

DECISION**THE COMPTROLLER GENERAL
OF THE UNITED STATES
WASHINGTON, D. C. 20548**

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FILE: B-216006**DATE:** October 31, 1984**MATTER OF:** Approval of Elderly and Handicapped
Housing Loans

DIGEST: GAO investigations raised questions about the legality of seven loan applications conditionally or finally approved by the Department of Housing and Urban Development under the Housing for the Elderly and Handicapped program authorized by 12 U.S.C. § 1701q. Prohibited identity of interests were involved in six of the seven projects; a serious question about the financial responsibility of the seventh-borrower was also raised. HUD certifying officials are advised that no exceptions will be taken by GAO to past or future disbursements under these loans if HUD takes the actions it proposes to cure the conflict of interest deficiencies and to verify financial responsibility of the seventh borrower before final loan approval.

By letter dated July 31, 1984, the Director, Office of Finance and Accounting, U.S. Department of Housing and Urban Development, requested a decision as to the legality of loans under the Housing for the Elderly and Handicapped program authorized by 12 U.S.C. § 1701q for seven projects which had previously been approved by HUD. Loan disbursements have been made on only one of the seven projects.

The questions as to the legality of the loans which are the subject of the request for a decision arose as a result of written Informal Inquiries issued by General Accounting Office audit staff to the HUD Chicago Regional Office. The Informal Inquiries raised identity-of-interest questions about six of the seven projects and questioned whether HUD financial responsibility regulations had been followed in conditionally approving a loan to a sponsoring organization on the seventh project. Because the certification of any improper payments under the loans in question would result in personal liability of HUD certifying officials, our decision was requested as to the propriety of proceeding with each of the projects and as to the legality of disbursements already made on one project concerning which disbursements have been made.

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As discussed below, we are satisfied with the actions HUD has proposed to cure deficiencies in the loans about which identity-of-interest questions were raised and do not intend to take exception to past or future disbursements under those loans, assuming that HUD carries through on its proposed actions.

With respect to compliance with financial responsibility regulations, the ultimate authority to make a determination of financial responsibility rests with HUD headquarters officials. Since this ordinarily requires the exercise of judgment, GAO will not substitute its judgment for that of agency officials. HUD should, however, verify the financial responsibility of the applicant about which serious questions were raised before the loan is finally approved.

Under the Housing for the Elderly and Handicapped program, commonly referred to as the section 202 program, non-profit sponsors may arrange with corporate, non-profit borrowers to secure direct loans from HUD for the construction and management of housing projects for the elderly and handicapped. Contracts for construction of the projects financed by the HUD loans are entered into by the borrower with HUD-approved construction contractors. HUD-approved contracts may also be entered into with management companies for management of the projects, following their construction.

12 U.S.C. § 1701q(d)(2) requires that corporations eligible to receive loans must be non-profit and specifies that no part of the earnings of the corporation may inure "to the benefit of any member, founder, contributor, or individual."

24 C.F.R. § 885.5 provides as follows with respect to the financial interests of borrower corporations:

"No part of the net earnings of the Borrower may inure to the benefit of any private shareholder, contributor or individual and the Borrower may not be controlled by or under the direction of persons or firms seeking to derive profit or gain therefrom."

A virtually identical financial interest restriction is provided under the definition of "sponsor" in the same section.

Finally, HUD's Building Loan Agreement provides:

"No officer, director, trustee, member, stockholder nor authorized representative of the Mortgagor shall have any financial interest in any contractual arrangement entered into by the mortgagor in connection with rendition of services, the provision of goods or supplies, management of the project, procurement of furnishings and equipment, construction of the project, procurement of the site or other matters whatsoever."

Noncompliance with this provision entitles HUD to require corrective action or to take more severe actions, including mortgage foreclosure.

The various projects which were the subject of GAO Informal Inquiries are discussed below.

Project No. 043-EH126 - Somerset Lane, Inc.

By Informal Inquiry dated June 19, 1984, the GAO Evaluator in Charge of an audit investigation of the section 202 selection process stated as follows:

"It appears that there may be a conflict of interest under HUD regulations 24 C.F.R. 885, with respect to payments made under this loan agreement, in that the application file shows that the sponsor, Salem Lutheran Foundation, the borrower, Somerset Lane, Inc., the contractor, Northland Park Homes, Inc., and the proposed management company, Deerwood Development are all affiliated with one another, all having been created and apparently controlled by the same individual. See attached documents from Somerset Lane, Inc., project file."

At the time this inquiry was issued, approximately \$638,372.45, or 60 percent, of the approved loan amount had been approved for disbursement. A memorandum on the Somerset Lane project from HUD's Assistant General Counsel, Assisted Housing Division, dated July 13, 1984, conceded an apparent identity of interest between Homewood Corporation, the parent company of the construction contractor, Northland Park Homes, Inc., and Somerset Lane, Inc., the borrower. The memorandum concluded that an identity of interest between borrower and construction contractor, if documented, would not void the contract between those parties, but would render contract amounts for contractor overhead and fee

unallowable. Since contract amounts for overhead and fee were stated to be substantially less than the 10 percent of loan proceeds customarily withheld pending completion of construction projects, and since the project was substantially complete, the memorandum authorized the continuance of progress payments under the loan, less the customary 10 percent holdback, pending final resolution of the identity of interest issue. Further disbursements were halted, however, pending issuance of this decision in response to the request of the Director, Office of Finance and Accounting.

In response to subsequent representations that the Somerset Lane project was more than 90 percent complete and that the delay in final completion caused by the withholding of loan disbursements was inconveniencing prospective tenants of the project, by letter dated September 27, 1984, the Acting General Counsel of GAO assured HUD that loan disbursements necessary to complete the project would not be challenged by GAO. The letter stated that further disbursements should "cover only the necessary costs of the contractor and * * * not include any direct or indirect profits." We assume that disbursements sufficient to allow project completion have since been authorized and/or made.

Information extracted from HUD files, including data included on application forms submitted by the sponsor/borrower in this case, demonstrates that there was, in fact, an impermissible identity of interest between the sponsor/borrower and the construction contractor. An identity of interest also existed between the sponsor/borrower and the proposed management company.

In this regard, the Articles of Incorporation for Somerset Lane, Inc., the borrower in this case, list as the sole corporate member the Salem Lutheran Foundation, a charitable foundation trust which is the sponsor in this case. The Salem Lutheran Foundation Trust Agreement reflects that the Foundation was established by George A. Skestos and is administered by Mr. Skestos and Kathryn M. Skestos as co-trustees. Mr. Skestos is also listed as the President and Treasurer of Homewood Corporation/Northland Park Homes, Inc., the construction contractor in this case, and of Deerwood Management Company, the proposed management company. He also has a substantial financial interest in these firms.

Because both Homewood Corporation/Northland Park Homes, Inc., and Deerwood Management Company are for profit companies in which Mr. Skestos has a financial interest, his interests in Salem Lutheran Foundation, and in Somerset Lane Inc., at the time of loan approval were in violation of

24 C.F.R. § 885.5 and of the terms and conditions of Somerset Lane's loan agreement with HUD, both quoted above, which preclude any financial interest in a section 202 project on the part of sponsor/borrowers.

The regulatory prohibition against an identity of interest between sponsor/borrower and construction contractor or management contractor was recognized by HUD's Assistant Secretary for Housing in a memorandum dated June 14, 1984. That memorandum concluded with respect to three other borrowers, discussed further below, controlled by Salem Lutheran Foundation that "Section 202 regulations prohibit control of the sponsor or borrower by any individual or entity seeking to derive profit from the project."

We agree with HUD's Assistant General Counsel, Assisted Housing Division, however, that in view of the advanced stage of contract completion, the identity of interest in the Somerset Lane case does not require termination of the construction contract. As mentioned above, the loan agreement precludes any connection between the borrower and profit making contractors connected with the project. The agreement also provides for HUD to direct correction of any violations of the agreement's terms and conditions. Audit and disallowance of contract vouchers representing contractor overhead and profit will eliminate any advantage gained by the identity of interest between contractor and borrower while still carrying out the purpose of the section 202 program on this project.

Our letter of September 22, suggested that care should be taken to "assure that any subcontractor affiliated with the contractor or any company with which the principal of the firm is associated will not receive profits from the project." To the extent that post contract audit determines that the 10 percent withheld from loan disbursements pending completion of the project is insufficient to recoup such amounts, HUD should take steps to recover them from the contractor.

Finally, HUD should require that a management company unaffiliated with the sponsor/borrower be selected to manage the Somerset Lane project.

Project No. 046-FH106 - Beaver Creek Elderly and
Project No. 046-FH-107 - Maineville Elderly

Following receipt of GAO's informal inquiry on these two projects, for which no loan funds had been disbursed,

HUD agreed that an identity of interest similar to that described above concerning the Somerset Lane project existed between the sponsor/borrower and the proposed construction and management contractors. By letter dated June 28, 1984, HUD informed Salem Lutheran Foundation, the sponsor of these two projects, that construction and management contractors unaffiliated with Mr. Skestos must be selected and approved prior to issuance of firm loan commitments by HUD. Additionally, in July 1984, Mr. Skestos relinquished his trusteeship of Salem Lutheran Foundation. Kathryn M. Skestos apparently has also relinquished her trusteeship.

In our opinion, HUD's action in these cases was correct. So long as contractors selected to replace Homewood Corporation/Northland Park Homes and Deerwood Management Company are not affiliated with the sponsor/borrower, such action will not be challenged by our Office.

Project No. 046-EH-105 - Trotwood Elderly

Following receipt of GAO's Informal Inquiry on this project, it was canceled by HUD because, in addition to an identity of interest between the sponsor/borrower and the proposed construction and management contractors, the land on which the project was to be built had been sold to the borrower by Homewood Corporation.

Project No. 042-EH-251 - S. L. Housing Alliance and
Project No. 042-EH-252 - S. L. Housing - Tiffin

GAO's Informal Inquiry on these two projects noted an affiliation between the sponsor, Salem Lutheran Foundation, the two borrowers, and Deerwood Management Company, the proposed management contractor. HUD's request for our decision states that "the funds on these projects will not be obligated until GAO inquiry is cleared." Although Mr. Skestos has relinquished his trusteeship of Salem Lutheran Foundation, he apparently is still President of Deerwood Management Company. Also, he was still affiliated with the Foundation at the time the loan applications for these projects were submitted. Accordingly, we conclude that HUD should assure that Deerwood Management Company is not selected to manage these projects in the event they go forward.


Project No. 042-EH-220 - Calvary Estates, Inc.

GAO's Informal Inquiry on this project, dated June 25, 1984, stated as follows:

"We have reviewed the above mentioned application file. It appears that the financial data supplied does not show an ability to support or insure repayment of the loan to the United States Government. The sponsor has a delinquent tax liability which has not yet been resolved and also recent financial data supplied shows a negative current ratio. This financial data appears to indicate the sponsor does not have the ability to support the project as required by 24 CFR 277.3 and 24 CFR 885.5."

On August 10, 1984, a conditional commitment for a loan of \$2,901,600 was issued for this project. The commitment may be accepted within 120 days but is subject to a number of conditions, including a requirement that the applicant "Provide current financial statements under the HUD requirements reflecting working capital sufficient for minimum capital investment on the borrower corporation."

HUD file material on this case reflects a heated disagreement between HUD regional and headquarters personnel as to the financial responsibility of this applicant. The concerns expressed by HUD regional personnel, including the institution of real estate foreclosure actions in the past, several recorded court actions concerning indebtedness, and past tax delinquencies, raise serious question as to the applicant's financial responsibility. No answer to our inquiry has been provided by HUD to date. The ultimate authority to select loan applicants rests with HUD headquarters officials. Our Office will not take exception to the certification of any payments under a properly approved loan on the ground that the sponsor/borrower did not comply with financial responsibility requirements unless HUD's approval action is clearly unreasonable.

for 
Comptroller General
of the United States