the requirements of the program. The areas of the resident home-ownership plan that currently require reports include but are not limited to (1) semiannual reports on vacancies, (2) semiannual reports or surveys of nonpurchasing tenants, (3) monthly reports on the status of resales, (4) monthly reports on the status of sales activity until all units have been initially sold, and (5) reports on changes in closing costs as needed.

Article XIII of the grant agreement states that if the total amount of grant funds allocated to the project under the grant agreement is not spent, the Cooperative must deposit any excess amount into the reserve for replacements account established for the project. The excess grant funds deposited into the reserve for replacements account must be used only for those purposes approved by HUD, and the Cooperative must receive prior approval from HUD to make withdrawals from the account for those purposes.

Article XXII of the grant agreement states that a default under the grant agreement will consist of any (1) material noncompliance with the Act; the regulations; the resident home-ownership plan; or any other Federal, State, or local law as determined by HUD or (2) other material breach of the grant agreement. If HUD preliminarily determines that the Association or Cooperative is in default, HUD will give the Association or Cooperative notice of a determination of default and the corrective or remedial action proposed by HUD. The Association or Cooperative must have the opportunity to show, within the time prescribed by HUD, that it is not in default or that the proposed corrective or remedial action is inappropriate before HUD implements the corrective or remedial action. Article XXII(b) states that when HUD determines that corrective or remedial actions by the Association or Cooperative have not been undertaken as instructed or will not be effective to correct the default and prevent further default, HUD may take the following additional corrective and remedial actions under the grant agreement: (1) demand repayment of all program funds disbursed, including funds held in escrow accounts funded by the grant agreement; (2) initiate litigation or other legal proceedings designed to require compliance with the Act, the regulations, the resident home-ownership plan, the grant agreement, or any other authorities; (3) require the Association or Cooperative to transfer all of its rights and interest in the project to HUD; or (4) take any other remedial action legally available. No delay or omission by HUD in exercising any right or remedy under the grant agreement will impair HUD's ability

to exercise such right or remedy or constitute a waiver of or consent in any default by the Association or Cooperative.

Article XXIII(a) of the grant agreement states that the Association or Cooperative, in performing the terms, provisions, and requirements of the grant agreement, must also follow the provisions and terms of HUD's use agreement with the Association and the resident home-ownership plan for the project, which are incorporated into the grant agreement.

Paragraph 2 of HUD's use agreement with the Association, dated August 29, 1996, states that the use agreement will remain in effect until each of the following four events has occurred but in no event longer than the remaining useful life of the project: (1) there are no longer any units of the project used as rental housing, (2) all initial members have sold their membership, (3) all of the members' promissory notes to HUD have been paid in full, and (4) all terms of the resident home-ownership plan have been performed. The Cooperative may petition HUD to determine that the remaining useful life of the project has expired not less than 50 years from the date of approval of the plan of action for the project. Paragraph 3 states that the project must be used solely as rental or cooperative housing, unless otherwise approved by HUD, for the full term of the use agreement.

Paragraph 4.a. of the use agreement states that during the conversion period and for as long as any unit in the project continues to be operated as rental housing after conversion, the Cooperative must, to the extent practicable, maintain 68, 11, and 21 percent of the rental units in the project as affordable to very low-income households, low-income households, and moderate-income households, respectively. Paragraph 10.b. states that the Cooperative, to the extent practicable, must sell memberships in the project to the same proportion of the very low-, low-, and moderate-income households as indicated in the resident income profile set forth in paragraph 4.a. of the use agreement. Paragraph 12 states that monthly carrying charges, including principal, interest, utility costs, taxes, property insurance, and home-ownership fees, for all members must not exceed 35 percent of the member's monthly adjusted gross income.

Section I of the resident home-ownership plan for the project, dated December 15, 1995, states that the Association submitted the resident home-ownership plan of action as an innovative model for the implementation of the resident home-ownership objectives of the Act.

Section IV.A. of the resident home-ownership plan states that prices and financing terms available from the Cooperative will be established so that an initial homeowner's expenses will not exceed 35 percent of the homeowner's adjusted monthly income. Estimated monthly home-ownership fees and an estimate of utility costs, taxes, and insurance for each unit size based on the financing available from the Cooperative are included in the monthly home-ownership cost schedule in tab 11 of the resident home-ownership plan. Any rental units vacated by current households, either during the conversion period or after the conversion to home ownership, must be marketed and households must be selected in accordance with the affirmative fair housing marketing and tenant selection plan in tab 16 of the resident home-ownership plan. The schedule of estimated monthly Cooperative homeowner carrying charges and expenses in tab 11 states that monthly housing expenses include homeowners' carrying charges and debt service. Utilities, taxes, and insurance are included in the homeowners' carrying charges. The

affirmative fair housing plan in tab 16 states that the Cooperative will advertise the availability of rental units in newspapers or publications.

Paragraph 7(a) of the Cooperative's occupancy agreement with members states that the members agree to occupy the unit at all times as a primary residence until the date on which the members sell their membership in the Cooperative.