

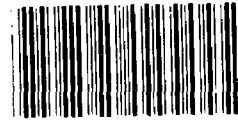
GAO

Briefing Report to the Honorable
Norman Mineta, House of
Representatives

August 1987

SUBSIDIZED
HOUSING

HUD Oversight of the
Villa San Pedro
Project



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San Francisco Regional Office

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1275 Market Street
San Francisco, CA 94103

B-227426

August 20, 1987

The Honorable Norman Mineta
House of Representatives

Dear Mr. Mineta:

In a November 20, 1986, letter you asked us to review Department of Housing and Urban Development (HUD) oversight of the Villa San Pedro housing project in San Jose, California. We briefed you on April 21, 1987, on the results of our work, and on May 14 you requested a report on our briefing. Specifically, you asked that the report contain (1) a brief chronology of events that occurred at the project, (2) a description of the administrative and legal remedies HUD officials have at their disposal to address problems at housing projects, (3) an assessment of whether these remedies were used aggressively and effectively in responding to the problems, and (4) an appraisal of the options available to HUD to ensure that the Villa San Pedro project remains low- and moderate-income housing.

The 100-unit Villa San Pedro project, developed by the nonprofit Villa San Pedro Corporation and managed by a three-member board of directors, has received assistance from three HUD programs. Under Section 221(d)(3) of the National Housing Act, as amended, HUD insured Villa San Pedro's mortgage, allowing it to obtain a below-market interest rate of 3 percent. Under Section 8 of the United States Housing Act of 1937, HUD is subsidizing the rental payments of low- and moderate-income tenants of the project. Under its Flexible Subsidy Program (authorized by Section 201 of the Housing and Community Development Amendments of 1978), HUD has provided interest-free loans to make specific project improvements and subsidize operations. HUD's involvement with the project under these three programs is to provide oversight and technical and financial assistance, not to run the project.

In summary, we found that during 1979-85 HUD had identified problems at Villa San Pedro that included deferred maintenance, inadequate and unaudited financial records, ineffective management, conflict between the project's board and the sponsoring nonprofit organization, deterioration of the project's roof and boiler that eventually led to

condemnation of more than half of its 100 apartments, and a tenant lawsuit and rent strike. In 1982 a legal dispute over title to the project also arose when the board of directors accepted an offer to purchase the project but changed their minds. This dispute is currently unresolved. In addition, the Villa San Pedro Corporation filed for reorganization under Chapter 11 of the bankruptcy statutes in May 1986. In September 1986 it defaulted on its mortgage, causing HUD to take over the mortgage from the lender.

HUD officials have four avenues for addressing the problems of projects such as Villa San Pedro: (1) persuading project owners to correct problems, (2) providing emergency repair funds under the Flexible Subsidy Program, (3) encouraging or, under some circumstances, forcing the sale of the project, and (4) employing administrative or legal action.

During 1979-86 HUD Region IX's project oversight officials considered the available remedies, rejected some, and used others. They were unable to resolve the project's problems, although their actions, we believe, were reasonable on the whole. HUD officials judged that available administrative actions would be ineffective or impractical or would increase the tenants' distress. They judged that legal actions would be infeasible because the directors had not yet defaulted on their mortgage and HUD officials had insufficient evidence of severe waste or irreparable harm to HUD's interests--conditions normally required for a favorable court ruling. HUD officials refused the project's request for flexible subsidies that could have been used to effect repairs in 1979 and 1983, provided some subsidies in 1985 when the situation became critical, then withheld remaining subsidies, reasoning that such funding would not correct the managerial problems that had originally led to deferred maintenance. Instead, they focused on persuading the project directors to improve management. At HUD's urging, the directors eventually hired a professional manager in 1983, but conditions did not materially improve as a result.

At present, HUD officials have two main options for restoring the project to effective management, good repair, and full occupancy by low- and moderate-income tenants. HUD can either seek the sale of the project or work with the current directors to improve management, while releasing remaining flexible subsidy funds to effect repairs.

HUD officials told us that they can seek the sale of the project, by either (1) allowing reorganization proceedings to continue until the owners are forced to sell the project to repay its debts or (2) requesting that the court dismiss the reorganization, foreclosing the mortgage, and selling the project. HUD favors allowing the reorganization proceedings to continue until the project is sold and plans to withhold further subsidies.

HUD hopes that the project will be sold to owners that could provide the capital needed to return Villa San Pedro to health. If reorganization proceedings continue until the directors are obliged to sell, HUD will have an opportunity to approve the purchaser by petitioning the court. HUD favors this approach and has persuaded the court to appoint a trustee manager to oversee project operations while the proceedings continue. The other approach for achieving the sale--foreclosing on the mortgage--would take effect sooner but would lead to auctioning the project to the highest bidder, thereby denying HUD a voice in selecting the new owner.

Under bankruptcy, the selling price of the project would be limited to the current mortgage balance, plus settlement expenses. Under foreclosure, the Villa San Pedro Corporation could reap a profit, estimated at \$1.8 million, because it would receive the difference between the current mortgage balance (\$1.2 million) and the estimated selling price (\$3 million). In any event, the sale cannot be accomplished until the ownership dispute is settled.

The second main option--releasing the flexible subsidy--would probably lead most rapidly to the repair of the project and the return of condemned units to use by low- and moderate-income tenants. However, HUD officials do not favor this option because the project would remain in the hands of a board whose competence HUD has questioned, whose title to the project is in doubt, and who would require continued flexible subsidies to repair the project and pay its debts. In addition, HUD officials would prefer that a private investor or nonprofit organization supply the funds needed to repair the project. Finally, withholding flexible subsidy funds, they said, is an important means of obtaining improved project management.

Each option has advantages and drawbacks. HUD's course, we believe, emphasizes protection of the government's financial interests and the long-term viability of the project but may

not be the fastest route to reoccupation of condemned units. Whether sold or not, the project will remain dedicated to low- and moderate-income housing until 1991, as required by an agreement that the project owners signed in order to receive rental subsidies.

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The information in this briefing report is based on our review of project records maintained by HUD's Region IX office in San Francisco and its Central Office in Washington, D.C.; discussions with various HUD officials, Villa San Pedro's current chairman of the board and its current management agent, and the city of San Jose housing inspector responsible for condemning the units in 1985; and observations we made when we visited the project. We were unable to contact the previous board of directors, who left office in August 1985. Our briefing report addresses the period 1979 to 1987, and our audit work was conducted between January and June 1987. Concurrent with our review, you requested the HUD Inspector General to perform a financial audit of the project's expenditures and internal controls; therefore, as agreed, we did not review these areas. We coordinated closely with the Inspector General's office throughout our audit.

We discussed the contents of this report with HUD regional officials and the chairman of the Villa San Pedro board and incorporated their comments where appropriate. However, as you requested, we did not obtain official comments from either the Department of Housing and Urban Development or Villa San Pedro.

As agreed with your office, unless you release the report earlier, we plan no further distribution of this briefing report until 30 days from the date of this letter. At that time, we will distribute the report to cognizant congressional committees, project officials, and HUD and

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make copies available to others who may have an interest in it. Major contributors to this report are listed in appendix I. If you have any questions, please call me at (415) 556-6200.

Sincerely yours,

A handwritten signature in black ink that reads "Thomas P. McCormick". The signature is written in a cursive style with a large, prominent initial 'T'.

Thomas P. McCormick
Regional Manager

C o n t e n t s

		<u>Page</u>
LETTER		1
SECTION		
1	CHRONOLOGY	8
	Project Description	9
	HUD Involvement	9
	Problems Emerge	9
	Crisis Reached	10
	Search for Resolution	11
2	REMEDIES AVAILABLE TO ADDRESS PROJECT PROBLEMS	14
	Persuasion	15
	Flexible Subsidy Funding	15
	Change of Ownership	15
	Administrative and Legal Remedies	17
3	HUD'S RESPONSE TO VILLA SAN PEDRO'S PROBLEMS	18
	Persuasion	19
	Flexible Subsidy Funding	20
	Change of Ownership	22
	Administrative and Legal Action	22
	Assessment of HUD Actions	25
4	OPTIONS NOW AVAILABLE TO HUD	28
APPENDIX		
I	MAJOR CONTRIBUTORS TO THIS BRIEFING REPORT	31
FIGURE		
1.1	Villa San Pedro Apartments	12

ABBREVIATIONS

GAO	General Accounting Office
HUD	Department of Housing and Urban Development

SECTION 1

CHRONOLOGY

1979 to 1983: Problems Emerge

- 1979 HUD's reviews document management and physical problems.
- 1980 Rift develops between trustees of the San Marcos Foundation (project sponsors) and Villa San Pedro board of directors.
- 1982 Directors decide to sell the project, then change their decision.
- 1983 Directors hire professional management agent and request HUD flexible subsidy funds.

1984 to 1985: Crisis Reached

- 1984 Problems with roof become severe.
- Directors hire new professional management agent and again request flexible subsidy funds.
- 1985 Tenants file suit over leaking roofs and failed boiler. Tenants also begin rent strike over these and other maintenance problems.
- Roof repairs begin, but storm causes severe damage before repairs are completed.
- City of San Jose condemns units.
- New board appointed by court order.

1986 to 1987: Search for Resolution

- 1986 Roofs repaired using HUD flexible subsidies.
- Project files bankruptcy and defaults on mortgage.
- Boiler repair started.
- 1987 Trustee appointed by bankruptcy court.

SECTION 1

PROJECT DESCRIPTION

The Villa San Pedro project, a 100-unit housing project, is owned and managed by the Villa San Pedro Corporation. The Villa San Pedro Corporation is sponsored by the San Marcos Foundation, a nonprofit agency founded in 1966 to provide assistance to the Hispanic community. The corporation is independent of the sponsoring foundation; however, its board of directors is composed of three trustees of the foundation. Neither the foundation's trustees nor Villa San Pedro's directors are to receive compensation for their involvement. Since 1983 a professional manager has had day-to-day responsibility for managing the project.

HUD INVOLVEMENT

HUD has provided assistance to Villa San Pedro under three programs.

- Under Section 221(d)(3) of the National Housing Act, as amended, HUD in 1970 insured the project's mortgage. An insured mortgage guarantees the lender repayment, because, should the project default, the lender can assign the mortgage to HUD and receive almost all of the outstanding principal. Because of this guarantee, the project was able to obtain a below-market interest rate of 3 percent.
- Under Section 8 of the United States Housing Act of 1937, as amended, HUD subsidizes the rental payments of the project's low- and moderate-income tenants.
- Under the Flexible Subsidy Program, HUD has provided an interest-free loan to effect repairs and repay debts.

PROBLEMS EMERGE

HUD officials identified financial, management, and physical problems during 1979-83, including

- uncorrected physical deficiencies, such as the need to paint the exterior, resurface the parking lots, and sand and paint the balconies;
- lack of a preventive maintenance program to address recurring maintenance needs;
- failure to maintain adequate financial records;

- funds spent on nonproject expenses without HUD officials' approval¹ (identified in a 1980 inspector general audit); and
- failure to submit audited financial statements for 1980 through 1982.

HUD officials and the current chairman of the board of directors attributed Villa San Pedro's problems primarily to ineffective management. Until 1983 the directors did not hire a professional management agent; instead, they depended on a series of resident managers. In 1983, after repeated urging by HUD officials, they hired a professional manager, who requested a HUD flexible subsidy. Regional officials had identified higher priority needs for flexible subsidies and did not grant the request.

A rift also developed between the directors and other members of the sponsoring San Marcos Foundation. In 1980 and again in 1982, some of the foundation trustees attempted to remove the directors, on the basis of their failure to pay membership dues to the foundation. In April 1982 the directors decided to accept an offer to purchase the project for the value of the mortgage. However, they changed their minds because, according to the current board chairman, they received a more attractive offer. The prospective buyer then filed suit over ownership of the project.

CRISIS REACHED

In July 1984 the city of San Jose cited the project for failing to repair leaking roofs. The chairman of the board received a suspended \$1,500 fine and 2 years' probation. In October 1984 the directors fired the management agent they had hired in 1983, because the agent's performance had been unsatisfactory. They hired a new management agent, who immediately prepared a request for flexible subsidy funding. This second request was approved by HUD headquarters in May 1985.

The tenants' union filed a lawsuit in April 1985, seeking repair of the roof leaks and restoration of hot water. Several tenants began a rent strike in July. In August the court, in response to the tenants' lawsuit, decided that the directors should be removed. The new directors took office in September 1985.

In April 1985 the city of San Jose threatened to condemn some of the units unless repairs were made. In October, with HUD

¹For example, \$14,000 in salary costs that could not be documented as valid project expenses.

direction and flexible subsidy funding, roof repairs began. However, after the roofs were removed, the contractor determined that the repairs would be more costly and complex than had been originally thought. Then, before the repairs were completed, heavy rain and winds caused severe water damage to the ceilings and interiors of many units. The city condemned 42 of the 100 units because of the damaged ceilings and the lack of heat and hot water. Later, 11 more units were condemned and an additional 5 were classified as substandard because of damage ranging from leaking to dry rot to cockroach infestation to broken plumbing fixtures, doors, and windows. (See fig. 1.1.)

SEARCH FOR RESOLUTION

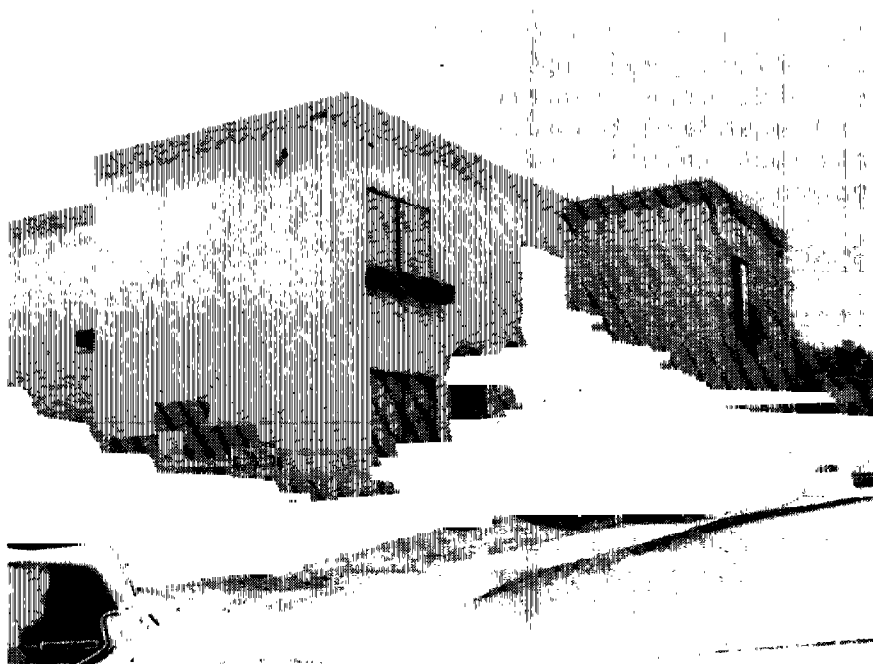
The directors tried to fire the second management agent in May 1986, because they believed he was not competently managing the project. However, HUD officials and the directors could not agree on a replacement. According to HUD officials, the candidates nominated by the directors were not certified management agents, so HUD withheld its approval.

In April 1986 the court decided the ownership lawsuit in favor of the prospective buyer, and the directors appealed. The appeal was still pending as of June 16, 1987. In May 1986 the project filed for reorganization under Chapter 11 of the bankruptcy statutes. The board chairman attributed the bankruptcy to pressure from HUD, a desire to prevent the sale of the project, and other pending lawsuits. In April 1987 the court appointed a trustee to oversee project operations. The project missed its September 1986 mortgage payment, thus defaulting on its mortgage, so in February 1987 the lender assigned the loan for \$1.2 million to HUD.

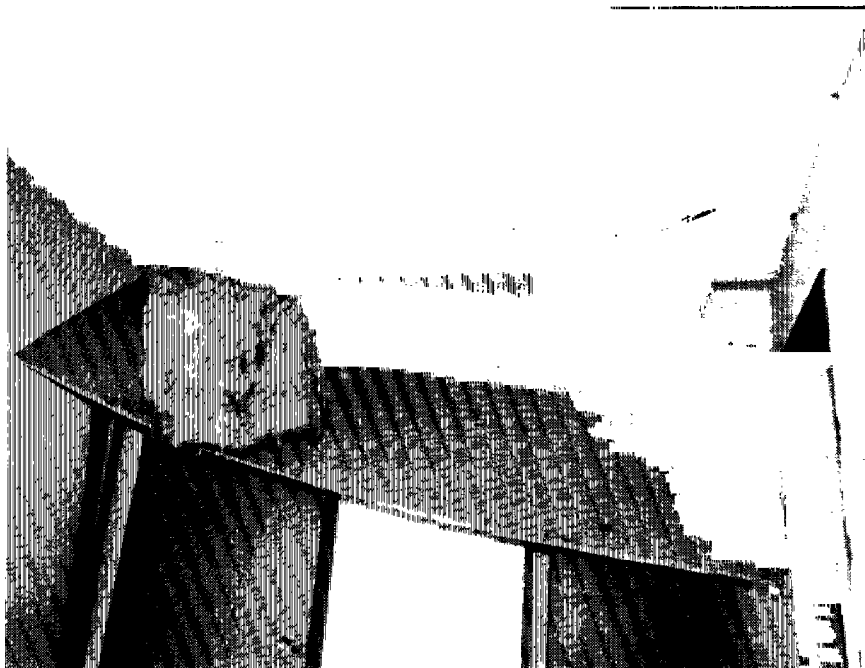
The roofs were repaired by June 1986 at a cost of about \$600,000; however, boiler repairs were delayed by difficulty in procuring a contractor, materials, and supplies and by the need to have the bankruptcy court approve spending the funds. Work on the boiler system began in December and was 90 percent complete in June 1987.

As the directors complete repairs, a San Jose housing inspector is inspecting the units to determine whether they can be released for rental. As of June 16, 1987, 28 of the 58 condemned or substandard units have been repaired and released for rental. Thirty units remained either condemned or substandard, needing such repairs as replacing ceilings, fixtures, and appliances.

Figure 1.1: Villa San Pedro Apartments



Exterior of apartment building showing repairs to lower wall and upper wall adjoining the roof area.



Damage to interior ceiling area resulting from the 1985 rain storm.

SECTION 2

REMEDIES AVAILABLE TO ADDRESS PROJECT PROBLEMS

Persuasion	Letters, meetings, and audits to influence project management.
Flexible Subsidies	Emergency funding to cover repairs and operating deficits.
Change of Ownership	Sale of the project to provide new management and capital.
Administrative and Legal Remedies .	Withholding of subsidies, takeover of the project's mortgage or the project itself, etc.

SECTION 2

Villa San Pedro is owned and operated privately, not by HUD. In general, HUD's responsibility to the project is to provide oversight and technical and financial assistance and to ensure that federal funds are spent properly and that units meet standards of safety and sanitation. When a project runs into severe difficulties, HUD has four avenues for addressing them: persuading project managers to correct problems, providing emergency repair funds under the flexible subsidy program, effecting a change in the ownership of the project, and employing administrative or legal action. HUD has little guidance on when a particular remedy should or should not be used; the decision is left to the discretion of local HUD officials in consultation with headquarters.

PERSUASION

In its simplest form, persuasion involves meetings and letters between HUD and project officers to influence them to pursue a course of action. HUD may also use inspections, audits, and management reviews, as well as its authority to approve rent increases, to convince project officers to take action.

FLEXIBLE SUBSIDY FUNDING

Under the Flexible Subsidy Program, HUD can lend a project emergency funds to make needed repairs and cover operating deficits. The purpose of the flexible subsidy program is to return projects to long-term viability. To receive flexible subsidies, project managers must meet standards of minimum competency, such as the skills and experience needed to diagnose the causes underlying the project's problems, to develop and implement a program to alleviate problems and provide a sound financial and physical future for the project, and to perform required monitoring.

In each region, projects applying for flexible subsidies are ranked by HUD officials, on the basis of their subjective judgment of each project's condition. Then headquarters staff evaluate all regional requests and fund projects from the top of each region's priority list.

CHANGE OF OWNERSHIP

HUD officials told us that when they are unable to obtain the cooperation of project management, they may adopt the strategy of encouraging the sale of the project. A voluntary project sale, called a transfer of physical assets, must be approved by HUD if the project received a loan guaranteed under section 221(d)(3). Such a sale can help turn a troubled project around by providing

Administrative and Legal Remedies

Administrative Remedies:

- Pay rental subsidies directly to the lender, used in the event of a financial default.
- Reduce, suspend, or withhold rental subsidies until default is corrected.
- Reduce the number of units receiving rental subsidies, thereby decreasing project income, when the owner has failed to lease all units to eligible families.
- Restrict participation in other HUD programs.

Legal Remedies:

- Foreclose, if HUD holds the mortgage, or request that the lender foreclose.
- Assume financial control by collecting all rents and charges and paying the project's obligations and the necessary expenses.
- Assume operational control of the project.
- Obtain a court injunction to force compliance with the agreements or to appoint a receiver that will take over and operate the project.

both new management to address managerial and recordkeeping problems and private funds to correct physical problems.

A change in the ownership can also result from a financial default on the mortgage. When the lender assigns the mortgage to HUD, HUD can foreclose and sell the project.

ADMINISTRATIVE AND LEGAL REMEDIES

Administrative and legal remedies stem from formal agreements that the project owners signed in order to receive mortgage insurance and rental subsidies. The agreements place certain performance requirements upon the owner, among them

- maintaining the property in good repair and condition,
- providing satisfactory management,
- maintaining records and other documentation in reasonable condition to permit proper review and audit,
- submitting annual audited financial reports, and
- responding promptly to HUD physical inspection reports.

When a project violates the performance requirements, it is considered to be in "technical default." Failure to meet a mortgage payment results in "financial default." In either case the formal agreements provide HUD with administrative and legal recourses. These are listed to the left.

Although HUD officials may invoke the administrative and legal remedies if the project does not meet performance requirements, the agency is not required to do so. In the case of Villa San Pedro, the tenants' suit sought damages from HUD for allowing the project to violate the formal agreements without taking remedial action. However, the court ruled that HUD is under no compulsion to exercise the administrative and legal remedies. HUD's use of these remedies is discretionary; therefore, according to the court, the tenants had no claim against HUD.

SECTION 3

HUD'S RESPONSE TO VILLA SAN PEDRO'S PROBLEMS

REMEDY	HUD'S USE
Persuasion	HUD used extensively to encourage directors to improve management and physical conditions.
Flexible Subsidy	Not provided in 1979, because management problems would remain. Not provided in 1983 because of higher regional priorities. Provided in 1985 when maintenance problems became severe; however, some funds withheld by HUD because of continued concerns over management.
Change of Ownership	HUD expected a voluntary change of ownership. The board considered it in 1982, but changed its mind; a subsequent lawsuit over the project's title made sale unlikely.
Administrative and Legal Remedies	Rental subsidies paid directly to the lender. Administrative remedies considered, but judged ineffective or harmful to tenants. Legal remedies considered in 1983, but not pursued. HUD officials did not believe the courts would be sympathetic to federal action. Use of legal remedies precluded by 1986 bankruptcy.

SECTION 3

HUD regional officials considered using each of the remedies available to address Villa San Pedro's financial, managerial, and physical problems. They relied primarily on persuading the directors to improve management. HUD officials were reluctant to use flexible subsidy funding because of continuing concern about project management. They believed they were constrained from aggressively pursuing change of ownership and administrative and legal remedies by legal and practical considerations. Although officials' actions were not effective in correcting the project's problems, we believe their actions were reasonable under the circumstances and within the broad discretion granted them.

PERSUASION

Between 1979 and 1983 HUD project oversight officials requested a 1980 inspector general audit and conducted three management reviews and five physical inspections to document the project's financial, managerial, and physical problems. The reports and reviews chronicled the deterioration of the project, for example,

- The inspector general audit in 1980 found that the project lacked written financial procedures and controls. Auditors questioned financial transactions.
- The 1979, 1981, and 1983 management reviews rated the overall management of the project as unsatisfactory and strongly recommended that the directors hire a management agent.
- The 1982 and 1983 physical inspections criticized the overall maintenance of the project and recommended that the project replace the roofs. In addition, the 1983 inspection recommended the boiler system be repaired.

HUD officials corresponded and met with Villa San Pedro officials a number of times, identifying deficiencies and requesting correction. Additionally, they concentrated on persuading the project's board of directors to obtain a management agent, because they believed that a professional manager could correct the problems, such as the project's incomplete financial records and deteriorating physical condition. The directors finally obtained a management agent in mid-1983 and replaced the agent in 1984; however, according to HUD officials, neither agent was successful in resolving the project's problems.

A HUD official used a possible rent increase as an incentive for improving the project's financial management. HUD officials recognized the need for a rent increase in August 1984 to upgrade the project's physical condition and pay off its debts, but they

rejected the directors' request because financial statements were inadequate and HUD requires that rent increase requests be supported by adequate financial statements. However, HUD granted a rent increase on May 1, 1985, despite the inadequacy of financial statements and other problems, because the need for repairs was becoming critical.

The primary HUD project oversight official also wrote letters in 1985 requesting that the board resign, because the official believed that a more competent board would be able to resolve Villa San Pedro's financial, managerial, and physical problems. The board was finally replaced in September 1985, as a result of court action in response to the tenants' suit.

FLEXIBLE SUBSIDY FUNDING

HUD officials considered a flexible subsidy for the project in 1979 but decided that the funding would not correct the managerial problems that were resulting in deferred maintenance. Although a 1982 physical inspection recommended that the project replace the roofs, HUD officials told us they did not consider the project for funding, because they (1) expected the project to be sold² and (2) continued to be concerned that such funding would not resolve its managerial problems.

In 1983 the management agent requested flexible subsidy funds to replace the roofs, update the boiler system, and address other problems. At that time HUD regional officials considered funding Villa San Pedro's request, despite concern over management, because deterioration was accelerating. However, the project was ranked ninth among 15 regional projects requesting flexible subsidies and HUD headquarters did not fund it. We were unable to assess the region's ranking of this project relative to others because HUD officials told us that the ranking of the projects was subjective and not documented.

On February 27, 1985, HUD regional officials responded to another Villa San Pedro appeal for a flexible subsidy by asking headquarters for \$1,162,000 to fix the project's roof, boiler system, and other items. This time they ranked the project number one because of its severe health and safety hazards. HUD headquarters approved the assistance during May 1985.

In addition to providing the funding, HUD officials developed the plans and specifications for repairing the roofs. In July 1985, the project's directors agreed that HUD would oversee the contracting process, work that normally would be the directors' responsibility. HUD officials said they were concerned that the lawsuits were diverting the board's attention from planning the

²This was the time of the disputed sale. (See p. 10.)

needed major repairs. Between June and August 1985, HUD officials supervised the selection of a consulting architect. In September 1985 HUD officials oversaw the selection of the contractor. Roof repairs began in October 1985. Then funding had to be increased when the problems were discovered to be more serious than had been thought.

By July 1986 the project had spent approximately \$646,000 in flexible subsidy funds. At that time HUD officials decided not to allow the project to spend the remaining \$516,000 in flexible subsidy funding, because they were concerned over how the money would be spent. According to HUD officials, the directors, claiming the protection of bankruptcy, refused to guarantee that the money would be spent as HUD required. HUD officials feared the directors would use the money to pay legal fees and other debts. HUD officials persuaded the directors, as a condition of releasing the subsidies, to obtain a court order in October 1986 agreeing that HUD funds be spent in accordance with HUD requirements. However, HUD officials still declined to release the remaining funds because of concern over project management.

In November 1986 HUD's Assistant Secretary for Housing instructed the region that except for boiler repairs, flexible subsidy funds would be withheld until concerns regarding Villa San Pedro's ownership were resolved. Moreover, according to a December 1986 policy directive, HUD officials must certify that the provision of flexible subsidy funding to a troubled project will correct all of its financial and physical problems and that adequate management will be in place. A HUD official told us he cannot certify that releasing the remaining subsidy assistance will resolve the project's financial, managerial, and physical problems. As a result, further flexible subsidy funding appears unlikely under present circumstances.

Villa San Pedro's chairman of the board took issue with HUD's assessment of present project management. The chairman said that the current board of directors (which took office in September 1985) has not had an opportunity to demonstrate its competence. The current board, the chairman said, was not permitted to replace the second management agent or to exercise its management skills.

However, a HUD official pointed out that the current board was in charge of the project for a year and a half until the court-appointed trustee took control, and no improvement in management was apparent. The directors were asked to submit plans for completing project repairs so that flexible subsidies could be released, but they did not respond. Also during this period, HUD had to negotiate with the local utility to prevent service from being suspended for nonpayment of bills. Finally, HUD officials were willing for the management agent to be replaced, but the directors did not nominate a suitable candidate.

CHANGE OF OWNERSHIP

HUD officials have been aware of the board of directors' interest in selling the project since 1982. They hoped a sale would revitalize the project with private funds and improved management. After the disputed sale of the project, however, a project sale became unlikely until the court settles which of the parties to the dispute actually holds title to the project.

ADMINISTRATIVE AND LEGAL ACTION

HUD officials considered taking various types of administrative or legal action against the directors between 1979 and 1986. However, they generally did not follow this avenue because they believed such actions would be impractical or ineffective.

HUD officials did not reduce or withhold rental subsidies or reduce the number of units receiving subsidies, because they thought such actions would increase the tenants' distress, rather than lead to improvements. In April 1986 HUD program and legal officials also considered restricting the former directors' participation in HUD's 221(d)(3) program. This action would have had no effect, however, since the directors did not have any interest in initiating other HUD projects.

HUD officials did pursue administrative action against the directors during late 1986 by sending rental subsidy payments directly to the lender. Villa San Pedro failed to meet its September 1986 mortgage payment, so HUD officials notified the board of directors and the management agent that they were sending rental subsidies directly to the lender, to be used to pay the mortgage and essential project bills, such as utilities. However, HUD officials sent the rental subsidies directly to the management agent by mistake and did not contact the agent to clear up the confusion. The management agent believed HUD officials had met the mortgage payment. Although HUD officials began sending subsidies to the lender the following month, the project never made the September payment and consequently defaulted on its mortgage. The lender assigned the loan to HUD on February 15, 1987. Later, HUD's regional counsel noted that sending rental subsidies to the lender may have violated laws governing bankruptcy proceedings because the subsidies might be considered project assets that were under the protection of the court. The direct payments were then stopped.

HUD officials considered taking legal action against the directors in 1983; however, lack of evidence deterred them. Legal actions are handled by a small group of attorneys at headquarters. Since legal resources are limited, HUD attorneys prosecute only cases of egregious conduct--those they feel they have the best chance of winning in court. HUD program officials and attorneys told us that Villa San Pedro was not a good candidate for legal action. We were told it was difficult for HUD officials to take a

project to court for violating its formal agreements, unless it had financially defaulted on its mortgage or committed severe waste. HUD officials believe the courts are unsympathetic to federal requests for action in cases of technical, nonmonetary infractions, because the projects are privately owned.

HUD officials reconsidered legal action in 1985; however, they decided to focus on accomplishing the roof repair. In 1986 legal action was blocked by the bankruptcy.

Assessment of HUD Actions

REMEDY	EFFECTIVENESS
Persuasion	Effective in eventually persuading board to hire a professional manager. Ineffective in persuading board to improve management and physical conditions, provide audited financial statements, or resign.
Flexible Subsidy Funding	Effective in correcting roof and boiler problems, but damage to units remains.
Change of Ownership	Ineffective due to legal problems.
Administrative and Legal Remedies	Administrative remedies ineffective. HUD's use helped drive project into default.

ASSESSMENT OF HUD ACTIONS

HUD officials aggressively pursued persuasion as a means of correcting Villa San Pedro's problems but were unable to effectively resolve the project's financial, managerial, and physical problems. At HUD's repeated urging, the directors eventually hired a management agent in 1983, but conditions did not materially improve as a result.

HUD officials approved the May 1985 rent increase without a firm basis, since the project had not submitted the adequate financial statements that are required by HUD. On the other hand, the project appeared to be in dire need of additional income.

HUD officials delayed providing flexible subsidy funds that could have been used to effect repairs. If HUD officials had approved flexible subsidy funding for the project in 1982 or 1983, the directors might have scheduled the roof repairs in time to avoid the 1985 crisis. However, it was HUD's judgment that repairs were not urgent at that time and that the maintenance problems were caused by mismanagement, which would not be corrected by flexible subsidies. After some flexible subsidies had been granted, concerns over project management led HUD officials to withhold the remaining funds. However, without these funds, 30 substandard or condemned units remained vacant as of June 16, 1987.

Although HUD officials expected a change of ownership in 1982, one has not occurred so far, in part because of the lawsuit over the project's title. However, HUD officials are hoping a sale will result from the bankruptcy hearings. They hope new ownership will be an important step toward resolving the project's difficulties. HUD officials could perhaps have forced a change sooner through foreclosure, but they would have had to give up their authority to approve the new owner and the Villa San Pedro Corporation could have reaped a profit estimated at \$1.8 million. (See pp. 28 and 29.)

Regarding HUD officials' use of administrative remedies, their decision to send subsidy payments directly to the lender may have unintentionally violated bankruptcy law. Further their mishandling of the September 1986 payment contributed to the project's default on its mortgage.

HUD officials refrained from using legal remedies because of a limited legal staff, insufficient evidence, and their assessment that their case might not be successful. The court in the tenants' suit ruled that HUD's use of the administrative and legal remedies is in fact discretionary. (See p. 17.)

In general, HUD regional officials adopted a course of action that in our opinion was reasonable under the circumstances and within the broad discretion granted them in dealing with troubled

projects. Their actions did not resolve the project's problems and had other drawbacks; however, the alternatives also had drawbacks that had to be considered.

SECTION 4

OPTIONS NOW AVAILABLE TO HUD

- 1) Work with current owners, providing flexible subsidy.
- 2) Seek project sale
 - a) by allowing the bankruptcy to continue until a sale is inevitable or
 - b) by requesting dismissal of the bankruptcy and foreclosing on the mortgage.

SECTION 4

At this point, HUD has two alternatives for repairing the project and ensuring its economic viability: (1) working with the current directors and providing them funding or (2) obtaining the project's sale to another party with the funds to turn it around. Regardless of which option HUD pursues, the project will remain dedicated to low- and moderate-income housing until 1991.

HUD could try to work with the project directors and release the remaining flexible subsidy funding. The advantage of this option is that the remaining units would probably be repaired and available to low- and moderate-income tenants much sooner. The court-appointed trustee could oversee the repair of the project and take responsibility for ensuring that funds are properly spent. However, if this course permits the project to resolve its financial problems and escape bankruptcy, the project might continue under the ownership of a board of directors whose competence HUD has questioned.

HUD's status as a creditor, i.e., the holder of the project's mortgage, provides the agency with some leverage for influencing the course of the bankruptcy. Like any creditor, HUD can request the court to dismiss the project's reorganization for cause--for example, if HUD can demonstrate that the project will be unable to reorganize its debts.

HUD officials told us that they have two courses for achieving a project sale:

- Continue the bankruptcy until the project owners are eventually forced into a "voluntary" sale to satisfy their creditors. The advantages of this option are that, by agreement with the trustee, HUD would have an opportunity to approve the purchaser of the project and could require, as a condition of sale, the repayment of the flexible subsidies. In this case, the selling price of the project would be limited to the current mortgage balance, plus settlement expenses.
- Petition the court to dismiss the reorganization, foreclose, and sell the project to the highest bidder. This course might achieve the sale sooner but would not allow HUD the opportunity to approve the new owners. In addition, under a foreclosure the Villa San Pedro Corporation could reap a profit. They would receive the difference between the current mortgage balance (\$1.2 million) and the selling price (estimated at \$3 million).

Under either option, it is unlikely the project could be sold until the lawsuit over ownership is settled and the title cleared. If the disputed sale to the prospective buyer for the value of the

mortgage is found to be valid, the proceeds of the sale would be used to pay off the mortgage. The buyer could then assume management of the project or sell it to another party at a profit.

HUD officials told us they favor waiting for the bankruptcy proceedings to bring about the sale of the project. They do not intend to release the remaining flexible subsidy funds until the question of who owns the project is resolved. They believe that providing funding would not alleviate the project's primary problem of poor management. They would also prefer that a private investor supply the funds needed to repair the project. Further, withholding flexible subsidy funds is an important means of obtaining improvements in project management. They think that if the current directors are permitted to continue managing the project, they will simply run it into the ground within 5 years.

Whether the project is sold or remains in the hands of the current owners, it will remain dedicated to low- and moderate-income housing until at least 1991. To receive rental subsidies, the project owners signed and later renewed a 5-year contract to maintain the property as subsidized housing. The contract, which expires in 1991, is binding on future owners as well.

Each option has advantages and drawbacks. HUD has adopted a course that we believe emphasizes protection of the government's financial interests and the project's long-term viability but may not be the fastest route to reoccupation of condemned units.

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