# Laurentian Hall Apartments, Pittsburgh, PA

## Mark-to-Market Program

**Office of Audit, Region 3**
**Philadelphia, PA**

**Audit Report Number: 2017-PH-1002**
**March 24, 2017**

**To:** Brenda Brown, Director, Asset Management Division, Baltimore Multifamily Hub, 3BHMLAP

**//signed//**

**From:** David E. Kasperowicz, Regional Inspector General for Audit, Philadelphia Region, 3AGA

**Subject:** The Owner of Laurentian Hall Apartments, Pittsburgh, PA, Did Not Always Manage Its HUD-Mortgaged Project in Accordance With HUD Requirements

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of the Mark-to-Market-mortgaged Laurentian Hall Apartments multifamily project.

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 Web site. 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 215-430-6734.

**Audit Report Number: 2017-PH-1002**
**Date: March 24, 2017**

**The Owner of Laurentian Hall Apartments, Pittsburgh, PA, Did Not Always Manage Its HUD-Mortgaged Project in Accordance With HUD Requirements**

# Highlights

## What We Audited and Why

We audited Laurentian Hall Apartments (project) because of its failure to submit financial statements in a timely manner and because we had never audited the project before. Our audit objective was to determine whether the project's owner managed the project in accordance with its U.S. Department of Housing and Urban Development (HUD)-held mortgage and other HUD requirements.

## What We Found

The owner of Laurentian Hall Apartments did not always manage its multifamily project in accordance with HUD requirements. Specifically, the owner (1) did not submit financial statements and mortgage payments as required, (2) improperly leased commercial space without HUD's consent to a related party at below market rent, (3) disbursed funds for building improvements without HUD's approval, (4) did not properly procure products and services, (5) created a lien on the property in violation of its mortgage terms, and (6) incurred costs that were not eligible for the project's operations. As a result, the project was in default of its HUD-held mortgage and it incurred more than $71,000 in unsupported costs from unapproved building improvements and improper procurement of products and services, and nearly $9,000 in ineligible expenditures. The project also lost the opportunity to increase surplus cash available to pay its mortgage by $282,578 because it didn't collect fair market rent on its commercial space, and it exposed project assets to risk from creditor claims of up to $25,000.

## What We Recommend

We recommend that HUD require the owner to (1) pay the project $282,578 from non-project funds for the commercial rent not collected because the lease charged less than fair market rent, and (2) request approval from HUD to lease the commercial space and if HUD approves the request, then execute a lease at fair market rent. We also recommend that the Director of HUD's Asset Management Division, Baltimore Multifamily Hub (1) recalculate the project's annual surplus cash balances to determine whether the project should make additional payments from surplus cash toward its mortgage beyond the $13,740 that it paid during the audit, and (2) provide training and technical assistance to the owner and its management agent to ensure compliance with the terms of its mortgage and other applicable HUD requirements.

# Table of Contents

# Background and Objective

Laurentian Hall Apartments (project) is a 36-unit building located in Pittsburgh, PA, owned by a nonprofit corporation, Laurentian Hall Associates, Inc.. It receives project-based Section 8 assistance through its housing assistance payments contract with the U.S. Department of Housing and Urban Development (HUD). The building has 35 Section 8 rental units available to eligible families of low to moderate incomes. The project has a management agent agreement with RSI Property Management Corporation and is governed by the owner's board of directors.

The project's Federal Housing Administration mortgage was initially insured under the Section 221(d)(3) program.[1] On July 8, 1998, the owner restructured its mortgage during HUD's Mark-to-Market demonstration program.[2] HUD paid off the first mortgage and replaced it with a nonperforming,[3] HUD-held mortgage of $978,870. The mortgage documents required the owner to submit certified financial statements that identified surplus cash 2 months after the end of each year, accompanied by a payment of $36,300 toward principal and interest. The payment due could be higher or lower depending on the surplus cash balance.

The Section 8 program was authorized by Congress in 1974 and developed by HUD to provide rental subsidies for eligible tenant families residing in newly constructed, rehabilitated, existing rental, or cooperative apartment projects. Laurentian Hall received the following payments under its housing assistance payments contract:

| Year | Section 8 funds authorized and disbursed |
|---|---|
| 2015 | $135,382 |
| 2014 | 120,947 |
| 2013 | 101,060 |
| **Total** | **357,389** |

1 The Section 221(d)(3) program insures mortgage loans to facilitate the new construction or substantial rehabilitation of nonprofit multifamily rental or cooperative housing for moderate-income families, the elderly, and the handicapped.

2 In 1997, Congress established the Mark-to-Market program to help preserve the availability and affordability of low-income rental housing while reducing the cost to the Federal Government of rental assistance provided to low-income households using project-based Section 8 funds. Under this program, HUD resets the rents to the prevailing market level and restructures the property's mortgage debt, if needed, to permit a positive cash flow. As a result, the restructured project is subject to long-term use and affordability restrictions.

3 Mortgage payment requirements on a "nonperforming mortgage" are determined at the end of the project's fiscal year and are based on the amount of surplus cash reported by the owner in the project's annual financial statements.

The project's use agreement, housing assistance payments contract, mortgage restructuring mortgage and its rider, mortgage restructuring mortgage note, and HUD multifamily project handbooks require the owner to manage its project in accordance with its mortgage terms and applicable HUD requirements.

Our objective was to determine whether the project's owner managed the project in accordance with its HUD-held mortgage and other HUD requirements.

# Results of Audit

## Finding: Laurentian Hall Apartments' Owner Did Not Always Manage Its HUD-Mortgaged Project in Accordance With HUD Requirements

The owner of Laurentian Hall Apartments did not always manage its multifamily project in accordance with HUD requirements. Specifically, the owner (1) did not submit financial statements and mortgage payments as required, (2) improperly leased commercial space without HUD's consent to a related party at below market rent, (3) disbursed funds for building improvements without HUD's approval, (4) did not properly procure products and services, (5) created a lien on the property in violation of its mortgage terms, and (6) incurred costs that were not eligible for the project's operations. These conditions occurred because the owner generally disregarded the terms of the mortgage and HUD's requirements and lacked an understanding of applicable HUD regulations. In addition, the owner did not have controls to ensure that the project was managed in accordance with HUD requirements. As a result, the project was in default of its HUD-held mortgage and it incurred more than $71,689 in unsupported costs from unapproved building improvements and improper procurement of products and services, and $8,597 in ineligible expenditures. The project also lost the opportunity to increase surplus cash available to pay its mortgage by $282,578 because it didn't collect fair market rent on its commercial space, and it exposed project assets to risk from creditor claims of up to $25,000.

### The Owner Did Not File Financial Statements and Make Mortgage Payments as Required

The owner did not file financial statements in a timely manner and pay annual surplus cash balances to HUD on its mortgage. The mortgage documents required the owner to submit certified financial statements, either audited or unaudited, that identified surplus cash 2 months after the end of each year,[4] accompanied by a payment of $36,300 toward principal and interest. Depending on the amount of the surplus cash balance, the payment due could be less, or the project could be required to pay additional surplus cash toward the mortgage.[5] However, although the owner timely filed certified financial statements for the period ending December 31, 2013, it did not pay the related surplus cash balance of $10,676 to HUD on its mortgage. The owner filed financial statements almost a year late for 2014[6] and more than 4 months late for

4 By the end of February of the following year.

5 Section B.1 of the mortgage restructuring note states that the annual mortgage payment amount was $36,300. Section C.1 of the note states that the annual mortgage payment varies based on the amount of surplus cash. If the surplus cash balance was greater than the annual mortgage payment, the project was required to make an additional payment on the mortgage. If the surplus cash balance was not sufficient to make the full annual mortgage payment, the project was required to pay only the surplus cash balance to HUD as its annual payment. If the surplus cash balance was negative, the project was not required to remit an annual payment.

6 Filed on February 14, 2016.

2015.[7] Although the financial statements, which were audited, showed that the project had $8,994 in surplus cash for 2014 and $8,259 in surplus cash for 2015, the owner did not make a mortgage payment by paying its annual surplus cash to HUD. Additionally, note G in the 2015 financial statements reported cumulative surplus cash totaling $27,929, which is the sum of the surplus cash balances reported for 2013, 2014 and 2015. During the audit, an owner official stated that the project would make a mortgage payment if he was contacted by HUD. HUD informed us that the project made a payment of $13,740 toward its mortgage on January 31, 2017.

Section 3.3 of HUD's Real Estate Assessment Center's financial reporting and auditing guidance for multifamily program participants, required the project to submit audited financial statements within 9 months after the end of the fiscal year. The Center reviews the audited financial statements and determines the final amount of the required mortgage payment. The Center may adjust the surplus cash balance reported as a result of its review. The mortgage note stated that if HUD determined that the amount of surplus cash exceeded the actual amount paid by the owner, the owner was required to pay the shortfall within 30 days or provide a detailed explanation to HUD for not doing so. However, the owner did not file the project's audited financial statements for 2013 and it filed audited financial statements for 2014 late. The statements were due by the end of September 2015, but the owner filed them in February 2016.

The conditions described above occurred because the owner did not fully understand the mortgage terms and believed it could wait until HUD notified it that payments were due before making mortgage payments. The owner stated that it did not have the mortgage documents and was unaware of the terms. Further, although the Center emailed delinquency notices to the management agent, the agent claimed that he did not receive them because he had begun using a new e-mail address and failed to update it in HUD's system. As a result, the owner defaulted on the mortgage because it did not pay its surplus cash due as mortgage payments.[8]

### The Owner Leased Commercial Space without HUD's Consent to a Related Party at Rent Below Market Rate

Contrary to its use agreement, the project's owner leased the project's commercial space to a related party at a price below market rate without HUD's approval. In May 2009, the project's owner executed a rental agreement with two parties to lease commercial space in the property for $1,250 per month. The president of the project's owner entity is also the director of one of the lessees, creating a related party transaction. Further, this lessee manages the other lessee. The use agreement required the property to be used only for rental housing unless another use was approved by HUD. However, the project's owner did not seek HUD's approval to rent the commercial space. Further, when the lease ended in 2012, the owner continued to rent the commercial space to the lessees for the same rental amount without seeking HUD approval. The owner also failed to report on the project owner's and management agent's certifications and on

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7 Filed on July 21, 2016.

8 According to the restructuring note, if the borrower fails to pay installments of principal and interest due, the mortgage will be in default.

rent schedule forms the potential increased rental income value and that the lease was with a related party.

The commercial space was leased for below fair market rent, even though the project owner's and management agent's certification required the management agent to make a reasonable effort to maximize project income. As described in HUD Handbook 4350.1, by improperly leasing its commercial space for less than market rate, the owner reduced the funds available for the project's operating expenses. This failure weakened its financial position, including its ability to make mortgage payments from surplus cash.

According to a 2003 appraisal, the project had 5,762 square feet of commercial space. The owner estimated that the fair market value for the commercial space was approximately $6 to $7 per square foot per year when the lease was signed in 2009 and $12 per square foot in 2017. Based on a comparison of the rent listed in the lease to the estimated fair market value calculated by using the square footage listed in the appraisal and an average of the owner's estimates,[9] the project lost $36,858[10] in potential rental income per year.

The conditions described above occurred because the owner did not fully understand HUD requirements and disregarded the information required on HUD forms. As a result, HUD was not aware of the lease, and the project lost $282,578[11] in potential rental revenue for the commercial space between May 2009 and December 2016. If this is not corrected, it could potentially lose $36,858 in rental revenue over the next year.

### The Owner Made Unapproved Project Improvements Using Operating Funds

The project's owner improperly used $71,689 in operating funds for project improvements. Section 2-6 of HUD Handbook 4370.2, REV-1, states that operating funds should be used only to make mortgage payments, make required deposits to the reserve for replacements, or pay for reasonable expenses necessary for the operation and maintenance of the project. The use agreement states that the project's reserve for replacements fund could be used for project improvements and mechanical equipment and disbursements but only after consent was received in writing from HUD. Additionally, the restructuring mortgage required that the project obtain consent from HUD for alterations, additions, or improvements to the property. However, in 2014 and 2015, the owner used operating funds, without HUD approval, to make $71,689 in project improvements, shown in the following chart.

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9 The average of the owner's estimates was $9 per square foot per year. This is the average of the $6 lower estimate provided for the beginning of the lease and the $12 estimate in 2017.

10 $36,858 = ($9 per square foot per year x 5,762 square feet) - ($1,250 monthly rent amount x 12 months)

11 $282,578 = ($9 per square foot per year x 5,762 square feet x 7 years and 8 months) - ($1,250 monthly rent amount x 7 years and 8 months)

| Year | Description | Amount |
|---|---|---|
| 2015 | Air conditioning system replacement | $39,920 |
| 2014-2015 | New security panel | 7,995 |
| 2015 | Floor coverings | 7,359 |
| 2015 | Electrical retrofit | 7,000 |
| 2015 | Exterior and interior work | 5,115 |
| 2015 | Parking lot and sidewalk repair | 4 ,300 |
| | **Total** | **71,689** |

During this period, the project did not disburse funds from its reserve for replacement account, which had a balance of $73,706 as of May 2016. This condition occurred because the owner disregarded requirements. The owner believed that it knew more about project improvements than HUD and that HUD would not approve its requests to use the reserve for replacement funds. As a result, improvements totaling $71,689 were not supported. Additionally, because the owner used operating funds instead of reserve for replacement funds for the improvements, it reduced the surplus cash balance, resulting in the project having fewer funds available to make mortgage payments to HUD.

### The Owner Did Not Ensure That Cost Estimates Were Obtained

The owner did not ensure that the management agent obtained the required number of cost estimates before spending $39,920 to replace an air conditioning system. HUD Handbook 4381.5, paragraph 6.50(a), requires management agents to obtain written cost estimates from at least three contractors for any contract, supply, or service that is expected to exceed $10,000 per year. Section 4(b) of the project owner's and management agent's certification also stated that the management agent agreed to obtain the required cost estimates and ensure that all expenses of the project were reasonable and necessary. In 2015, the management agent obtained only one cost estimate before paying $39,920 to replace an air conditioning system.

This condition occurred because the owner believed it was an emergency and that additional estimates were not required. However, the purchase was made 29 days after the cost estimate, which indicates that it was not an emergency. Further, the owner lacked controls to ensure the required cost estimates were obtained. For example, the owner's agreement with the management agent prohibited the agent from incurring an expense for maintenance, alteration, refurbishing, or repair greater than $3,000 unless (1) the expense was specifically authorized by the owner or was for an emergency repair immediately necessary for the preservation and safety of the premises; (2) the repair was needed to avoid danger to life and property; or (3) the repair was needed to comply with Federal, State, or local law, but it did not discuss cost estimates. As a result, HUD and the project did not have assurance that the $39,920 paid to replace the air conditioning system was fair and reasonable.

### Unauthorized Lien on the Project's Property

The owner allowed a $25,000 increase to an existing lien on the property which is prohibited by the restructured mortgage. At the time the mortgage was restructured, a $714,542 lien existed on the property for loans made to the owner by the Urban Redevelopment Authority of Pittsburgh. However, in 2011, the owner secured an additional $25,000 loan from the Authority, which resulted in an increase to the existing lien on the property. This condition occurred because an owner official stated he was not familiar with the terms of the mortgage and believed HUD would not allow him to use project funds for improvements. As a result, project assets were exposed to risk from potential creditor claims.

### The Project Incurred Ineligible Expenses Related to Its Leased Commercial Space

The owner improperly used $8,597 in project funds to pay for expenses related to the lease of the project's commercial space, including $2,205 for undisclosed management fees and $6,392 for natural gas expenses. According to Section 3.14 of HUD Handbook 4381.5, management fees can be paid only from project income after the owner submits its management certification to HUD. In addition, the project must submit a new management certification before changing the management fee. When the owner signed the lease for the commercial space in 2009, the owner and management agent failed to disclose that the monthly management fee had increased by $73.50 per month for services performed related to the commercial space. In the most recent management certification, which was signed in 2013, the owner and management agent again failed to disclose the additional $73.50 management agent fee per month. As a result, during the period July 2013 to December 2015, the project incurred ineligible management fees totaling $2,205,[12] because they were not approved by HUD, as required.

The lease agreement provided that the lessees would pay for the natural gas it used. However, the project paid for the gas used by the lessees. The owner admitted that the lessees should reimburse the project. Based on square footage, we determined that the lessees should have paid $6,392 for natural gas that it used from January 2013 to December 2015.[13] However, since the project paid for the gas, the gas expenses totaling $6,392 were ineligible.

These conditions occurred because the owner disregarded applicable requirements. As a result, the project paid $8,597 for ineligible expenses related to its commercial space. Additionally, because the owner used the project's operating funds for these expenses, surplus cash was reduced, resulting in fewer funds available to make mortgage payments to HUD.

### Conclusion

The owner of Laurentian Hall Apartments did not always manage its multifamily project in accordance with HUD requirements. The conditions identified above occurred because the

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[12] $2,205 = $73.50 x 30 months (July 2013 to December 2015)

[13] $6,392 = prorated amount of natural gas used by the lessees based on square footage. The total square footage for the project was 34,574 square feet, and the square footage of the commercial space was 5,762 square feet. Therefore, the commercial space occupied 16.7 percent of the total square footage of the project (5,762 / 34,574 = 16.7 percent rounded). The total payments made by the project for natural gas during the period January 2013 to December 2015 were $38,274 ($38,274 x 16.7 percent = $6,392 (rounded)).

owner generally disregarded the terms of the mortgage and HUD's requirements and lacked an understanding of applicable HUD regulations. In addition, the owner did not have controls to ensure that the project was managed in accordance with HUD requirements. As a result, the project was in default of its HUD-held mortgage and it incurred more than $71,689 in unsupported costs from unapproved building improvements and improper procurement of products and services, and $8,597 in ineligible expenditures. The project also lost the opportunity to increase surplus cash available to pay its mortgage by $282,578 because it didn't collect fair market rent on its commercial space, and it exposed project assets to risk from creditor claims of up to $25,000.

## Recommendations

We recommend that the Director, Asset Management Division, Baltimore Multifamily Hub, direct the owner of the Laurentian Hall Apartments to

1A. Pay the project $282,578 from non-project funds for the fair value of the commercial rent not collected from the lessees.

1B. Request approval from HUD to lease the commercial space. If HUD approves the request, then execute a lease at fair market rent thereby increasing the project's rent revenue by at least $36,858 per year.

1C. Request approval from HUD for the $31,769[14] in project operating funds spent on building improvements or repay the project from nonproject funds for any amount not approved.

1D. Provide documentation to show that the $39,920 paid to replace an air conditioning system was fair and reasonable or repay the project from nonproject funds any amount determined not to be fair and reasonable (excluding any amount repaid as a result of recommendation 1C).

1E. Remove the $25,000 lien on the project property.

1F. Repay the project $8,597 from nonproject funds for the ineligible expenses it incurred for management fee and gas utility expenses that were identified by the audit and any additional management fee and gas utility expenses improperly paid outside of our review period.

1G. Develop and implement controls to ensure that financial statements are submitted to HUD in a timely manner, including paying the correct amount of annual payments according to the terms of the mortgage.

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[14] To avoid double-counting, we reduced the amount shown as unsupported for recommendation 1C by the amount discussed in recommendation 1D. The $31,769 is the full amount of unsupported expenditures of operating funds ($71,689) less the amount cited in recommendation 1D ($39,920).

1H. Develop and implement controls to ensure that the project complies with applicable HUD requirements.

We recommend that the Director, Asset Management Division, Baltimore Multifamily Hub

1I. Recalculate the project's annual surplus cash balances for 2013, 2014, and 2015 after resolution of recommendations 1A, 1C, 1D, and 1F to determine whether the project should make additional payment to HUD from surplus cash toward its mortgage beyond the $13,740 that it paid during the audit.

1J. Provide training and technical assistance to the owner and its management agent to ensure compliance with the terms of its mortgage and other applicable HUD requirements.

# Scope and Methodology

We conducted the audit work from June 2016 through February 2017 at the Laurentian Hall Apartments located at 5321 Penn Avenue in Pittsburgh, PA, RSI Property Management Corporation offices located at 3702 Allendale Circle in Pittsburgh, PA, Bloomfield-Garfield Corporation offices located at 5149 Penn Avenue in Pittsburgh, PA, and our offices located in Philadelphia and Pittsburgh, PA. The audit covered the period January 1, 2013, through December 31, 2015, but was expanded when necessary.

To accomplish our objective, we reviewed

- HUD's files for the project, including a management agent certification, management reviews, monitoring reports, the use agreement, mortgage restructuring mortgage, mortgage restructuring mortgage note, and rider to the mortgage restructuring mortgage;
- The owner's corporate bylaws, board meeting minutes, 2013 owner-certified financial statements and 2014 and 2015 audited financial statements;
- The management agent's agreement with the owner, project budgets, general ledger, cash disbursements journal, check listing and invoices;
- Applicable HUD regulations, handbooks, and guidance;
- The owner's lease and rent comparability study;
- Allegheny County real estate records; and
- Commercial leasing trends for the City of Pittsburgh obtained via Internet queries.

To achieve our audit objective, we relied in part on computer-processed data from the management agent's computer system. Although we did not perform a detailed assessment of the reliability of the data, we did perform a minimal level of testing and found the data to be adequate for our purposes. The tests for reliability included but were not limited to comparing computer-processed data to invoices, checks and the commercial lease agreement rental income terms.

In addition, we interviewed employees of RSI Property Management Corporation and Bloomfield-Garfield Corporation (one of the project lessees), tenants of the project, former and present property managers, and HUD staff. We also conducted a physical inspection of the project's common areas and the leased commercial space.

To determine whether the owner managed the project in accordance with HUD requirements, we nonstatistically selected a sample of expenditures to review from the project's expense summary by vendor report from the period July 2013, through December 31, 2015, totaling $730,101. We selected 112 disbursements totaling $116,734 from 9 vendors for our sample. We used a nonstatistical design because it allowed us to select management fee, natural gas, and building improvement expenditures for review because they represented the highest risk to HUD based on specific requirements in the use agreement, the mortgage documents, the commercial lease agreement and HUD handbooks.  Although this approach did not allow us to make a projection to the entire population, it was sufficient to meet the audit objective.

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.

# Internal Controls

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

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

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

### Relevant Internal Controls

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

- Effectiveness and efficiency of operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.
- Reliability of financial information – Policies and procedures that management has implemented to reasonably ensure that it obtains relevant, reliable information to adequately support program expenditures and discloses that information in the required reports.
- Compliance with laws and regulations – Policies and procedures that management has implemented to reasonably ensure that program expenses are supported and comply with program funding guidelines and restrictions.

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 Deficiencies

Based on our review, we believe that the following items are significant deficiencies:

- The owner generally disregarded the terms of the mortgage and HUD's requirements and lacked an understanding of applicable HUD regulations.

- The owner did not have controls to ensure that the project was managed in accordance with HUD requirements.

# Appendixes

## Appendix A

**Schedule of Questioned Costs and Funds To Be Put to Better Use**

| Recommendation number | Ineligible 1/ | Unsupported 2/ | Funds to be put to better use 3/ |
|---|---|---|---|
| 1A | | | $282,578 |
| 1B | | | 36,858 |
| 1C | | $31,769[15] | |
| 1D | | 39,920 | |
| 1E | | | 25,000 |
| 1F | $8,597 | | |
| 1I | | | 13,740 |
| **Totals** | **8,597** | **71,689** | **358,176** |

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local policies or regulations.

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.

3/ 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

[15] See footnote 14 on page 10.

that are specifically identified.  In this instance, if the owner implements our recommendations, the project will increase the project's rent revenue; protect project assets from creditor claims; and make payments toward its mortgage from surplus cash for calendar years 2013, 2014, and 2015.

# Appendix B

## Auditee Comments and OIG's Evaluation

**Ref to OIG Evaluation** | **Auditee Comments**

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March 2, 2017

**Via Email- David.E.Kasperowicz@hud.gov**

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**RE: Laurentian Hall Apartments - Pittsburgh, PA**
**Draft Audit Report**

Dear Mr. Kasperowicz:

We represent Laurentian Hall Associates, Inc. (Owner) which has asked us to respond to your undated Draft Audit Report. Thanks, you for extending the response date to march 3, 2017.

I will respond as fully as possible, although, as discussed below, more time is needed to fully respond with regard to certain issues and, as indicated in your draft report, most issues will have to be resolved with HUD Asset Management. I will respond to the individual draft findings that begin on page 5 of the Draft Audit Report:

1. **The Owner Did Not File Financial Statements and Make Mortgage Payments as Required.**

Comment 1 — The Owner believes that most financial statements were submitted on time. There were some delays caused by the late delivery of data by the management agent to the accountant. This has been remedied going forward by replacing the management agent.

Comment 2 — The Owner did not make its mortgage payments as it was waiting for HUD to review the financial statements and inform them as to how much HUD determined was due. The Owner has since made payments totaling $13,739.50. The Owner is working to fully resolve this and to with its accountant and new management agent.

{22188.24/892206:}

# Auditee Comments and OIG's Evaluation

| Ref to OIG Evaluation | Auditee Comments |
|---|---|

David E. Kasperowicz
Regional Inspector General for Audit
U.S. Dept. of Housing and Urban Development
March 2, 2017
Page 2

2. **The Owner Leased Commercial Space Without HUD's Consent to a Related Party at Rent Below Market Rate.**

Comment 3

The Owner has determined that the square footage amount cited by HUD (5,762 square feet) is incorrect and apparently includes the entire basement, most of which is not leasable. The Owner measured and has determined that the correct square footage of the office space being leased is 1,750 square feet. The tenant also has the use of two restrooms which total 100 square feet. The basement also includes a 740-square foot hallway, but it is for access and not part of the leased premises or usable.

Comment 4

The Owner also believes that the correct per square foot rental rate for the leased premises considering the market conditions and the condition of the commercial space is $6.00 for the years 2012 through 2017. The value has somewhat increased going forward in light of the substantial, very recent improvement in the neighborhood, but this is still Class C space.

The leased premises is low ceiling basement space. The tenant is required to provide all of its own services including maintenance of "all electrical, plumbing, sanitary, heating, ventilating, air conditioning, security systems and other facilities and appliances in the Premises..." The tenant must also provide janitorial service and keep the sidewalk clear of snow and ice.

Laurentian Hall is located in the commercial portion of Bloomfield that was economically depressed for many years and that has been only very recently begun to be revived.[1] A large portion of the Penn Avenue roadway (including underground utilities and sidewalks) near the property was under total reconstruction and essentially closed from August 2013 through June 2015. This caused a great deal of disruption and inconvenience to the commercial tenant from lack of access, construction noise and dirt and heavy construction vehicles.

Comment 5

The Owner considers itself fortunate to have a tenant since 2007 that can accept the occasional flooding that occurs in one section of the space whenever there is a substantial rainfall, and live with water leakage from condensate lines above the space that discolor ceiling tiles and require their replacement during months of heavy air-conditioning usage by the residential tenants. Most other commercial tenants would likely find alternative space rather than endure these problems or would require the

[1] This fact makes it even more important that this affordable housing be preserved and not drained of its resources.

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## Auditee Comments and OIG's Evaluation

| Ref to OIG Evaluation | Auditee Comments |
|---|---|

David E. Kasperowicz
Regional Inspector General for Audit
U.S. Dept. of Housing and Urban Development
March 2, 2017
Page 3

landlord to spend the tens of thousands of dollars it would cost to correct them. Of course, the needs of the residential tenants have always come first.

Even if you include the restroom space, the total rentable space only totals 1,850 square feet which at $6.00 per square foot would yield rent totaling $11,100.00 per year. Even at $6.50 per square foot rent would be $12,025.00. Using your figure of $9.00 per square foot the rent would be $16,650.00. Your figure, however, is not supported by any data.

Comment 6

Your findings go back to 2009. I believe your findings cannot go back more than five years.

Comment 7

As I believe HUD is aware, the commercial space was only an unfinished basement area when the building was converted to apartments and until owner and previous tenant, using non-HUD funds, built it out so that it could produce any rent at all. As no HUD funds were used for this space, all commercial rent should be permitted to benefit the operation of the building, not be used for debt service.

3. **The Owner Made Unapproved Project Improvements Using Operating Funds, and**

4. **The Owner Did Not Insure That Cost Estimates Were Obtained**

Comment 8

As stated in your draft report, $39,920.00 was for the air conditioning work. This consisted of the emergency replacement of the air conditioning chiller. Additional information is being sought and it is very unlikely that the chiller could have been purchased an installed and the old chiller disposed of at a lower cost. Time was of the essence. The health and welfare of the many fragile elderly tenants was at stake. The chiller was delivered within seven days of being ordered and installed less than a week later, over the Memorial Day weekend.

Comment 9

The $31,769.00 of other expenses cited under this section of the draft Audit Report are potentially items that could have been paid for out of the reserve for replacement but, at the time the reserve the replacement was so perilously low that the Owner felt it was far more prudent to not reduce the reserve further.

{22188.24/892206:}

| Ref to OIG Evaluation | Auditee Comments |
| --- | --- |

David E. Kasperowicz
Regional Inspector General for Audit
U.S. Dept. of Housing and Urban Development
March 2, 2017
Page 4

5. **Unauthorized Lien on the Project's Property**

Comment 10

The Owner will, as you suggest, request that HUD Asset Management approve the $25,000.00 mortgage lien held by the Urban Redevelopment Authority of Pittsburgh. Such mortgage liens are permitted under HUD regulations with HUD consent and are clearly subordinate to the HUD mortgage lien. In fact, the URA already holds mortgage liens on the property which are subordinate to HUD's mortgage and were approved by HUD. It was much more prudent to obtain these funds from the URA than further deplete the anemic reserve for replacements account. HUD's interests were far better protected by this loan than they would have by depleting project reserves. The URA provided the funds in keeping with their mission of providing and protecting safe, secure and quality affordable housing.

6. **The Project Incurred Ineligible Expenses Related to Its Leased Commercial Space**

Comment 11

The Owner is further investigating the issue of the natural gas cost not charged to the tenant. The OIG draft Audit Report says this amount is estimated at $6,392.00 based on the square footage of the leased space versus the square footage of the building. There are two problems with this. One of course if the fact that the area of the space is at most 1,850 square feet, not 5,762. The second it the fact that gas heat is only used for part of the premises and electric baseboard heat is used for the rest. Thus, the cost of gas is relatively negligible. Also, there is only one gas line and one gas meter for the building making the determination of this cost challenging.

Comment 12

The Owner will, as you suggest, also request that HUD Asset Management approve the increase in the Management Fee as reasonable.

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## Auditee Comments and OIG's Evaluation

**Ref to OIG Evaluation**

**Auditee Comments**

David E. Kasperowicz
Regional Inspector General for Audit
U.S. Dept. of Housing and Urban Development
March 2, 2017
Page 5

Laurentian Hall Associates, Inc. looks forward to promptly resolving all issues. They justifiably believe that they are an important partner in carrying out HUD's mission "to create strong, sustainable, inclusive communities and quality affordable homes for all."

Very truly yours,

BLUMLING & GUSKY, LLP

Raymond N. Baum

RNB/crc
cc: Richard Swartz, President, Laurentian Hall Associates, Inc.
Brian D. Murray, Sr. Account Executive Branch, Pittsburgh

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## OIG Evaluation of Auditee Comments

Comment 1 The owner stated that it believed that most financial statements were submitted on time. The audit covered the period January 1, 2013, through December 31, 2015. As stated in the audit report, the owner filed its financial statements, due with the mortgage payments, almost a year late for 2014 and more than 4 months late for 2015. Additionally, it did not file audited financial statements for 2013 and filed them late for 2014.

Comment 2 The owner stated that it did not make mortgage payments because it was waiting for HUD to review the financial statements and inform it of the amount that was due. However, the mortgage documents required the owner to submit certified financial statements that identified surplus cash 2 months after the end of each year, accompanied by a payment of $36,300 toward principal and interest. Although the financial statements for the project showed surplus cash of $10,676 for 2013, $8,994 for 2014, and $8,259 for 2015, the owner did not pay the surplus cash to HUD.

Comment 3 The owner stated that the correct square footage of the leased space was 1,750 square feet rather than the 5,762 square feet cited in the audit report. The owner asserted that the figure cited in the audit report included the entire basement, most of which is not leasable. According to a 2003 appraisal, the project had 5,762 square feet of commercial space. While onsite, we toured the space. We observed that the space had a single entry door with a lobby area and hallways that had offices on each side. It appeared that the entire finished area of the basement was being used. Based on the appraisal and our observation, we believe that 5,762 square feet was a reliable estimate of the leased space. As part of the audit resolution process, HUD will evaluate the owner's assessment and determine the amount of space occupied by the lessees.

Comment 4 The owner stated that the correct rent per square foot for the leased space, considering the market conditions, was $6 per year for the period 2012 through 2017. However, during the audit the owner estimated that the fair market value for the commercial space was approximately $6 to $7 per square foot per year when the lease was signed in 2009 and $12 per square foot in 2017. As part of the audit resolution process, HUD will evaluate the owner's estimation and determine a reasonable amount per square foot for the rental of the commercial space.

Comment 5 The owner stated that it considers itself fortunate to have a tenant since 2007 that can accept occasional flooding and live with water leakage from condensate lines above the space during periods of heavy air-conditioning usage. Most other commercial tenants would likely find alternate space rather than endure these problems or would require the landlord to spend tens of thousands of dollars to correct the problems. The flooding and water leakage is a concern. By signing the use agreement, the owner agreed to maintain the project in good repair and condition. Water infiltration inside a building can lead to problems with mold that can present a health hazard to humans. If the commercial space was in disrepair, resulting in a lower rent, the owner should have made the necessary repairs.

Comment 6 The owner stated that it believed that our findings cannot go back more than 5 years. The owner's belief is inaccurate. The scope of our audit work and the related findings are not limited. In this case, contrary to its use agreement, the owner leased the project's commercial space to a related party in May 2009 at a price below market rate without HUD's approval. When the lease ended in 2012, the owner continued the arrangement without creating a new lease and again without HUD approval. The arrangement is ongoing. Therefore, we questioned the arrangement from its origin.

Comment 7 The owner asserts that non-HUD funds were used to build out the commercial space and therefore all commercial rent should benefit the operation of the building and not be used for debt service. However, the use agreement required the property to be used only for rental housing unless another use was approved by HUD. The owner did not seek HUD's approval to rent the commercial space. The project owner's and management agent's certification required the management agent to make a reasonable effort to maximize project income. The project correctly recorded the commercial rent that it collected as revenue in its accounting records and financial statements. It included the commercial rent that it collected in the calculation of surplus cash balances available for mortgage payments for 2013, 2014 and 2015.

Comment 8 The owner stated that additional information regarding the replacement of the air conditioning chiller was being sought. It also stated that it was very unlikely that it would have paid less than $39,920 to purchase and install the new chiller and dispose of the old one. We are encouraged that the owner is seeking additional information regarding the replacement of the chiller. As discussed in the audit report, without the required cost estimates, there was no assurance that the $39,920 price paid to replace the chiller was fair and reasonable. As part of the audit resolution process, the owner can provide documentation to HUD to show that $39,920 was a fair and reasonable price to replace the chiller and avoid having to repay the project from nonproject funds.

Comment 9 The owner stated that it could have paid for $31,769 of project improvements from the reserve for replacement account but at the time the account was so perilously low that it felt it was far more prudent not to reduce the reserve further. However, as stated in the report, HUD Handbook 4370.2, REV-1, states that operating funds should be used only to make mortgage payments, make required deposits to the reserve for replacement account, or pay for reasonable expenses necessary for the operation and maintenance of the project. The use agreement states that the project's reserve for replacements fund could be used for project improvements and mechanical equipment and disbursements but only after consent was received in writing from HUD. Additionally, the restructuring mortgage required that the project obtain consent from HUD for alterations, additions, or improvements to the property. However, in 2014 and 2015, the owner used operating funds, without HUD approval, to make $71,689[16] in project improvements. The owner made no disbursements from the reserve for replacement account during 2014 and 2015 and the account balance was more than $73,000 in May 2016. Because the owner used operating funds instead of reserve for replacement funds for the improvements, it reduced the surplus cash balance, resulting in the project having fewer funds available to make mortgage payments to HUD.

Comment 10 The owner stated that it would, as we suggest, request approval from HUD for the $25,000 mortgage lien. It stated that such liens are permitted under HUD regulations and that it was much more prudent to obtain these funds than further deplete the anemic reserve for replacement account. It also stated that HUD's interests were far better protected by this loan than they would have been by depleting project reserves. We did not suggest that the owner request approval from HUD for the $25,000 lien, rather, we recommended that the owner remove the lien. Also, although liens may be permitted under HUD regulations, in this case the restructured mortgage required the owner to keep the property free from liens, inferior or superior, to the lien of HUD's mortgage. The owner's statement that HUD's interests were far better protected by this loan than they would have been by depleting project reserves is uncertain. The owner did not involve HUD in the decision to obtain the loan that created the lien. As stated in the audit report, the owner obtained the loan because it believed that HUD would not allow it to use project funds for improvements.

Comment 11 The owner stated that it is further investigating the issue of the natural gas cost not charged to the tenant. The owner disagrees with our estimate of $6,392 based on square footage and it asserts that gas heat is only used for part of the premises and electric baseboard heat is used for the rest. The owner stated that the gas cost is relatively negligible and that there is only one gas line and one gas meter for the building making the determination of this cost challenging. We are encouraged that the owner is investigating this issue. The lease agreement provided that the lessees would pay for the natural gas it used. Based on square footage, we determined that the lessees should have paid $6,392 for natural gas that it used from January 2013 to December 2015. As part of the audit resolution process, the

[16] This figure includes the $39,920 that the owner spent to replace the air conditioner chiller that was discussed in Comment 8 ($31,769 + $39,920 = $71,689).

owner can provide documentation to HUD to show that it has a more accurate methodology to estimate the amount of natural gas used by the lessees.

Comment 12 The owner stated that it will, as we suggest, request that HUD approve the increase in the management fee as reasonable. We did not suggest that the owner request approval from HUD for the management fees totaling $2,205, rather, we recommend that the owner repay the project that amount from nonproject funds because the owner and management agent failed to disclose the fee increase on its management certifications and obtain approval from HUD.