audit report

Issue Date
August 2, 2004
Audit Case Number
2004-AT-1012

TO: Michael A. Williams, Director, Office of Public Housing, 4FPH

Margarita Maisonet, Director, Departmental Enforcement Center, CV

James D. McKay

FROM: James D. McKay
Regional Inspector General for Audit, 4AGA

SUBJECT: Housing Authority of the City of Durham
Durham, North Carolina

INTRODUCTION

We completed an audit of the Housing Authority of the City of Durham's (Authority) management controls over development activities. Our audit was initiated as a result of the audit of the Department of Housing and Urban Development's (HUD) oversight of Public Housing Agency development activities with related nonprofit entities. Our objective was to determine whether the Authority had adequate controls to ensure assets were properly safeguarded and whether it was in compliance with applicable laws, regulations and HUD requirements, as they pertained to development activities.

To accomplish our objectives we reviewed applicable HUD regulations, the Authority's Annual Contributions Contract (ACC), and other requirements. We also: interviewed appropriate Authority and HUD North Carolina State Office of Public Housing management and staff, reviewed Authority and Development Ventures, Inc., (DVI) books, records, and minutes of Board meetings, and, reviewed HUD files and reports.

We conducted our field work from October 14, 2003, through March 12, 2004, and covered the period January 1, 2000, to September 30, 2003. We performed our audit in accordance with generally accepted government auditing standards.

We discussed our audit results with Authority officials during our review and met with them for an exit conference on June 17, 2004. At the exit conference, Authority officials generally agreed with the Finding and stated that they were not taking issue with anything in the report. The Authority provided written comments to our draft on June 29, 2004, and, contrary to their statements at the exit conference, generally disagreed with the report. The complete text of the Authority's comments, along with our evaluation of the comments can be found in Appendix D of this report. In addition, supporting documentation provided by the Authority is available for review upon request.

In accordance with HUD Handbook 2000.06 REV-3, within 60 days, please provide us, for each recommendation without a management decision, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Additional status reports are required at 90 days and 120 days after report issuance for any recommendation without a management decision. Also, please furnish us copies of any correspondence or directives issued because of the audit.

Should you or your staff have any questions, please contact me at (404) 331-3369, or Gerald Kirkland, Assistant Regional Inspector General for Audit at (865) 545-4369.

SUMMARY

The Authority violated its ACC contract with HUD by inappropriately advancing funds and guaranteeing loans for non-Federal development and other activities that were not approved by HUD. As of September 30, 2003, the Authority had advanced at least $1,994,955 from its Conventional Public Housing General Fund to DVI, DVI projects, and other entities. The Authority also violated its Turnkey III Administrative Use Agreement (Agreement) when it inappropriately advanced or failed to require loan repayments totaling at least $2,803,579. Appendix B of this report shows the amounts owed the Authority from the various entities. Also, in violation of its ACC, the Authority guaranteed a $350,000 loan obtained by a Limited Liability Company (LLC) and executed a Promissory Note for a $1.5 million line of credit on behalf of another LLC. The Authority also failed to properly allocate operating costs to other entities. Further, the Authority has not completed several of its development efforts, thus we question its ability to successfully complete its HOPE VI Revitalization Plan. These actions occurred because the Authority Board of Commissioners and management did not establish and implement sufficient controls to monitor activities and ensure transactions adhered to Federal regulations. Further, the Board did not adequately fulfill its fiduciary responsibilities to oversee Authority operations, and management disregarded HUD requirements and instructions. These actions reduced funds available to operate and maintain the Authority's conventional public housing and deprived tenants of needed housing.

As a result of our discussions with HUD officials, the Deputy Assistant Secretary, Office of Public Housing Investments, required reviews of all drawdowns of HOPE VI funds. Similarly, the Director of Public Housing required the Authority to obtain approval for any other drawdowns of HUD funds.

We also identified other management and financial weaknesses that we will address in a subsequent audit report.

We recommend the Director, Office of Public Housing:

- Require the Authority to repay $3,454,660, or current balance owed, to its Conventional Public Housing General Fund or Turnkey III program, as appropriate.

- Require the Authority to obtain release of any currently encumbered assets, including the Promissory Note for a $1.5 million line of credit with Wachovia Bank and the loan guaranty for a $350,000 loan obtained by Fayette Place, LLC.

- In coordination with the Office of Public Housing Investments, continue to perform reviews of all drawdowns of funds until HUD determines the Authority is properly administering its programs.

- Perform a comprehensive review of the Authority's capacity and ensure the Authority takes appropriate measures to address any capacity issues to successfully complete activities in accordance with the HOPE VI Grant Agreement and Revitalization Plan. If the review finds the Authority does not have the capacity to complete the activities, or finds the Authority in serious default of the Grant Agreement or regulations, terminate the Grant and recapture the remaining $27,590,236, or current balance, of unused funds.

- Issue a Notice of Substantial Default in accordance with Section 17(C) of the ACC. Should the Authority fail to cure the default, require the Authority to convey title to the projects, or deliver possession and control of the projects to HUD

Other recommendations include advising the Authority not to make further advances or encumber assets without prior written approval from HUD, requiring the Board of Commissioners to establish adequate controls, and requiring the Authority to develop and implement an acceptable cost allocation plan.

We also recommend the Director, Departmental Enforcement Center, in consultation with the Director, Office of Public Housing, Greensboro, North Carolina, take administrative actions against the former Executive Director, Interim Executive Director and Board members, including issuing Limited Denials of Participation or debarments, as appropriate.

BACKGROUND

The Authority was created in 1949 under North Carolina law to provide safe and sanitary housing for persons of low and moderate income. A seven member Board of Commissioners governed the Authority. Deloris C. Rogers has served as the Chairperson since February 24, 2000. The Board of Commissioners accepted the resignation of James R. Tabron, the former Executive Director, in April 2003. Frank Meachem currently serves as the Authority's Interim Executive Director.

The Authority is required to develop and operate public housing complexes in compliance with its ACC with HUD. The Authority administered 13 Conventional Public Housing communities consisting of 2,133 dwelling units. It also managed a Section 8 Program consisting of 2,834 housing choice vouchers. As of June 20, 2003, the Authority had 1,496 applicants on the public housing program waiting list and 3,244 applicants for the Section 8 Program.

The Authority is the parent company of two wholly owned not-for-profit subsidiaries: Learning Assistance, Inc., an educational foundation created in 1987 to increase educational, employment, and economic opportunities for Authority residents; and DVI, a housing development corporation created in 1985 to develop low-income properties. Neither of the subsidiaries have employees. The Authority's Board of Commissioners serves concurrently as the Board of Directors of both subsidiaries. The Authority's Executive Director normally serves as the Secretary/Treasurer for DVI. Currently, the Interim Executive Director is serving as the Secretary/Treasurer. The Authority also holds a majority interest in East Durham Properties, LLC.

DVI also owns or has an ownership interest in at least five apartment complexes and an industrial center, the Golden Belt Center. The apartment complexes are: Northtowne Apartments, Woodridge Commons Apartments, Edgemont Elms Townhomes, Fayette Place Apartments, and Preiss-Steele Place. The Golden Belt Center is comprised of 9 buildings totaling about 180,000 square feet. The complex is in dire need of renovations and is largely unoccupied.

Appendix C provides additional information about the various entities.

The Authority's financial records were maintained primarily at its central office located at 330 East Main Street, Durham, North Carolina.

Finding 1: The Authority Inappropriately Advanced Funds and Guaranteed Loans

The Authority violated its ACC contract with HUD by inappropriately advancing funds and guaranteeing loans for non-Federal development and other activities that were not approved by HUD. As of September 30, 2003, the Authority had advanced at least $1,994,955 from its Conventional Public Housing General Fund to DVI, DVI projects, and other entities. The Authority also violated its Turnkey III Agreement when it inappropriately advanced or failed to require loan repayments totaling at least $2,803,579. Also, in violation of its ACC, the Authority guaranteed a $350,000 loan obtained by a LLC and executed a Promissory Note for a $1.5 million line of credit on behalf of another LLC. The Authority also failed to properly allocate operating costs to other entities. Further, the Authority has not completed several of its development efforts, thus we question its ability to successfully complete its HOPE VI Revitalization Plan. These actions occurred because the Authority Board of Commissioners and management did not establish and implement sufficient controls to monitor activities and ensure transactions adhered to Federal regulations. Further, the Board did not adequately fulfill its fiduciary responsibilities to oversee Authority operations, and management disregarded HUD requirements and instructions. These actions reduced funds available to operate and maintain the Authority's conventional public housing and deprived tenants of needed housing.

Criteria:

Part Two, Section 401(D) of the ACC allows the Authority to withdraw monies from the General Fund only for (1) public housing development costs, (2) operating expenditures, (3) purchase of investment securities approved by the Government, and (4) other purposes specified in the ACC or specifically approved by the Government.

Part Two, Section 313 of the ACC specifically prohibits the Authority from transferring, conveying, assigning, leasing, mortgaging, pledging, or otherwise encumbering project assets including rent, revenues, and income. Further, Section 506(2) states that such pledges or encumbrances are considered a substantial default of the contract.

Title 24 of the Code of Federal Regulations, Part 904, sets forth requirements for the Turnkey III program. It provides that any reserves remaining after the sale of the last home must be paid to HUD. However, HUD formally waived the requirement for the return of such funds and executed an ACC Amendment for Loan Forgiveness with the Authority on April 16, 1993.

The Administrative Use Agreement for Proceeds of Sales of Homeownership Projects that the Authority entered into on April 16, 1993, provides that the Board of Commissioners is responsible for ensuring that proceeds from sales are used in accordance with the requirements of the Agreement.

The Office of Management and Budget's (OMB) Circular A-87 establishes principles for determining the allowable costs incurred by State, local, and federally recognized Indian tribal governments (governmental units) under grants, cost reimbursement contracts, and other agreements with the Federal Government. To be allowable under Federal awards, costs must be necessary and reasonable for proper and efficient performance and administration of Federal

awards. A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the cost. The question of reasonableness is particularly important when governmental units or components are predominately federally funded. In determining reasonableness of a given cost, consideration shall be given to whether the cost is of a type generally recognized as ordinary and necessary for the operation of the governmental unit or the performance of the Federal award.

Inappropriate Advances of Conventional Public Housing Funds

In violation of its ACC, the Authority inappropriately advanced funds from its Conventional Public Housing General Fund to DVI, DVI projects and other entities without HUD approval. These entities used the funds for non-Federal developments and other activities that were not approved by HUD. As of September 30, 2003, the entities owed the Authority $1,966,117. DVI and its related entities owed almost $1,694,000. Appendix B shows the amounts owed by each entity. As discussed later in this Finding, the Authority also paid another $28,838 for closing costs on properties purchased by East Durham Properties, LLC, which was not recorded as a receivable due from the LLC.

The Authority inappropriately advanced at least $848,099 to DVI, or directly paid vendors, for expenses pertaining to the Golden Belt Center. The Golden Belt Center is an industrial facility intended for mixed use or economic development, not housing.

With HUD approval, the Authority transferred Fayetteville Gardens, formerly a 200-unit public housing complex, to Fayette Place, LLC. DVI has a 99 percent ownership interest in Fayette Place, LLC. However, without HUD approval the Authority also used at least $367,777 from its Conventional Public Housing General Fund to pay fees associated with the financing of the Fayette Place project.

Fayette Place, LLC pursued tax-exempt bonds to fund the necessary renovations to convert the complex into privately owned low-income housing. In 2002, Fayette Place, LLC received a bond allocation for $7.8 million of tax exempt bonds with an additional 4 percent of Low Income Housing Tax Credits. The tax credits were to be sold to investors to generate additional funds for renovations. In order to obtain the bonds, Fayette Place, LLC had to demonstrate that it had necessary credit enhancements to fund the remaining renovation costs. This had to be done by December 31, 2002, or the bond allocation would be lost. DVI applied for Federal Housing Administration mortgage insurance under Part 221 (d)(4) of the National Housing Act of 1937, as amended.

Fayette Place, LLC obtained a $350,000 bank loan to fund the initial closing so it would not lose the bonds. Further, Fayette Place, LLC obtained a $7.8 million a line of credit to fund the issuance of the bonds. However, as of March 12, 2004, the necessary credit enhancements had not been obtained. Thus, there are insufficient funds to make the renovations. As such, Fayette Place, LLC has not been able to sell the bonds. In the interim, the Authority is paying fees, including interest on the line of credit, associated with the financing. The Authority estimated the annual amount of the fees at $376,000 until final closing occurs, but could not provide an

estimated closing date for the project. As of September 30, 2003, Fayette Place, LLC owed the Authority $367,777.

In a letter to the Authority attorney, the Interim Executive Director stated that payment of the fees was not budgeted nor anticipated and may result in reducing salaries and other related expenditures. According to the recently resigned Director of Finance, if the 221 (d)(4) application is not approved, the Authority will be crippled because it will have to immediately pay about $1 million in development costs and about $2 million within 2 years. HUD's North Carolina Office of Housing has not yet determined whether the application will be approved. Further, when the Authority transferred the property to Fayette Place, LLC, 126 of the families were provided Section 8 vouchers. Subsequently, most of them moved from the property. We visited the property and noted that most of the units were vacant.

The Authority Violated its Turnkey III Administrative Use Agreement

The Authority violated its Turnkey III Agreement when it inappropriately advanced about $2 million of the funds to DVI for renovation and other expenses of the Golden Belt Center. The Authority also failed to require DVI to fully repay loans the Authority made for the purchase of Northtowne Apartments and Woodridge Commons Apartments. Appendix B shows the balance owed the Authority by the various entities of $2,597,065 as of September 30, 2003. Also, without authorization the Authority used Turnkey III funds to pay property taxes for Fayette Place Apartments, $134,790, and to pay longevity bonuses to Authority staff, $71,724. In total, the Authority inappropriately advanced or failed to require loan repayments totaling at least $2,803,579.

HUD was not aware the Authority used Turnkey III funds for Golden Belt until the Authority submitted its financial statements for the fiscal year ended December 31, 2000, which included a finding on an outstanding loan of Turnkey III funds to Golden Belt. The Authority did not request HUD's approval to use Turnkey III funds on the Golden Belt project until July 18, 2001. However, at the time of the request, the Authority had already advanced about $2 million to renovate and maintain part of the site. Estimated costs to complete renovations were $12 million. HUD approved the Authority's request to amend the Turnkey III Agreement to permit proceeds to be used for economic development. The October 23, 2001, approval letter stated the Golden Belt Center was authorized a loan of $1,804,670, with repayment over a 30-year period with initial payments deferred for 3 years. In February 2002, the Authority requested HUD to forgive the loan. HUD denied the request for debt forgiveness, but increased the deferred payment period to 5 years. As of September 30, 2003, Golden Belt owed the Authority $1,343,874 for the Turnkey III loan (See Appendix B).

In November 2003, we toured the Golden Belt Center. The buildings were mostly vacant. A handful of small businesses occupied one small building and a job-training agency occupied a small portion of another building. The unrenovated buildings were laden with lead based paint creating a serious health hazard. The following photographs show portions of the buildings.

Exterior of a typical unrenovated building.

First floor of Building #2.

Second floor of Building #2 showing severe lead base paint. Similar examples were observed during our walk through of other buildings.

Further, as shown in the following picture, the Authority was using some of the facility as storage space.

Stoves stored on the first floor of Building #6.

The Authority also advanced Turnkey III funds to DVI to purchase Northtowne Apartments and Woodridge Commons Apartments. The loans were made pursuant to the Authority's Turnkey III Use Agreement, which permitted the funds to be used for a revolving loan development fund. As the loans were repaid, the funds were to be placed back into the revolving fund to ensure program continuity. Even though DVI sold Northtowne in August 2003 the $231,094 balance due on the loan was not returned to the Turnkey III revolving loan fund. DVI made limited

repayments to the Authority for the Woodridge note before the Authority subordinated its note so DVI could obtain a bank loan. DVI used Woodridge Commons Apartments as equity to obtain a bank loan for $800,000 and used the funds to pay cost overruns on Golden Belt. Subsequently, DVI discontinued making payments on the Turnkey III loan, which had a balance due of $1,022,097. HUD was not aware the Northtowne loan was not repaid or that the Authority subordinated its Woodridge note. Because the Authority did not require the funds to be repaid, it violated the terms of its Turnkey III Agreement. As such, the Authority should repay the $231,094 and $1,022,097 to its Turnkey III program from non-Federal funds.

On October 30, 2003, the Authority requested to use recaptured Turnkey III funds for general operating uses along with development expenses associated with Fayette Place. In its January 6, 2004, response the Greensboro HUD office approved the request to use funds for general operating purposes, as long as its use was specifically for the Low Income Public Housing Program. The use of funds for Fayette Place was denied. However, despite HUD denying its request and even though the Authority's former Finance Director advised the Executive Director that paying the taxes would be improper and against HUD's instructions, the Authority used $134,790 of Turnkey III funds to pay taxes for Fayette Place. Further, prior to receiving HUD's response, the Authority paid longevity bonuses to staff totaling $71,724 from Turnkey III funds. We confirmed with the PIH Director that he did not authorize payment of the longevity bonuses.

Inappropriate Loan Guarantee

In violation of Part Two, Section 313 of the ACC, Authority management provided a loan guaranty for a $350,000 loan obtained by Fayette Place, LLC. The Chairperson of the Authority's Board of Commissioners and the former Executive Director signed the loan guaranty in December 2002. However, the minutes of the Authority's Board of Commissioners meetings do not indicate the loan guaranty was discussed or approved by the Board. The guaranty is unsecured and does not identify specific Authority assets as collateral; however, the Authority could be responsible for the balance of the loan should Fayette Place, LLC default on the loan payments.

Inappropriate Promissory Note

In June 2003, in violation of Part Two, Section 313 of the ACC, the Authority's Board Chairperson executed a Promissory Note for a $1.5 million Line of Credit with Wachovia Bank on behalf of East Durham Properties, LLC. The Authority's Interim Executive Director also signed the Promissory Note. East Durham Properties, LLC was created to purchase properties to be included in the Authority's HOPE VI project. Wachovia Bank provided funds from the line of credit to pay 90 percent of the purchase cost of each property. East Durham Properties, LLC provided the remaining 10 percent. As properties are purchased, the Authority requests HUD approval of the properties and release of HOPE VI funds so the Authority can purchase the properties from East Durham Properties, LLC at cost.

East Durham Properties, LLC purchased at least 13 properties with total contract sales prices of $395,231. Since the Authority holds a 99 percent ownership interest in East Durham Properties, LLC, it appears the Authority is purchasing properties prior to receiving HUD approval. Should

properties acquired by East Durham Properties LLC not be approved for purchase with HOPE VI funds, the Authority's risk is increased because East Durham Properties might be unable to pay the associated loan funds used to purchase the properties. Also, the Authority paid $28,838 from its Conventional Public Housing General Fund for closing expenses for the purchases on behalf of East Durham Properties, LLC. The Authority did not record the $28,838 as a receivable due from the LLC.

Despite our request for the Authority to provide us with all information pertaining to any loans, loan guarantees, notes, and related entities, it did not initially disclose to us the existence of the inappropriate $350,000 loan guaranty, the $1.5 million Promissory Note, or the existence of East Durham Properties, LLC. We identified these independently of the Authority. The Authority subsequently provided information on the items when specifically requested. The Authority would not or could not assure us that it had disclosed all of its or related entitys' loans, loan guarantees or lines of credit.

Unoccupied Project

The Authority also constructed a 30-unit low-income public housing project, Laurel Oaks, which was substantially completed in 1999. The Authority was preparing to lease the units to low-income tenants. However, the project is currently unoccupied, because the Authority failed to properly record an easement for water and sewer lines. Subsequently, a neighboring property was sold and the new owner refused to grant the Authority an easement. The Authority has been in litigation with the property owner. In the interim, the substantially completed, but unoccupied project, has been vandalized. Meanwhile, as of June 20, 2003, the Authority had 1,496 applicants on the public housing program waiting list and 3,244 applicants for the Section 8 Program. Further, the Authority lost the potential rent revenue and operating subsidy that would have been generated from occupied units.

Inadequate Cost Allocation

During our survey, we determined the Authority did not have an acceptable cost allocation plan; however, we did not expand the scope of audit to include a detailed review of cost allocations. Authority staff, equipment, and office space were being used to perform non-Authority business without appropriate allocation of costs. Only salary costs were allocated, however, the Authority based the allocation on how much time supervisors thought their staff spent on various programs or working for other entities rather than on the percentage of time staff actually worked on programs or for other entities, or some other acceptable allocation method. Many of the entities the Authority is involved with did not have staff. The Authority allocated some salary costs to three projects owned by DVI: Edgemont Elms Apartments, Preiss-Steele Apartments, and Woodridge Apartments. However, no costs were allocated to DVI or the Golden Belt Center. Yet, neither DVI nor Golden Belt had staff.

On February 13, 2004, the Authority's Independent Public Accountant (IPA) issued a qualified opinion on the Authority's financial statements for the fiscal year ended December 31, 2002. The IPA's qualified opinion was based in part on the Authority's failure to properly and consistently allocate costs among proprietary funds. The IPA could not reasonably determine the effect of this departure from Generally Accepted Accounting Principles on the proprietary funds.

Conclusion

Given the Authority's record of misuse of funds, ACC violations, and the inability to efficiently administer or complete its developments, we question whether additional Federal funds should be provided to the Authority for any development activities, including HOPE VI funds.

The National Housing Act of 1937, Section 6(j)(4) establishes methods for recovering diverted funds. It provides that HUD may terminate assistance, withhold allocations, reduce future assistance payments, and take other measures. Further, Section 6 provides that upon occurrence of a substantial default, HUD may take possession of the project. Title 24 of the Code of Federal Regulations, Part 24.305, provides causes for debarment. One such cause is the commission of an offense indicating a lack of business integrity or business honesty that seriously and directly affects the present responsibility of a person. Further, a person may be debarred for violating the terms of a public agreement so serious as to affect the integrity of an agency program.

The actions by the Board, former Executive Director, and Interim Executive Director caused the Authority to violate the terms of the ACC and the Administrative Use Agreement for Proceeds of Sales of Homeownership Projects. The violations seriously affected the Authority's operations, deprived low-income tenants of needed housing, and placed Authority assets at substantial risk. Those actions warrant HUD taking steps to protect its interest and prevent further risk to Authority residents and the Federal Government.

RECOMMENDATIONS

We recommend the Director, Office of Public Housing:

1A. Require the Authority to repay $1,966,117, or current balance owed, to its Conventional Public Housing General Fund from non-Federal funds representing funds it advanced to DVI, DVI projects and other entities.

1B. Require the Authority to repay $1,022,097, or the current balance owed, to its Turnkey III program from non-Federal funds representing funds it loaned for the purchase of Woodridge Commons Apartments.

1C. Require the Authority to repay the $231,094, or current balance owed, to its Turnkey III program from non-Federal funds representing funds it loaned for the purchase of Northtowne Apartments.

1D. Require the Authority to repay $134,790 to its Turnkey III program from non-Federal funds representing funds it used to pay Fayette Place property taxes.

1E. Require the Authority to repay $71,724 to its Turnkey III program from non-Federal funds representing funds it used to pay unauthorized longevity bonuses.

1F. Require the Authority to repay $28,838, or current balance owed, to its Conventional Public Housing General Fund from non-Federal funds representing funds used to pay closing costs on properties purchased by East Durham Properties, LLC.

1G. Require the Authority to obtain release of any currently encumbered assets, including the Promissory Note for a $1.5 million line of credit with Wachovia Bank and the loan guaranty for a $350,000 loan obtained by Fayette Place, LLC.

1H. Seek legal guidance and require the Authority to terminate the $1,804,670 loan to DVI for Golden Belt, and require the funds to be returned to the Turnkey III program to be used for other housing purposes as approved by HUD.

1I. Advise the Authority not to make further advances or encumber assets without prior written approval from HUD.

1J. Require the Authority to develop and implement an acceptable cost allocation plan in compliance with the OMB's Circular A-87.

1K. Require the Board of Commissioners to establish sufficient controls to monitor the Authority's activities and ensure transactions adhere to Federal regulations.

1L. Request the Mayor of the City of Durham or the City Council, as appropriate, to replace Board members who did not fulfill their fiduciary responsibilities.

1M. In coordination the Office of Public Housing Investments, continue to perform reviews of all drawdowns of funds until HUD determines the Authority is properly administering its programs.

1N. Perform a comprehensive review of the Authority's capacity and ensure the Authority takes appropriate measures to address any capacity issues to successfully complete activities in accordance with the HOPE VI Grant Agreement and Revitalization Plan. If the review finds the Authority does not have the capacity to complete the activities, or finds the Authority in serious default of the Grant Agreement or regulations, terminate the Grant and recapture the remaining $27,590,236, or current balance, of unused funds.

1O. Issue a Notice of Substantial Default to the Authority in accordance with Section 17(C) of the ACC. Should the Authority fail to cure the default, require the Authority to convey title to the projects, or deliver possession and control of the projects to HUD.

We recommend the Director, Departmental Enforcement Center:

1P. In consultation with the Director, Office of Public Housing, Greensboro, North Carolina, take administrative actions against the former Executive Director, Interim Executive Director and Board members, including issuing Limited Denials of Participation or debarments, as appropriate.

MANAGEMENT CONTROLS

Management controls include the plan of organization, methods and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, directing and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

We determined the following management controls were relevant to our audit objectives:

- Compliance with Laws and Regulations – Policies and procedures management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

- Safeguarding Resources – Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss and misuse.

To assess the relevant controls, we:

- Interviewed Authority staff;

- Reviewed the Authority's general ledgers, bank statements, and other accounting and administrative reports;

- Reviewed the Authority's financial statements,

- Reviewed the minutes of board meetings for the Authority and DVI.

A significant weakness exists if management controls do not provide reasonable assurance that resource use is consistent with laws, regulations, and policies; and that resources are safeguarded against waste, loss, and misuse.

Based on our review, we identified the following significant weaknesses:

- Compliance with Laws and Regulations – Without HUD approval, and in violation of its ACC, Authority management inappropriately advanced at least $1,994,955 from its Conventional Public Housing General Fund. Also, in violation of its Turnkey III Use Agreement, the Authority inappropriately advanced or failed to require loan repayments totaling at least $2,803,579. Also, the Authority provided a loan guaranty for a $350,000 loan obtained by a LLC and executed a Promissory Note for a $1.5 million line of credit on behalf of another LLC. The Authority also failed to properly allocate operating costs to other entities in accordance with the OMB's Circular A-87.

- Safeguarding Resources - Authority management inappropriately guaranteed loans needed to fund development activities of affiliated non-profit entities.

FOLLOW-UP ON PRIOR AUDITS

OIG conducted an audit of the Authority's Public Housing Programs and issued Audit Report No. 97-AT-202-1005, dated September 24, 1997. The report included two findings. The first finding pointed out that improvements were needed in maintenance procedures. The OIG reported that 27 of 30 housing units inspected failed HUD's Housing Quality Standards and had a total of 165 violations. The second finding pointed out that the Authority had overstated scores for two of the 12 indicators in its Public Housing Management Assessment Program certification score. The scores were overstated because the Authority (1) did not have accurate data for maintenance work orders, and (2) did not fail some units that had Housing Quality Standard violations. The report included four recommendations. The recommendations were closed following corrective action. The findings did not affect our audit objective.

James E. Kinkead, PC, Certified Public Accountant, IPA, completed the audit of the Authority's financial statements for the 12-month period December 31, 2001. The report did not include any findings.

The IPA issued a qualified opinion on Authority's financial statements for the 12-month period ended December 31, 2002. The qualified opinion was based in part on the Authority's failure to properly and consistently allocate costs among individual proprietary funds in a manner consistent with generally accepted accounting principles. The report contains 18 findings.

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS PUT TO BETTER USE

Recommendation	Ineligible1/	Funds Put to Better Use 2/
1A	$ 1,966,117	
1B	1,022,097	
1C	231,094	
1D	134,790	
1E	71,724	
1F	28,838	
1G		$ 350,000
1G		1,500,000
1H		1,804,670
1N		27,590,236
Total	$ 3,454,660	$ 31,244,906

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/ Funds Put To Better Use are quantifiable savings that are anticipated to occur if an OIG recommendation is implemented resulting in reduced expenditures in subsequent period for the activities in question. Specifically, this includes costs not incurred, de-obligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made, and other savings.

Appendix B

AUTHORITY ACCOUNTS RECEIVABLE AS OF SEPTEMBER 30, 2003

Entity/Account	Conventional Public Housing General Fund	Turnkey III Retained Funds
Golden Belt[1]	$ 848,099	$ 1,343,874
Woodridge[1]	152,449	1,022,097
Fayette Place[1]	367,777	--
Northtowne[1]	--	231,094
Voucher Ledger	222,266	--
Edgemont Elms[1]	139,901	--
DVI	108,552	
Oxford Commons[1]	77,018	--
Not Given	29,049	--
Learning Assistance, Inc.	21,006	--
Total	$ 1,966,117	$ 2,597,065

[1] Entities related to DVI .

Appendix C

DESCRIPTION OF RELATED ENTITIES AND DEVELOPMENTS

The Authority is the parent company of two wholly owned not-for-profit subsidiaries: Learning Assistance, Inc., an educational foundation created in 1987 to increase educational, employment and economic opportunities for Authority residents; and DVI, a housing development corporation created in 1985 to develop low-income properties. Neither of the subsidiaries have employees. The Authority also holds a majority interest in East Durham Properties, LLC.

East Durham Properties, LLC was formed on March 28, 2003, for the purpose of engaging in the purchase, development, ownership and sale of real property within the state of North Carolina. The Authority created it to purchase properties to be included in the HOPE VI project. The Authority has a 99 percent interest in East Durham Properties, LLC. The remaining 1 percent interest is held by The Community Builders, Inc.

DVI is the sole owner of three properties, Northtowne Apartments, Woodridge Commons Apartments, and Golden Belt Center. The Authority's Affordable Housing Division managed Northtowne Apartments and Woodridge Commons Apartments. The Authority's Special Programs Division managed Golden Belt.

A tobacco company donated the Golden Belt Center to DVI in December 1997 in exchange for a $450,000 tax write-off. The facility, built in part in 1901, is intended for mixed use or economic development purposes, primarily as an incubator for start-up and small businesses, not for housing purposes. It is comprised of nine buildings totaling approximately 180,000 square feet. The facility is largely unoccupied and in need of substantial rehabilitation, estimated at about $12 million.

DVI also had a partial ownership interest in three privately owned low-income housing complexes: Edgemont Elms Townhomes, Preiss-Steele Place Apartments, and Fayette Place Apartments.

Edgemont Elms is a low-income housing tax credit project. DVI owns a 1 percent general partnership interest in Edgemont Elms Limited Partnership, which owns Edgemont Elms Apartments. The National Equity Fund (tax credit investor) owns the remaining 99 percent limited partner interest. The Authority's Affordable Housing Division managed Edgemont Elms.

Preiss-Steele is a low-income tax credit elderly facility. DVI owns a 1 percent general partnership interest in Oxford Commons Limited Partnership, which owns Preiss-Steele Place Apartments. The National Equity Fund owns the remaining 99 percent limited partner interest. The Authority's Affordable Housing Division managed Preiss-Steele.

Fayette Place Apartments is a planned rehabilitation low-income tax credit and tax-exempt bond project. Currently, DVI owns a 99 percent managing membership interest in Fayette Place, LLC, which owns Fayette Place Apartments. Creative Housing Development Strategies, Inc., (CHDS) has the remaining 1 percent interest. The ownership structure is temporary. Once final closing occurs, CHDS will transfer its 1 percent to DVI, and DVI will transfer its 99 percent to National Equity Fund. Final closing was anticipated in October or November 2003; however, as discussed in the Finding this did not occur.

DVI also is the parent company of two wholly owned for-profit subsidiaries: CHDS and New Millennium Initiative, LLC. CHDS is a housing development corporation created in 1992 to be the general partner in the Oxford Commons Limited Partnership and other lawful purposes as directed by DVI. New Millennium was created in 1999 for the purpose of acquiring, renovating and operating the Golden Belt Center. DVI currently owns a 99 percent managing membership interest and CHDS owns the remaining 1 percent membership interest.

Appendix D

AUDITEE COMMENTS

A Commitment to Quality Living

June 29, 2004

Mr. James D. McKay
Regional Inspector General for Audit
U.S. Department of Housing and Urban Development
Office of the Inspector General for Audit, Region 4
Richard B. Russell Federal Building
75 Spring Street, SW, Room 330
Atlanta, GA 30303-3388

Dear Mr. McKay:

The Housing Authority of the City of Durham has completed its review of the draft audit report, as stated in your letter of June 10, 2004. We would like to thank the OIG and HUD staff for their openness during the exit interview on June 17.

Pursuant to your request, we are providing written comments for inclusion in the final written report.

If you need additional information, please contact me.

Sincerely,

Frank Meachem
Interim Executive Director

FM/bbe

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(919) 683-1551 • FAX (919) 683-1237

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Summary

The Housing Authority of the City of Durham (DHA) does not believe that it violated its ACC contract with HUD by inappropriately advancing funds and guaranteeing loans for non-Federal developments and other activities that were not approved by HUD as set forth in the draft audit report of June 10, 2004.

In the draft report, it was alleged that as of September 30, 2003, DHA had advanced at least $1,966,118 from its Conventional Public Housing General Fund to "DVI, DVI projects and other entities" and at least $2,598,065 of Turnkey III Retained Funds to "DVI and DVI projects." Reviews of our records reflect that unfortunately the information provided was not accurate. Updated and corrected information, as of May 31, 2004, identify $704,990 owed to the Conventional Public Housing General Fund by "DVI, DVI projects and other entities." Also, the payments identified in the audit that were paid from the Turnkey III Retained Funds were approved by HUD.

DHA did not violate the ACC when it provided a guaranty of a $350,000 loan obtained by Fayette Place, LLC and executed a Promissory Note for a $1.5 million loan on behalf of East Durham Properties, LLC. For Fayette Place, LLC the issue is whether we violated Part Two, Section 313 of the ACC, when we provided a guaranty of the loan from Mutual Community Savings Bank. The unsecured guaranty does not infringe on any of the items identified in Section 313. The line of credit, through the LLC, was structured in order to ensure that there would be no risk to DHA's assets. Under North Carolina law, the Managing Member of an LLC is not liable for the debts of the LLC; and, DHA, therefore, is not liable for the debts of East Durham Properties LLC.

An allocation plan for operating costs for our other entities was in place at the time of the audit and has been refined to better account for the activities of all the funds. The only funded development effort that has not been completed is Laurel Oaks, which has had an unusual amount of legal obstacles that are not the fault of the Authority. Our HOPE VI Revitalization Plan is moving forward based on the schedule approved by HUD. We have a developer partner, The Community Builders, who has vast experience in HOPE VI programs to assist us in this venture.

Background

The Authority was created in 1949 under North Carolina law to provide safe and sanitary housing for persons of low and moderate income. A seven-member Board of Commissioners governs the Authority. Frank Meachem currently serves as the Authority's Interim Executive Director.

The Authority is required to develop and operate public housing complexes in compliance with its ACC with HUD. It currently administers 13 Conventional Public Housing communities consisting of 1676 dwelling units. It also managers a Section 8 Program consisting of 2684 housing choice vouchers. As of May 31, 2004, the Authority had 787 applicants on the public housing program waiting list and 3320 applicants for the Section 8 Program.

The Authority is the parent company of two wholly owned not-for-profit subsidiaries: Learning Assistance, Inc., an educational foundation created in 1987 to increase educational, employment, and economic opportunities for Authority residents; and DVI, a housing development corporation created in 1985 to develop low-income properties. Neither of the subsidiaries have employees. The Authority's Board of Commissioners serves concurrently as the Board of Directors of both subsidiaries. The Authority's Executive Director serves as the Secretary/Treasurer for DVI. Currently, the Interim Executive Director is serving as the Secretary/Treasurer. The Authority also holds a majority interest in East Durham Properties, LLC.

DVI also owns or has an ownership interest in at least five apartment complexes and an industrial center, the Golden Belt. The apartment complexes are: Northtowne Apartments, Woodridge Commons Apartments, Edgemont Elms Townhomes, Fayette Place Apartments, and Preiss-Steele Place. The Golden Belt Center is comprised of nine buildings totaling about 180,000 square feet, and is located in the center of the Housing Authority's service area.

The Executive Director relies heavily on the Director of Finance and Administrative Services, Comptroller, and Independent Public Accountant for financial information and guidance, and the legal counsel for review of contracts and procedures.

The Durham Housing Authority has a long-standing positive relationship with the HUD Greensboro office.

RESPONSE TO FINDINGS

Inappropriate Advances of Conventional Public Housing Funds

The Authority uses the Low-Rent Public Housing Program as a General Fund for the paying of most costs and the receipt of income. This practice results in amounts being due to various other funds. Traditionally, these amounts, to and from, were settled on a monthly basis. While the developments owned by the non-profit corporations were healthy, they were generating positive rental incomes and paying market rate interest on the loans from Turnkey III to the non-profits. The audit report for 2000 and 2001, made no findings of any deficiencies in the administration's management of the General Fund.

As stated in the January 13, 2004 OIG Audit, it is permissible for the Authority to use the General Fund as long as the accounts are cleared periodically. The 2001 IPA Audit reported that the Authority generally settled its due to/ from accounts on a monthly basis that would qualify as "periodically." Unfortunately, because of the OIG Audit, beginning in early 2003, the 2002 Audit was not completed until February 2004.

Comment 1

Beginning in 2002, the accounts were not being cleared periodically. Also, at this time, the non-profit developments began to experience increasing vacancies and decreasing collections. Also, as interest rates declined there was no effort to refinance the existing loans to the private lenders and the Turnkey III revolving loan fund. Also, as the Authority subsidy declined, the administration allocated costs more vigorously to the non-profits. These events resulted in the large balances that are owed from the non-profits to the Authority.

The draft audit report refers to the authority using $1,966,118 from its conventional Public Housing General Fund to DVI, DVI projects, and other entities. Attached, please find documentation that will reduce this amount to $704,990.15 as of 5/31/04.

Comment 2

Inappropriate Advances of Turnkey III Retained Funds

The Authority finds the statement: "Authority management violated its ACC when it inappropriately advanced $2,598,065 Turnkey III funds to DVI and its projects" to be inaccurate. The funds for Woodridge and Northtown were advanced appropriately pursuant to the Turnkey III revolving loan fund. Apparently the $1,300,000 advanced for Golden Belt was originally inappropriately advanced, but this advance was later formally approved by HUD in 2001. Any subsequent advances of Turnkey III funds, up to the allotted $1,800,000, were appropriate.

In April 1993, the Authority and HUD entered into an Administrative Use Agreement where HUD waived the requirement for the Authority to return funds received from the sale of homeownership units through the Turnkey III program. Among the proposed uses for the funds received by the Authority through the sale of these units was the creation of a revolving permanent mortgage loan fund to aid the permanent financing of and construction of rental and for-sale units.

In April 1997, the Authority made a loan to Development Ventures Incorporated ("DVI") to assist in the financing of the purchase of the Woodridge Commons Apartments ("Woodridge") to be utilized as affordable rental housing. The loan was secured by a first-lien Deed of Trust on the Woodridge property listing the Authority as beneficiary.

In October 2000, the Authority agreed to subordinate its first-lien position on its Deed of Trust securing the loan to DVI. The Authority executed a Subordination Agreement on October 30, 2000, that subordinates the Authority's Deed of Trust to the Deed of Trust of a private bank providing financing to DVI secured by Woodridge.

The draft OIG audits states: "Because the Authority did not require the funds to be repaid, it is in violation of its Turnkey III Administrative Use Agreement. As such, the Authority should repay the $231,094 [from a separate project] and $1,022,097 [from Woodridge] to its Turnkey III program from non-Federal funds."

The OIG infers that the Authority's execution of the October 30, 2000, Subordination Agreement with respect to the Woodridge loan is tantamount to relieving DVI of the obligation to repay the loan.

The Woodridge loan from the Authority to DVI is secured by a Deed of Trust on Woodridge granted in favor of the Authority by DVI and recorded with the Register of Deeds of Durham County on April 4, 1997. The Deed of Trust grants the Trustee, representing the Authority as beneficiary, the power to sell any or all of the Woodridge property in the event of any uncured default in order to satisfy any remaining obligation of the Woodridge loan owed to the Authority. This Deed of Trust grants the Authority a

representing the Authority as beneficiary, the power to sell any or all of the Woodridge property in the event of any uncured default in order to satisfy any remaining obligation of the Woodridge loan owed to the Authority. This Deed of Trust grants the Authority a secured interest in Woodridge pursuant to the procedures of Chapter 45 of the North Carolina General Statutes.

On October 30, 2000, the Authority executed a Subordination Agreement that allowed the Deed of Trust in favor of the private bank to take a priority interest in the Woodridge property over the Authority loan. The Subordination Agreement was recorded with the Register of Deeds for Durham County on October 30, 2000. The Subordination Agreement subordinates the April 4, 1997, Deed of Trust in favor of the Authority to a Deed of Trust executed by DVI in favor of the private bank. The Subordination Agreement explicitly preserves all other rights of the Authority in the April 4, 1997, Deed of Trust.

The Subordination Agreement provides Woodridge no relief from the repayment requirements of the Authority loan. If DVI defaults on its Woodridge loan repayment obligations to the Authority, DVI is still liable to the Authority for repayment of the outstanding balance of the loan. The Subordination Agreement explicitly states:

> Except for the terms of this Subordination Agreement [indicating that a first-lien priority position is granted to the Deed of Trust in favor of the private bank], the rights of the parties of the first part and to the aforesaid recorded Deed of Trust in Book 2298, Page 693 [the Deed of Trust for the Authority loan to DVI] of the Durham County Public Registry and the Promissory Note evidenced thereby are and *shall be in full force and effect*. [Emphasis added.]

The execution of the Subordination Agreement does not relieve DVI of its obligations to repay the Authority the funds loaned from the revolving loan pool created from the proceeds of Turnkey III home sales in accordance with the Administrative Use Agreement. In addition to the continued obligation of DVI to make payments to the Authority to reimburse the Woodridge loan, all remedies that were available under North Carolina law to the Authority to secure repayment prior to the execution of the Subordination Agreement remain intact and in force.

The Authority is moving to cross collateralize all the DVI loans so that upon the sale of any DVI assets the loans from other developments will be satisfied. The loan has not been canceled, it is continuing to earn interest and will be paid or reduced with the sale of the first DVI asset.

Comment 3

The loan to acquire Northtowne was the second loan from the revolving loan fund. This loan was for $231,094. Northtowne was sold and the proceeds were returned to the Authority. Our Interim Executive Director obtained permission, from the field office, to use a portion of the proceeds for general operating expenses of the Authority and $71,724 was spent in longevity salary payments for 2003. An additional $134,790 was loaned to

Fayette Place, LLC to pay property taxes that were owed and past due. The remaining funds from the sale remain in the Turnkey III fund. The Administrative Use Agreement provides for annual reporting. The 2003 sale of Northtowne will be reported in the 2003 audit.

The Golden Belt advance of $1,300,000 of Turnkey III funds was not in compliance with the revolving loan agreement because the funds were not being used for low-income housing. When this was recognized, the Authority obtained permission from HUD to use the funds already advanced and approximately $500,000 in additional Turnkey III funds for Golden Belt. Pursuant to that agreement, after a five-year moratorium, the funds will be paid back over 30 years with interest.

The funds advanced were used to preserve Golden Belt pending completion of a development plan. Dollars were spent for weatherization, required environmental cleanup and general maintenance. When a tenant requested space, renovations would be performed to make the space rentable. Subsequently, the Board determined that the market in Durham would not support another large-scale development such as Golden Belt in light of the present economy. Rather than move forward, the Board instructed the administration to operate the facility at minimal cost pending a rebound in the economy or sale of the property. Rather than sell the property into a market that would not generate adequate funds to pay all the indebtedness against the property, the Administration has managed the property at minimal expense, while preserving the property from damage, weather and fire.

Inappropriate Loan Guarantee

The OIG audit states DHA violated Part Two, Section 313 of the ACC when it provided a guaranty of the $350,000.00 loan from Mutual Community Savings Bank ("MCSB") to Fayette Place, LLC without prior HUD approval. Section 313 provides, in pertinent part, that:

> "the Local Authority shall not *transfer, convey, assign, lease, mortgage, pledge, or otherwise encumber,* or permit or suffer any transfer, conveyance, assignment, leasing, mortgage, pledge, or other encumbrance of such *Project, any* appurtenances *thereto, any rent, revenues, income, or receipts there from or in* connection *therewith,* or any of the benefits or contributions granted to it by or pursuant to this Contract, or any interest in any of the same"

The issue is whether DHA *transferred, conveyed, assigned, leased, mortgaged, pledged or otherwise encumbered a "Project"* by the execution of the Guaranty. Part One, Section 2 of the ACC specifically identifies each Project to include, NC013001 containing 240 units (Few Gardens), N0013002 containing 247 units (McDougald Terraces), NC013003 containing 113 units (McDougald Terrace), NC013004 containing 50 units (Scattered Sites), C013005 containing 200 units (Fayetteville Street), NC013006 containing 106 units (Oldham Tower), NC013007 containing 200 units (Cornwallis Road), NC013008 containing 108 units (Liberty Street), NC013009 containing 77 units (Club Boulevard). NC013010 containing 47 units (Hoover Road), NC013011 containing 178 units (JJ Henderson Tower), NC013012 containing 224 units (Morreene Road), NC013013 containing 102 units (Damar Court), NC013015 containing 152 units (Oxford Manor), N00130016 containing 150 units (Kerrwood Estates), NC013018 containing 200 units (Birchwood Heights), and NC013020 containing 55 units (Forrest Hill Heights).

The *transfer and conveyance of* Fayette Place were done pursuant to a HUD approved disposition plan dated October 23, 2002.

Comment 4

DHA strongly denies that it *assigned, leased, mortgaged, pledged or encumbered* any of its Projects in connection with the execution of the unsecured guaranty to MCSB. Fayette Place, LLC executed the promissory note, not DHA. The promissory note is secured by a deed of trust on the property owned by Fayette Place LLC, but it is not secured by one of DHA's "Projects." DHA executed a guaranty that specifically says that *the Guaranty is unsecured."*

There is no *assignment* of rents, security deposits or leases from the "Projects."
No "Project" or portion thereof has been *leased* in connection with the unsecured guaranty.

DHA has not *pledged* an asset like a certificate of deposit, accounts receivable from Project rents, a security deposit from tenants, or any other asset in executing the unsecured guaranty as we have seen in other OIG audit reports. A pledge requires delivery of a tangible or intangible thing to a creditor as security for a debt. The North

Carolina Supreme Court has stated long ago "certain well-defined tests of a pledge have been established by various decisions of this court. They may be classified broadly as follows: (1) the pledged property must be actually delivered to the pledge; (2) if the pledged property is returned to the pledger, it must not be commingled or mixed with other property of the pledger, but it must be understood that the pledger holds it as agent of the pledge; (3) if the pledged property consists of notes, accounts, or other evidences of indebtedness, and the pledge places such accounts or notes in the hands of the pledger for collection, the funds arising from the collection of the pledged property must be kept separate, distinct, and intact. Buddy vs. Commepraal Credit Co. 202 N.C. 604, 163 S.E. 676,678 (1932). The Authority has delivered nothing to MCSB in connection with the unsecured guaranty.

Blacks Law Dictionary defines pledge as "1. a bailment or other deposit of personal property to a creditor as security for a debt or obligation; 2. the item of personal property so deposited; 3. Broadly, the act of providing something as security for a debt or obligation; 4. The thing so provided." A pledge is something *more than a mere lien* and something less than a mortgage. See Black's Law Dictionary quoting Leonard A. Jones, A Treatise on the Law of Collateral Securities and Pledges. Section 2, at 4 (Edward M. White rev., 3d ed. 1912). Clearly, the Authority has not pledged a thing of value by the execution of the unsecured guaranty to MCSB.

The unsecured loan guaranty does not constitute an *encumbrance* of any one of DHA's "Projects." "An encumbrance is any burden or charge on the land and includes any right existing in another whereby the use of the land by the owner is restricted." Gerdes v. Shew. 4 N.C. App. 144,148,166 S.E.2d 519, 522 (1969). There is no charge or burden upon the Projects as a result of the unsecured guaranty. Black's Law Dictionary defines an encumbrance as "a claim or liability that is attached to property or some other right and that may lessen its value, such as a lien or mortgage...."

The draft audit report concedes that the "guaranty is unsecured and does not identity specific DHA's assets as collateral....", it must be conceded also that no encumbrance currently exists with respect to a Project of DHA.

The draft audit report goes on to say, "however, the Authority is responsible for the balance of the loan should Fayette Place LLC default on the loan payments." This misses the point. The prohibition in the ACC is against encumbering assets; there is no ACC violation just because DHA may possibly be sued for a debt, however remote a possibility that might be.

Apparently, the theory is that DHA has already encumbered its "Projects" because: (i) it is possible that Fayette Place LLC could default on its loan to MCSB; (ii) DHA may not have sufficient non-Project assets to make payments on the loan; (iii) MCSB might bring suit against Fayette Place, LLC on the promissory note and against DHA on the unsecured guaranty; (iv) Fayette Place LLC might not have sufficient income or assets to satisfy MCSB's claim; and therefore (v) MCSB could obtain a judgment lien against DHA for $350,000.00. This is a highly unlikely scenario for the reasons stated below.

Moreover, even if all of these unlikely events were to happen and MCSB were to obtain a judgment against DHA as a result of the unsecured loan guaranty, MCSB would still not have a charge or lien against the DHA's "Projects" under North Carolina law.

North Carolina General Statute Section 157-21 provides that "all property of the authority shall be exempt from levy and sale by virtue of an execution, and no execution shall issue against the same. *No judgment against the authority shall be a charge or lien against its property, real or personal"* MCSB has a full range of legal remedies available to it as against Fayette Place LLC and its property; however, MCSB's remedies are limited by statute as against the "Projects" of DHA. North Carolina General Statute Section 157-18 makes it clear that MCSB's remedies would be (i) an action to compel DHA to pay the loan and (ii) an action to enjoin the Authority from violating any rights of MCSB. MCSB's remedies would be more expansive, however, if DHA had actually mortgaged property to MCSB, which of course, DHA has not by merely executing the unsecured guaranty.

The Fayette Place transaction is being unwound at this time. The $7.8 million in bond proceeds has been held in escrow accounts, and there have always been sufficient funds available to pay off the bondholders. Once the bondholders are paid, this will leave the $350,000 loan held by MCSB as a lien against the property owned by Fayette Place LLC, which property has been appraised at $3,315,000.00. Even if MCSB were to foreclose against Fayette Place, there is far more value in the property than MCSB is owed on its loan to Fayette Place LLC for there to be a deficiency judgment against either Fayette Place LLC on the note or against DHA on the unsecured guaranty. It is therefore unreasonable to conclude that the DHA's "Project" assets were ever put at risk by executing the unsecured guaranty.

Comment 5

Inappropriate Promissory Note

The OIG audit has taken the position that the execution of the line of credit with Wachovia Bank in the amount of $1.5 million by DHA as Managing Member of East Durham Properties LLC is a violation of Part Two, Section 313 of the ACC.

Part of the OIG's concern seems to be that the line of credit is an effort to circumvent the HUD approval process. For example, the draft report states: "Since the Authority holds a 99 percent ownership interest in East Durham Properties, LLC, it appears the Authority is purchasing properties prior to receiving HUD approval." In addition, the OIG's draft report expresses concern that the line of credit places the Authority's public housing assets at risk. Specifically, the draft report states that "the Authority ... executed a Promissory Note ... on behalf of [the] LLC" and that "should properties acquired by East Durham Properties LLC not be approved for purchase with HOPE VI funds, the Authority's risk is increased because East Durham Properties LLC might be unable to pay the associated loan funds used to purchase the properties." The OIG perceives the line of credit to be a direct encumbrance on DHA, as evidenced by the recommendation to "release ... any currently encumbered assets, including the Promissory Note for a $1.5 million line of credit with Wachovia Bank" by the inclusion of this line of credit in discussions of loan guaranties and similar relationships and by the conclusion that this line of credit "placed Authority assets at substantial risk."

As will be discussed below, both of these concerns are misplaced. The line of credit was not designed to circumvent the HUD approval process and, in fact, was designed to facilitate the HUD approval process in the context of an acquisition-intense revitalization initiative. Second, the line of credit was specifically structured in order to ensure that there would be no risk to DHA's assets. The limited liability company structure was selected in order to ensure that DHA would have no obligation for East Durham Properties LLC's debt. Under North Carolina law, the Managing Member of an LLC is not liable for the debts of the LLC and the Authority is, therefore, not personally liable for the debts of East Durham Properties LLC.

Acquisition Approval

The East Durham Properties structure, with the use of the line of credit, permitted the purchase of properties without public funds as an intermediate step towards purchase by DHA. The purchase *of* the property by the LLC is conducted under normal commercial standards before DHA, as an entity, enters into the transaction. The purchase by ***DHA*** is conducted strictly in accordance with the HUD regulatory approval process. The structure does not have the intent or the fact of circumventing the HUD approval process.

DHA can only use public funds to purchase properties which meet certain eligibility criteria related to items such as title, etc. In this neighborhood, however, little attention has been given to matters of title over time, as the assets have had limited value. In addition, many of the more deteriorated or blighted properties are ones which have been, for all intents and purposes, abandoned. For example, a property might have been the

home of a parent and is now owned by all of the children jointly, with no one taking responsibility for its maintenance. A typical buyer is not likely to try to track down each of the siblings in order to purchase the property. However, it is in the interests of the revitalization effort to build on or renovate the property to provide quality housing for the area's low income residents and remove blighted property from the area. The mechanism of purchasing the parcels with segregated private funds into East Durham Properties allows these issues to be resolved without risk to public funds and makes the public acquisition feasible.

Once the property is owned by East Durham Properties, LLC, it is bundled with related properties and submitted to HUD for acquisition approval. At this point, HUD approval is not assumed, although given the conceptual approval through the acquisition plan review, DHA believes HUD approval is likely. The proposed transfer between East Durham Properties LLC and DHA complies with all of the components of the HUD approval process under the regulations and the HOPE VI grant agreement. By resolving issues in advance, DHA also avoids the need for regulatory waivers with respect to these issues. In the event HUD disapproves the purchase, the property can be sold by East Durham Properties LLC to third parties without negative consequences, in fact, due to the value added by site assembly. East Durham Properties LLC may well be able to sell the parcels for more than the original acquisition price if the need were to arise. However, in the transaction between East Durham Properties LLC and DHA, the sale is at cost.

Comment 6

The East Durham Properties structure was designed to ensure compliance with HUD acquisition regulations in both the letter and the spirit of the regulations. East Durham Properties LLC complied with the procedures for appraisals, fair purchase price, and relocation procedures even though no public funds were involved in its acquisition of the property. This was done to ensure that the intent of the regulations was followed. East Durham Properties LLC then resolved the title issues and bundled the properties for submission to HUD for HUD's review. This bundling was intended to facilitate HUD's review process. In addition, all approval processes were incorporated into the review of the proposed acquisition by DHA of the land at the point where DHA as an entity enters into the transaction. While the conceptual acquisition plan increased the probability of HUD approval, it was always understood that HUD could disapprove the purchase and East Durham Properties LLC bore any risk involved in the sale of the parcels. As will be described below, this risk was entirely on East Durham Properties LLC and the private financing, and most importantly none of DHA's "Project" assets are at risk.

Exposure of the Authority's Project Assets

The "Borrower" under the line of credit is East Durham Properties LLC, not DHA. While the draft OIG report implies at the top of page 11 that there is a guaranty obligation in connection with this line of credit, and while the recommendation on page 3 to "release ... encumbered assets" implies that DHA's assets have been offered as collateral for the loan, this is not, in fact, the case. DHA has not executed any guaranty or other document placing public housing assets at risk in connection with the line of credit. Neither the promissory note, nor the deed of trust, contain any obligation of DHA

to repay the debt and the line of credit as a whole was specifically negotiated to avoid any form of guaranty structure in order to ensure that no public housing funds would be at risk in the transaction.

The draft report correctly notes that DHA and certain staff physically executed the promissory note. However, the documents are also clear that DHA was executing the note as managing member of East Durham Properties LLC, consistent with standard procedures for a limited liability company, in the same way that an employee of DHA does not become personally liable for DHA's obligation when signing a contract on behalf of DHA, DHA did not assume any personal liability or obligation with respect to the debt by executing the note in its role as managing member of East Durham Properties LLC. North Carolina law is clear that "a person who is a member, manager, director, executive, or any combination thereof of a limited liability company is not liable for the obligations of a limited liability company solely by reason of being a member, manager, director, or executive *and does not become so by participating, in whatever capacity, in the management or control of the business." G.S.* Section 57C-3-30(a).

Significantly for the analysis of the risk to DHA is also the collateral that *was* offered for the line of credit The debt is secured by the real property purchased by East Durham Properties LLC. In the event of any non-payment under the line of credit, the lender's rights are to seek a foreclosure on the land acquired. The only assets at risk are the properties which were acquired with the private-funds proceeds of the line of credit. Under the line of credit, the loan to value ratio is 90%. In other words, the amount of funds advanced under the line of credit can never exceed 90% of the appraised value of the land. This ensures that the value of the land is more than sufficient to fully secure the debt. In a worst-case scenario, the land could be sold to third parties and the proceeds of the sale would yield sufficient funds to repay the line of credit debt. This 90% loan to value ratio also ensures a 10% cushion, in case land values decline or some other factor depresses the sale proceeds. However, due to the short, 18-month, term of the debt, real estate values are unlikely to swing dramatically. Further, as East Durham Properties acquires real estate, it assembles larger sites which are generally valued for more than the value of the component lots. In total, the lender is likely to be able to recover in excess of the outstanding loan amount from a sale of the land.

The draft report expressed concern that, "should properties acquired by East Durham Properties LLC not be approved for purchase with HOPE VI funds, DHA's risk is increased because East Durham Properties might be unable to pay the associated loan funds used to purchase the properties." As described above, this concern inaccurately describes the worst case scenario. DHA has no liability for the loan and therefore no obligation to repay the loan in the event the acquisition is not approved for purchase. The worst-case scenario is that East Durham Properties LLC would offer the properties for sale to third parties. Since the appraised value is in excess of the amount of the loan obligation and since the appraised value does not reflect the added value due to site assembly, the sale of the real property collateral is more than adequate to ensure repayment of the debt.

Comment 7

Unoccupied Project

The OIG draft report briefly discusses the status of Laurel Oaks without making a finding of an ACC violation or other HUD program requirement. Our response to the draft report is therefore to more fully document the record and history of Laurel Oaks for the benefit of HUD and other stakeholders.

The most common misconception is that Laurel Oaks has failed to open on time for the sole reason that DHA failed to record a sanitary sewer easement prior to construction completion. As the record will show, this development required not one, but three easements prior to occupancy. The necessity for the first easement was discovered in 1998, but the necessity for the second and third easements was not discovered until 2001. The easement *issues* are often referred to as the easement *issue* because the significance of all three easements has been lost.

There have been several additional factors to contribute to the delay such as (i) the site selection process, (ii) NIMBY litigation, (iii) breach of the real estate contract by the land seller, (iv) bankruptcy of the original general contractor, and (v) eminent domain litigation. Although DHA's application for forty units of additional public housing in Durham was approved by HUD on April 5, 1991, the site selection process was so intense that it was not until January 10, 1995 when the Authority received approval for the construction of Laurel Oaks on the subject site. DHA lost the entire year of 1995 to a NIMBY lawsuit which we eventually won in federal court. As DHA was prepared to move forward in January 1996, the seller of the subject site, Fair City-Pines Corporation ("Fair City-Pines"), reneged on the real estate contract and the Authority lost months while suing Fair City-Pines to enforce the real estate contract. Construction commenced in August 1998; however the general contractor went into bankruptcy in May 2000 resulting in several additional months of delay. Finally, because the three easements were not obtained for the development prior to construction start, the Authority has spent more than a year obtaining these property interests by condemnation.

Current Status

Laurel Oaks is currently under construction, and when completed, it will consist of thirty 3-bedroom townhouse units located near the intersection of Cornwallis Road and NC Highway 55 in southwest Durham, NC. Laurel Oaks will be the first public housing community built in Durham since 1981. Bid proposals were submitted to the Authority on March 5, 2004, for a completion contractor, and on March 17, 2004, the Authority executed a contract to complete the construction of Laurel Oaks. The Authority issued its Notice to Proceed with construction on April 14, 2004, and construction completion is expected on October 15, 2004.

The Development Process

On July 13, 1990, DHA submitted an application for the development of 40 units of public housing to HUD, and on April 5, 1991, HUD approved the application. On July

22, 1991, DHA executed an agreement for architectural/engineering services with Clinton E. Gravely, Architect and Associates (the "Architect/Engineer") to begin preparation of preliminary drawings to determine the number of units, size of units, site plan, and other information needed to submit a development proposal to HUD.

An extensive search was conducted for sites suitable for the 40 public housing units for approximately two years, considering approximately twenty-seven possible sites. During this time period, DHA submitted development proposals to HUD for at least two sites, but both sites were rejected as unsuitable. On September 9, 1993, the Laurel Oaks site was made available and offered for sale by Fair City-Pines through its representative, John Edmonds.

On April 8, 1994, Fair City-Pines executed a real estate contract giving DHA the right to purchase the Laurel Oaks site for $210,000, and a development proposal for the Laurel Oaks site was submitted to HUD on April 8, 1994. On January 10, 1995, HUD approved the Laurel Oaks site for development of the forty units.

On February 24, 1995, area neighborhood groups mobilized in opposition to the Laurel Oaks project and filed a NIMBY lawsuit against DHA seeking to prevent the development of the 40 public housing units. Five months later, on July 21, 1995, the federal court dismissed the lawsuit, and the plaintiffs appealed the decision to the Fourth Circuit Court of Appeals. The Fourth Circuit upheld the decision of the lower court and dismissed the lawsuit.

Just when DHA thought the battles were over, Fair City-Pines breached its real estate contract with the Authority and refused to sell the Laurel Oaks site to the Authority. Consequently, on January 18, 1996, DHA filed suit against Fair City-Pines seeking to compel its performance of the real estate contract. In settlement of the lawsuit, Fair City-Pines executed the deed and conveyed the Laurel Oaks site to the Authority on April 12, 1996.

During the years 1996 and 1997, the Architect/Engineer was busy preparing plans and specifications for the development, and submitting plans and specifications to various departments of the City of Durham (the "City), the North Carolina Department of Transportation ("NCDOT"), and HUD for the necessary development approvals, including site plans for the buildings, easements, roads, etc. These plans, specifications and approvals were also necessary for DHA to prepare bid documents for the construction of the development.

On December 17, 1997, an invitation for bids was published for the construction of the development to include forty 3-bedroom units, a property management/community building, and related site improvements. The first bid opening, on January 27, 1998, resulted in less than the required three bids. The second bid opening on February 3, 1998, resulted in four bids and a successful bidder was determined.

As a result of the planning process, on March 3,1998, DHA (Mr. Tabron) sent a letter to Fair City-Pines (Mr. Edmonds), indicating the need for a sanitary sewer easement to

connect the sewer line at Laurel Oaks to a City sewer line located on the property of Fair City-Pines. The easement location is in a designated stream buffer area unsuitable for any above ground permanent construction. On March 25, 1998, Fair City-Pines sent a letter to DHA expressing concerns about the easement request and asked DHA to address these concerns.

On April 1, 1998, DHA executed a construction contract with Centech Building Corporation ("Centech"), and on April 7, 1998, DHA executed an amendment to its ACC for Laurel Oaks reducing the number of units from forty to thirty.

On April 14, 1998, DHA sent a letter to Fair City-Pines addressing their concerns regarding the easement expressed in their March 25, 1998 letter. On April 27, 1998, Fair City-Pines sent a letter stating that it was prepared to grant the request for an easement for the sewer connection and instructed DHA to contact Fair City-Pines' local counsel to formalize the sewer easement.

On August 10, 1998, construction on the Laurel Oaks development commenced pursuant to the Authority's issuance of a Notice to Proceed to Centech. DHA did not have an easement for the sewer line at the time when construction commenced.

In January 1999, DHA, acting in reliance upon the representations made by Fair City-Pines in its April 27, 1998 letter, but without an executed or recorded easement, constructed the sewer line. Fair City-Pines did not object to the construction, however. DHA phoned The Banks Law Firm, P.A. ("Legal Counsel") regarding the need for an easement for the sewer line on January 5, 1999. On January 7, 1999, Legal Counsel prepared a first draft of the sewer easement. Legal Counsel determined that the easement could not be completed without a survey to provide the metes and bounds legal description of the easement location. This description would need to match the description for the plat of easement to be approved by the City for purposes of the sewer line being dedicated to the City for maintenance. On January 8, 1999, DHA also made Legal Counsel aware of the prior negotiations with Fair City-Pines by faxing copies of the letters between the Authority and Fair City-Pines concerning the sewer easement.
In February 1999, Legal Counsel discussed the proposed plat of easement with DHA's surveyor, McCarthy-Love (the "Surveyor").

On March 22, 1999, the Surveyor completed the metes and bounds legal description for the sewer easement and plat of easement for the City, and on March 25, 1999, the Architect/Engineer sent the Surveyor's final plat of easement to DHA with instructions to obtain the execution of the plat of easement by Fair City-Pines. However, construction of the sewer line was completed in February 1999.

DHA met with Legal Counsel, on April 8, 1999, to discuss the final plat of sewer easement for dedication to the City. Thereafter, on April 14, 1999, Legal Counsel completed the sewer easement and delivered the sewer easement and plat of easement to local legal counsel for Fair City-Pines for review and execution by Fair City-Pines. Fair City-Pines refused to execute it.

The construction contract completion date was to be November 13, 1999, with liquidated damages to commence the very next day in the amount of $200 per day for each day of delay. When construction was not completed on time, DHA issued a notice of default to Centech on May 12, 2000. On May 31, 2000, Centech filed a petition in bankruptcy under Chapter 11.

DHA filed a motion in bankruptcy court on June 20, 2000, requesting permission from the bankruptcy court to terminate the construction contract with Centech; however, the bankruptcy court denied the motion on July 19, 2000, and set a new completion date for the construction contract. When Centech failed to complete the project on time pursuant to the new completion date set by the bankruptcy court, DHA filed another motion on October 25, 2000, seeking permission to terminate the construction contract with Centech. On November 17, 2000, the bankruptcy court denied the second motion to terminate the contract. Soon thereafter, Centech's proceeding in bankruptcy court for reorganization under Chapter 11 was converted to a proceeding for liquidation under Chapter 7, and Centech was ordered to dissolve on December 28, 2000.

The bankruptcy court lifted the automatic stay on January 16, 2001, and this action allowed DHA to terminate the construction contract. The Authority terminated the contract on January 19, 2001.

On February 21, 2001, DHA formally requested Travelers Casualty and Surety Company of America (the "Surety") to take over and complete the project. Negotiations began between DHA and the Surety regarding the terms of the Takeover Agreement.

On March 26, 2001, Fair City-Pines conveyed its property surrounding Laurel Oaks to T-WOL Acquisition Inc. ("TWOL") for $10. It is important to note that Fair City-Pines and TWOL have a special relationship. For example, John Edmonds is a judgment creditor of Fair City-Pines, but he also represented Fair City-Pines in negotiations with DHA over the real estate contract, sewer easement, and a possible joint venture mixed-finance transaction commonly referred to as Creekside. Mr. Edmonds is also an owner and president of TWOL. It is also important to note that the sewer line was constructed two years earlier on the property of Fair City-Pines with the knowledge of John Edmonds.

On June 11, 2001, DHA the Surety executed the Takeover Agreement pursuant to which Blair Construction Company was named as the Replacement Contractor. DHA granted the Surety a time extension from June 11, 2001, to December 31, 2001, during which no liquidated damages would be assessed against the Surety. After December 31, 2001, liquidated damages would be assessed in the amount of $200 per day if the project were not completed. The mobilization date for Blair Construction Company was to be July 2, 2001.

Pursuant to the North Carolina Department of Transportation ("NCDOT") review of the plans and specifications for the development, it was determined that two additional easements would be necessary for the completion of the development, a road widening

easement and a drainage easement, both of which would be needed from the adjacent property owner, TWOL. On September 25, 2001, the Architect/Engineer contacted TWOL concerning the road widening easement and drainage easement, but described the discussions as "fruitless." TWOL reminded DHA on October 19, 2001, that the sewer easement was never executed by Fair City-Pines, and DHA commenced negotiations with TWOL for the purchase of all three easements.

In November 2001, DHA and the Architect/Engineer contacted NCDOT and requested the elimination of the requirement for a road widening easement and drainage easement. TWOL's response was to write a letter dated November 20, 2001, to NCDOT and DHA falsely indicating that DHA had never requested the road widening easement and drainage easement from TWOL, and that TWOL was nonetheless prepared to immediately execute the road widening easement and drainage easement for the benefit of Laurel Oaks[1]. Therefore, on December 12, 2001, NCDOT continued to require DHA to obtain the road widening and drainage easements from TWOL. On December 18, 2001, Legal Counsel sent the road widening and drainage easements to TWOL for execution per TWOL's letter dated November 20, 2001. TWOL refused to execute them.

The completion date for Blair Construction Company to finish the development under the Takeover Agreement passed on December 31, 2001, and on February 26, 2002, Blair Construction Company notified the Authority that it would mobilize to complete the construction by March 18, 2002, contingent upon DHA obtaining the three easements. On April 4, 2002, Blair Construction Company ceased construction activities on the Laurel Oaks site due to the unresolved easement issues.

From February 2002, through November 2002, DHA had each parcel appraised at fair market value and made purchase offers to TWOL based upon these appraisals. None of the offers were accepted by TWOL.

Eminent Domain

On March 17, 2003, DHA requested that the City of Durham utilize its *quick take* eminent domain powers to condemn the necessary parcels for the three easements on behalf of DHA. However, the City Council voted 6-1 against the request indicating that it preferred that DHA utilize its own eminent domain powers to acquire the needed parcels.
"[
On March 27, 2003, DHA passed a resolution authorizing the use of its eminent domain powers to acquire the necessary parcels and indicating that the acquisition of the parcels from TWOL was for a public purpose, in the public interest, and necessary for public use. DHA filed its Application for a Certificate of Public Convenience and Necessity with the North Carolina Utilities Commission on March 31, 2003. This application is a prerequisite to a housing authority's right to file suit for condemnation.

On April 1, 2003, TWOL filed suit against DHA seeking damages for alleged trespass

[1] It should be noted that TWOL's own development plans would have been benefited from the Authority's efforts to widen Cornwallis Road and construct the culvert.

committed and nuisance created by the installation of the sewer line on property formerly owned by Fair City-Pines and now owned by TWOL. This lawsuit also sought a declaratory judgment that TWOL was the true owner of the Laurel Oaks site.

On May 14, 2003, NCDOT informed DHA that it should use its eminent domain powers to acquire the property needed to construct the necessary road widening and drainage improvements on TWOL's property, and on May 22, 2003, the North Carolina Utilities Commission held a hearing on DHA's application for a Certificate of Public Convenience and Necessity.

On May 28, 2003, the Durham County Superior Court issued an Order dismissing all of TWOL's claims except its request for declaratory judgment regarding ownership of the Laurel Oaks site.

On August 27, 2003, the North Carolina Utilities Commission issued a Certificate of Public Convenience and Necessity to DHA which cleared the way for DHA to file its complaint for condemnation of the three easements. The condemnation action, against TWOL seeking to condemn the parcels for the three easements was filed on September 2, 2003.

The Durham Superior Court ruled on December 12, 2003, that DHA was entitled to the three easements pursuant to its powers of eminent domain, and DHA immediately notified the Architect/Engineer of the Court's ruling. The Architect/Engineer asked to proceed to obtain another contractor through the informal procurement procedure method (3 quotes) in lieu of formal procurement, to complete Laurel Oaks as an emergency as authorized in a resolution by the DHA's Board of Commissioners at its June 27, 2002 meeting, and HUD stated that the informal procurement method would be acceptable due to the immediate threat to life and property if Laurel Oaks remains vacant. The Superior Court order was signed on January 6, 2004, resolving all issues except for the amount of compensation that DHA will be required to pay TWOL for the easements.

Bid proposals were submitted to DHA on March 5, 2004, for a completion contractor, and on March 17, 2004, DHA executed a contract with Hart Brothers Contracting, Inc. to complete the construction of Laurel Oaks. A Notice to Proceed with construction was issued on April 14, 2004, and construction completion is expected on October 15, 2004.

On June 11, 2004, the Durham County Superior Court dismissed TWOL's claim to ownership of the Laurel Oaks site, and TWOL has thirty (30) days in which to appeal.

Comment 8

Inadequate Cost Allocation

The audit report for 2000 and 2001, made no findings of any deficiencies in the administration's cost allocation plan. The audit for the year ending December 31, 2002, which was submitted in February 2004, identified a concern in the cost allocation plan. As a result, the non-federally funded housing developments that are owned by the wholly owned public non-profit subsidiaries were undercharged.

The agency does currently have a cost allocation plan in place which allocates costs for contracts, legal retainer, insurance, postage, copier costs, salaries, employee benefits, auditing fees, etc. to each non-profit development. This cost allocation plan is based on per allocations as well as per equivalent position allocations. During the fiscal year 2002, the agency's cost allocation plan was not administered correctly.

DURHAM HOUSING AUTHORITY
COST ALLOCATIONS FOR ALL PROGRAMS

1. Staff salaries are charged based on unit allocation.

2. Staff employee benefits are charged based on unit allocation.

3. Invoices that can be allocated directly to the appropriate program are charged at the time the check is generated.

4. Contracts, insurance,etc that cannot be separated at the time of check writing are pro-rated monthly based on allocation spreadsheet.

5. Maintenance parts that are used from the central office warehouse are charged monthly based on work order print-out that itemizes parts used, costs of parts and location that parts are used in.

6. Postage, copier usage and office supplies are charged monthly to appropriate program.

Comment 9

Board of Commissioners' Response to the Audit

The Board appreciates the opportunity to review and comment on the Audit by the Office of Investigator General (OIG). The following discussion is the Board's response to the allegations of the audit that the Board did not establish and implement sufficient controls to monitor activities, and ensure transactions adhered to federal regulations.

General discussion of the Board's responsibility

It is a recognized responsibility of the Board of Commissioners to establish and implement sufficient controls to monitor activities, and ensure transactions adhere to federal regulations. The first step in fulfilling this responsibility is for the Board to employ, consult, and consider the advice of qualified, experienced, reliable and competent personnel to guide the decisions of the Board. The Board employs an Executive Director (ED), Legal Counsel (Counsel) and Independent Public Accountant (IPA). Secondly, the Board is guided by the HUD regulators responsible for overseeing the activities of the Authority. The Board should consult with and receive advice from independent experts on matters particularly within the expertise of these experts. Also, the Board should avail itself of the resources and expertise provided by national and regional associations of housing officials and advocates.

The Board employed Mr. James R. Tabron from 1980 through May 2003. Mr. Tabron provided strong managerial, administrative and supervisory leadership to the Authority. He led the Authority to a position of national, state and local prominence, achieved high performance standards throughout his tenure, and was well recognized by his peers and in this community as evidenced by his serving in leadership capacities on a number of volunteer boards and commissions. Assisting Mr. Tabron throughout his tenure, and now leading the Authority as ED, is Mr. Frank Meachem. Mr. Meachem has over 30 years of experience in public housing, with special emphasis in operations and management.

In order to assist the Board in legal and regulatory compliance, the Board employs The Banks Law Firm as Counsel. Counsel is charged with the responsibility of providing legal services, as requested, regarding matters within its professional and expert competence. There is a close working relationship between the Board and Counsel regarding legal issues that arise from time to time, and on-going statutory and regulatory compliance. The Banks Law Firm is the most respected law firm in North Carolina in the field of public housing. At least four members of the firm provide legal services to the Authority on a wide range of legal matters. The members of the firm have extensive experience in low-income housing development, finance, and public regulatory compliance. The firm represents the City and County of Durham, and over 10 other housing authorities in North and South Carolina.

In order to assist the Board in accounting and regulatory compliance, the Board employs the Firm of James E. Kinkead, P.C. as IPA. The IPA is charged with the duty of auditing the financial records of the Authority, and determining whether or not the Authority is in

compliance with all applicable rules and regulations. The IPA is a Certified Public Accountant with particular expertise in public housing. The IPA is an approved HUD auditor. The audit is conducted in compliance with the requirements of the Government Auditing Standards. The Board's Finance Committee meets with the IPA at the beginning of the audit process, and at the end of the audit process. A draft and final of the audit is provided to the Board for its review and discussion. The Board has established a committee to interface with the IPA from year to year to understand the purpose, intent and significance of the audits. Thereafter, the Board receives reports from the staff to ensure that the audit findings are cleared from year to year.

The Board uses the audit reports as a primary tool to fulfill its responsibility to monitor the Authority. The audit reports provide information that gives a perspective to financial matters and also facilitates necessary corrective action by the Board. The Board relies on the audit to provide information on whether the basic financial statements present a fair assessment of the financial position of the Authority and whether its operations are in conformity with generally accepted accounting principles. The Board uses the audit to assess the Authority's internal controls and its compliance with applicable HUD laws and regulations. The Board relies on the IPA to use professional judgment to determine the extent of testing necessary to support the audit findings and report on the Authority's compliance with applicable laws and regulations. The Board also relies on the IPA to report on any instances of noncompliance, evaluate the effectiveness of the internal controls of the Authority, and identify all material questioned expenditures.

The Authority is under the direct jurisdiction of the Greensboro HUD field office, which is one of the most experienced, diligent and respected field offices in the country. The field office monitors the Authority to ensure its compliance with federal laws and regulations. The Board encourages the staff to have frequent contact with the field office and to provide information about all Authority activities. There are numerous required submissions of financial information which are provided to the field office. The Board is has reviewed and commented on numerous HUD reviews that have taken place of the last 5 years. Board members meet with HUD officials in exit conferences following site visits and audits, and, from time to time, HUD officials have attended Board meetings. The purpose of these interactions is for the Board to understand the purpose, intent and significance of the HUD reviews, and to identify areas of concern requiring proper Board oversight.

Each year the Authority submits its annual budget to the field office prior to the beginning of the fiscal year for review. The Authority also sends its regular year-end financial statements, audits and a report of its performance to the field office. As a result, all major areas of Authority operations are reviewed pursuant to assessment programs established by HUD. These assessments concern the Authority's performance in areas of physical condition, financial condition, management operations and resident satisfaction. There are also other HUD entities that participate in the assessment process, including the Real Estate Assessment Center, which is responsible for assuring that the Authority's accounting is based on the generally-accepted accounting principals. Also, the Troubled Agency Recovery Center audited the Authority for the year 2002 in order to address

specific concerns set forth in the Authority's financial reports. The Board reviews, comments and works with the staff to ensure that the deficiencies or audit findings identified by HUD are cleared from year to year.

As necessary, the Board also requests and receives advice and counsel from other independent experts on such topics as market analysis, architectural design, and financial analysis. These experts are chosen by the Administration in relation to the specific professional or expert competence requested by the Board.

The Board members are members of the National Association of Housing and Redevelopment Officials (NAHRO) and the Carolinas Council, and receive publications, attend seminars, and network with other housing authority Boards. Mr. Tabron was an active member of PHADA, and served as the national president of the organization in 2001. Through these connections, the Board keeps current on issue of importance in fulfilling its duty to the Authority.

Comment 10

In fulfilling its responsibility to establish and implement sufficient controls to monitor activities, and ensure transactions adhere to federal regulations, the Board also has to establish policies and procedures for the free flow of pertinent, timely and accurate information. Each month, the Board is provided detailed information about the financial condition of the Authority and its non-profit wholly owned subsidiaries. The Executive Director and each department, including the finance and administration department, provide a monthly report of significant happenings and findings. Also, the Board is provided data on a range of financial and administrative issues for the Authority, such as balance sheets, statements of operating receipts and expenditures, Turnkey III balance statement, Hope IV financial statement, Section 8 financial statement and Capital Fund summary. The Board also receives reports on collection losses, vacancy rate/days for public housing, average vacancy days per unit, families on conventional waiting list, families on Section 8 waiting list and delinquent residents in possession.

The Board meets monthly and receives reports from the Administration about the state of the Authority. Each department is represented at the meeting by the senior staff. In addition to the Director of Finance and Administration, the Comptroller and the Internal Auditor are usually in attendance to answer any questions the Board has about the financial data provided in the Board package. In addition, the Board sets internal controls by requiring the hiring of competent employees, documenting procedures, separating duties among employees, and maintaining adequate records to prevent or detect fraudulent activities. The Board also establishes policies that mandate that the Executive Director distribute responsibilities among various staff members, with clearly written position descriptions.

The Board is required to understand the responsibilities and roles as between the Commissioners and the Executive Director. Absent information dictating a different approach, the Board must observe the chain of command, and act collectively to avoid situations where they might appear to be managers instead of policy-makers. The

Executive Director and his staff are responsible for the day-to-day operation of the Authority. The Board members are not managers of the Authority.

The Board consists of 6 members selected by the City Council and 1 member selected by the Mayor of the City of Durham. The initial term of office is 5 years for Council appointees and 3 years for the Mayor's appointee. A Commissioner shall hold office until his or her successor has been appointed, and has qualified. The Commissioner shall receive no compensation for his or her services. There are no specific qualifications required for the appointment of a Commissioner, and there are no seats set aside for persons with specific credentials, other than a seat available for a resident served by the Authority.

Discussion of the audit in the context of the January 13, 2004 OIG Audit Report

It is the Board's understanding that the present audit is an expansion of the work that was already started as part of the January 13, 2004 OIG Audit Report, Office of Audit, Region 4. In the January Audit, the OIG was primarily concerned about HUD's oversight of housing authorities. The concern was that, if HUD's oversight was inadequate, there was an opportunity for misuse of federal funds to enrich housing officials. The Board was under the impression that the field office knew, encouraged and approved of the Authority's development activities. Over the years, the Authority has maintained a close working relationship with the field office. It was not the practice to formally document what was perceived to be its knowledge, encouragement and approval of Authority development activities. An example is the acquisition of Woodridge with Turnkey III funds from the revolving loan account. Prior to the acquisition of Woodridge, the Authority was contacted by the field office, and encouraged to buy the property. Neither party required an amendment of the Plan of Use for the Turnkey III funds. The Authority acquired the property, and reported it on its financial reports for 6 years before this audit without complaint.

Another concern of the OIG is that housing authorities should not be making private investments that might be used to provide financial benefits to housing officials. The Board has not approved any private investments. Rather, any funds that the Administration has used to develop low-income housing have been through the public non-profit, wholly owned subsidiaries that are controlled by the Board. The public, non-profit corporations are like any other program of the Authority. These corporations were set up by the Authority because HUD encouraged the Authority to use the opportunity to generate millions of dollars from the sale of low-income housing tax credits. Each year our budget shrinks, each year the need for housing increases, and each year Congress does not have the money to help. With the low-income housing tax credits, we have been able to expand housing for low-income people.

The Board does not see the public non-profit corporations as private entities that could ever work in ways contrary to the best interest of the Authority. There are no shareholders who could take over the Board. There are no directors or officers, other than Board members and employees of the Authority. We understand our mission is to

create housing for low-income residents of Durham County. The non-profit corporations are used to fulfill our mission. No housing authority official or Board member has ever profited from any of the development activities of the non-profit corporations. No housing authority official or Board member has ever received anything of value, other than the satisfaction of providing housing to low-income residents.

Another concern of the OIG is that the development transactions may be structured in such a way that a private investor might get a good deal, and that this might enure to the benefit of a housing official. The Administration has not entered into any inequitable agreements. All of the transactions have been fair and equitable. They have been offered in an open market environment. All of the transactions that had bond funding have been scrutinized by other governmental agencies.

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In light of the aforementioned discussion, the Board offers the following comments on the specific acts of the Authority that are the subject of criticism in the audit.

Comment 11

In violation of its ACC, the Authority inappropriately advanced funds from its Conventional Public Housing General Fund to DVI, DVI projects and other entities without HUD approval.

As is required, the Board does not engage in the day-to-day management of the Authority. Rather, the Board relies on the Executive Director, the Director of Finance and Administration and his staff to establish proper accounting procedures, such as managing the General Fund. The Board also relies on the IPA to audit the internal controls, accounting procedures and financial records of the Authority to determine whether or not the Authority is in compliance with all applicable rules and regulations, including proper management of the General Fund.

The Authority does use the Low-Rent Public Housing Program as a General Fund for the paying of most costs and the receipt of income. This practice results in amounts being due to various other funds. Traditionally, these amounts to and from were settled on a monthly basis. While the developments owned by the non-profit corporations were healthy, they were generating positive rental incomes, and paying market rate interest on the loans from Turnkey III to the non-profits. During this time, the due to and due from accounts were customarily settled on a monthly basis. The audit report for 2000 and 2001 made no findings of any deficiencies in the Administration's management of the General Fund.

Authority management violated its ACC when it inappropriately advanced at least $2,598,065 of Turnkey III funds to DVI and its projects

The Board finds the statement: "Authority management violated its ACC when it inappropriately advanced $2,598,065 Turnkey III funds to DVI and its projects" to be inaccurate. The $1,022,097 owed from Woodridge and the $231,094 owed from

Northtowne was advanced appropriately pursuant to the Turnkey III revolving loan fund. Apparently the $1,343,874 owed from Golden Belt was originally advanced without HUD approval, but this advance was later formally approved by HUD in 2001.

As required, the Board does not engage in the day-to-day management of the Authority. This prohibition precludes the Board from practicing law or rendering legal advice. Rather, the Board employs competent and experienced legal counsel. The attorneys hired by the Authority are charged with the responsibility of providing legal advice and counsel, as requested, regarding matters within their professional and expert competence. Their expertise includes real estate finance, regulatory compliance and contract law.
The Administrative Use Agreement gives the Authority the responsibility to make all loan decisions and specifically does not preclude the Authority from subordinating the original loan to Woodridge. The loan is still secured and interest is accruing on the loan. DVI is not in default under the loan agreement. There has been no forgiveness of the loan and nothing has been written off.

The loan to acquire Northtowne was the second loan from the revolving loan fund. This loan was for $231,094.17. Northtowne was sold, and the net proceeds of sale of $277,017.61 were returned to the revolving loan account. The Authority is required to account for the revolving loan account under the Administrative Use Agreement annually (Section 8.1) as part of the audit performed by the IPA. This audit is underway and the Northtowne sale will be accounted for in compliance with the Administrative Use Agreement.

Pursuant to the Administrative Use Agreement, Section 3.7, the Authority must obtain permission from HUD to modify the use of the funds. The original Golden Belt advance of Turnkey III funds was not in compliance with the revolving loan agreement and without permission from HUD. Subsequently, the Authority obtained permission from HUD to use the funds already advanced, as well as additional Turnkey III funds, for Golden Belt. Pursuant to that agreement, after a 5-year moratorium, the funds will be paid back over 30 years with interest.

At this time, the Board does not believe that the Authority is in default under the Administrative Use Agreement. Under the terms of the Agreement, once funds are loaned out, the funds are not controlled by the Agreement unless they are returned to the revolving loan account (Section 2.4). Also once the proceeds of sale are paid out the Agreement expires and the Authority has no further obligation under the Agreement. (Section 12.1). Under the Plan of Use, it is the intention of the Authority to use the funds that are returned to the revolving loan fund consistent with the Plan and other directives of HUD. The Board does not believe that the Administrative Use Agreement or any of its amendments require immediate repayment of all the Turnkey III loans. Also, to call the loans at this time would not be prudent.

Inappropriate loan guarantee

As required, the Board does not engage in the day-to-day management of the Authority. This prohibition precludes the Board from practicing law or rendering legal advice. Rather, the Board employs competent and experienced legal counsel. The attorneys hired by the Authority are charged with the responsibility of providing legal advice and counsel, as requested, regarding matters within their professional and expert competence. Their expertise includes real estate finance, regulatory compliance and contract law. Based on the analysis of counsel, execution of the unsecured guarantee for the $350,000 loan of Fayette Place, LLC is not a violation of the ACC provisions that preclude the Authority from encumbering the projects under the ACC.

Inappropriate promissory note for Hope IV Program

The discussion as set forth in the preceding paragraph is incorporated herein by reference. In addition, based on the analysis of counsel, execution of the master note for the line of credit for Hope VI is not a violation of the ACC provisions that preclude the Authority from encumbering the projects under the ACC. Also, the Board relies on the Administration to ensure that HUD is kept fully informed of the progress of the Hope VI project and the financing programs that are in place to move it forward. The Board has been advised that the financing program for acquiring property by East Durham Properties, LLC was previously approved by the HUD office that supervises the Hope VI project. Further, the HUD office has approved a least two drawdowns for the repayment of the line of credit, and were aware of the terms of the financing program.

The Authority did not adequately disclose all requested information to auditors

The Board's Finance Committee met with the OIG auditors before they began their audit. At that meeting, the members of the committee advised the auditors that, if there was any information needed which the auditors felt was not forthcoming from the Authority, the auditors should call members of the finance committee. There was no request of the committee for any information. Subsequently, when members of the committee learned from the Authority staff that the auditors were frustrated with the lack of certain information, the committee arranged for a meeting with the auditors and the Authority's general counsel to provide any and all documents requested by the auditors, including any information on the wholly owned, public non-profit subsidiaries of the Authority. Thereafter, the auditors did not request any additional information from the committee or general counsel.

The Authority has an unoccupied low-rent public housing community

As required, the Board does not engage in the day-to-day management of the Authority. This prohibition precludes the Board from participating in negotiating, purchasing and recording easements. Rather, the Board encourages the Administration to use all necessary resources internally and through outside counsel to manage the construction of real estate developments. The Board receives reports periodically of the progress of the development. It is the understanding of the Board that Laurel Oaks has been delayed, primarily due to the bankruptcy of the original contractor, delay inherent in the

Bankruptcy Court, road widening issues, and the completion of the project by a new contractor. The time that the project has been delayed by the dispute over the sewer easement is probably around one year. Although this is regrettable, this is not the result of the failure of the Board to establish and implement sufficient controls to monitor activities, and ensure transactions adhere to federal regulations. Also, this is not an indication of the competency of the Authority to develop other properties.

The Authority does not have an acceptable cost allocation plan

As is required, the Board does not engage in the day-to-day management of the Authority. Rather, the Board relies on the Executive Director, the Director of Finance and his staff to establish proper accounting procedures, such as cost allocations. The Board also relies on the IPA to audit the internal controls, accounting procedures and financial records of the Authority to determine whether or not the Authority is in compliance with all applicable rules and regulations, including an acceptable cost allocation plan. The audit report for 2000 and 2001 made no findings of any deficiencies in the Administration's cost allocation plan. The audit for the year ending December 31, 2002, which was provided to the Board in February 2004, identified a concern in the cost allocation plan. As a result, the non-federally-funded housing developments that are owned by the wholly owned, public non-profit subsidiaries were undercharged $9,981.06 in 2002. As a result, the Board has instructed the Administration to reevaluate the cost allocation plan. This process has been on-going, and is near completion. It is anticipated that any losses or gains experienced by the Low-Rent Public Housing Program will be accounted for immediately.

Comment 12

Response to Recommendations

1A. Require the Authority to repay $1,966,118, or current balance owed, to its Conventional Public Housing General Fund representing funds it advanced to DVI, DVI projects and other entities.

DHA Response

The administration has examined the General Fund as of May 31, 2004, and has documented that the balance owed is $704,990 (attachment). The balance will be the subject of a promissory note, secured by assets of the non-profits and scheduled to be paid back. As a result of this account balance, DHA will sell one or more of the non-profit developments to generate cash to clear the accounts. Also, it is anticipated that the loans to the private lenders and to the revolving loan fund will be renegotiated.

1B. Require the Authority to repay $1,022,097, or the current balance owed, to its Turnkey III program from non-Federal funds representing funds it loaned for the purchase of Woodridge Commons Apartments.

1C. Require the Authority to repay the $231,094, or current balance owed, to its Turnkey III program from non-Federal funds representing funds it loaned for the purchase of Northtowne Apartments.

DHA Response (1B & 1C)

The administration has reviewed the Turnkey III Retained Funds account and can document the balance owed to the account, as of May 31, 2004, to be $2,705,783. As a result of this balance, DHA through its non-profits will sell one or more of the non-profit developments to generate cash to clear the accounts.

1D. Require the Authority to obtain release of any currently encumbered assets, including the Promissory Note for a $1.5 million line of credit with Wachovia Bank and the loan guaranty for a $350,000 loan obtained by Fayette Place, LLC.

DHA Response

We do not believe there is any encumbrance of Authority assets as detailed in our response.

1E. Seek legal guidance and require the Authority to terminate the $l, 804,670 loan to DVI for Golden Belt, and require the funds to be returned to the turnkey III program to be used for other housing purposes as approved by HUD.

DHA Response

There is a promissory note in place for the repayment of the funds to the Turnkey Retained Fund account. At this time, it is anticipated that the market has turned and the property can be sold at a profit. The administration will undertake the procurement of a Real Estate firm to market the property.

1F. Advise the Authority not to make further advances or encumber assets without prior written approval from HUD.

DHA Response

DHA will not make any further advances and encumbrances without proper authorization from the HUD Greensboro office.

1G. Instruct the Authority to immediately discontinue using funds for development activities.

DHA Response

DHA has discontinued using Low-Rent Public Housing Program General Funds and Turnkey III Retained Funds for all development activities.

1H. Require the Board of Commissioners to establish sufficient controls to monitor the Authority's activities and ensure transactions adhere to Federal regulations.

DHA Response

Counsel will prepare for the Board of Commissioners a resolution clearly outlining the process and steps that the Executive Director shall follow in carrying out the activities of the Authority as prescribed by Federal regulations and make said resolution a part of the Executive Director to be reviewed annually.

1I. Declare the Authority in substantial default of its Consolidated ACC for low-income public housing, and take possession and control of all Authority operations and assets.

DHA Response

The Housing Authority of the City of Durham has made adjustments in its executive staff and will make relevant direction a part of the new executive director contract with annual review as stated in 1H. The Board of Commissioners has instructed the mayor and city council to appoint a balanced Board of Commissioners, with someone with expertise in all relevant disciplines.

1J. Require the Authority to develop and implement an acceptable cost allocation plan.

DHA Response

The Housing Authority of the City of Durham will review its present cost allocation plan and ensure its compliance with Office of Management and Budget, Circular-A-87.

1K. Immediately suspend disbursements of the remaining $27,590,236, or current balance, of HOPE VI Grant funds until you perform a comprehensive review to determine whether the Authority has the capacity to ensure the successful completion of the Plan in compliance with its Grant Agreement and program regulations.

DHA Response

The Housing Authority of the City of Durham has made satisfactory progress with its HOPE VI Grant. We have submitted and HUD has approved all of the required documents thus far. DHA has successfully relocated all 240 families from Few Gardens, demolished and cleared the site in conformance with EPA guidelines.

We have and are in the process of securing property to carry out the construction of a 43-unit mixed income project with tax credits. We have two applications for tax credits pending.

1L. Take appropriate administrative actions against the former Executive Director, Interim Executive Director and board members, including issuing Limited Denials of Participation or debarment.

DHA Response

DHA has already taken actions to address some of the concerns expressed by the OIG. The former Executive Director was separated from DHA in May 2003, and the former Finance Director was separated from DHA in May 2004. DHA has hired a new IPA.

Conclusion

The activities, in which DHA has participated, provided additional affordable housing opportunities to low-and-moderate income families. This would not have been possible without our initiatives.

At this time, the administration is computing present account balances. These will be the subjects of promissory notes, secured by assets of the non-profits.

The DHA staff and Board of Commissioners have gained an invaluable lesson from this experience and will benefit immensely through proper planning, reviews, documentation, and approvals prior to implementation of programmatic activities.

OIG Evaluation of Auditee Comments

Comment 1 Our review of the Authority's records during our fieldwork showed that balances owed the General Fund were not being cleared even earlier than 2002, as claimed by the Authority. For example, the balance of amounts owed by Golden Belt began increasing significantly at the beginning of 2001. Similarly, the balance owed by Woodridge began increasing at the beginning of 2000.

While HUD permits paying expenses from the General Fund, repayments must be made timely to clear the accounts. Allowing balances to increase for several years is inappropriate. The Authority reasoned that the accounts were not cleared because of vacancies and decreasing collections at the non-profit developments. If the non-profit developments were having financial difficulties, it is not HUD's responsibility to cover those detriments with public housing funds.

The schedule of accounts receivable and the documentation provided to support the schedule is insufficient to support changing the balances in our report. The schedule is a summary of the amounts owed the Authority less amounts owed by the Authority and funds available to be paid to reimburse the Authority.

The supporting documents provided are computer printouts of General Ledger accounts "Interfund Due To" and "Interfund Due From." These accounts did not exist on the general ledger at September 30,2003. Further, the documentation only shows transactions from January 1, 2004, to May 31, 2004. The documents also show several journal entries with notations that significant amounts were reclassified or adjusted. The Authority did not provide any explanation or support for the entries. The amounts shown on the schedule as funds available to be paid to the Authority are meaningless unless the amounts are actually paid.

We did not revise this section of the Finding.

Comment 2 As stated in the Finding, the Authority did provide inappropriate advances for Golden Belt. However, the amount inappropriately advanced was not $1.3 million as stated by the Authority; it was about $2 million. HUD subsequently approved a loan of $1,804,670, representing funds already advanced. Unless the Authority has evidence to the contrary, HUD did not authorize any additional advances of funds for Golden Belt.

The Authority is correct in that the loans to Northtowne and Woodridge were authorized by the Turnkey III Use Agreement, which we stated in the Finding. However, the Authority allowed DVI to stop making payments on the Woodridge loan. The Authority claimed the proceeds from the sale of Northtowne were returned to the Authority. At the time of our review, the funds had not been repaid to the Turnkey III revolving loan fund and the Authority has not provided any additional documentation supporting the funds were repaid.

We did not question the Authority's legal status regarding the subordination of the Woodridge loan. We questioned that the loan payments were not made. However, since the Authority has a Deed of Trust granting it the power to sell Woodridge to satisfy the loan, it should consider doing so.

Comment 3

The Authority did obtain approval from the HUD Field Office to use funds recaptured from Turnkey III loans for general operating purposes, as long as its use was specifically for the Low Income Public Housing Program. However, longevity salary payments do not qualify as general operating purposes for the Low Income Public Housing Program. The approval also was not obtained until January 2004, after the longevity salary payments had already been paid in December 2003. The January 2004 letter from the Field Office also denied the Authority's request to use the funds for development expenses associated with Fayette Place. Despite being told that the funds could not be used for expenses associated with Fayette Place, the Authority proceeded to loan $134,790 to Fayette Place, LLC to pay past due property taxes.

Based on the Authority's comments we revised the caption on this section of the Finding and added the ineligible $134,790 used to pay Fayette Place taxes and the $71,724 used for longevity salary payments.

Comment 4

The Authority's claim that it did not encumber any of its projects with the execution of an unsecured guaranty is incorrect. Execution of the loan agreement violated the ACC regardless of whether the loan guaranty was secured by specific assets. The ACC specifically prohibits encumbrance of projects, any rents, revenues, income, or receipts there from or in connection therewith. The issue is not that the Authority pledged any assets. The encumbrance exists because the Authority could be liable for the debt, which places its ACC projects, and their rents, revenues, income, and receipts at risk.

We did not revise this section of the Finding.

Comment 5 The issue is not that the purchases of the properties by East Durham Properties, LLC might have been done to circumvent HUD's approval process. The issue is whether the Promissory Note for the $1.5 million Line of Credit violated the ACC. While the properties are not subject to an ACC, the Authority is the managing member and 99 percent owner of the LLC. We believe the Authority's assets, including its ACC projects are at risk given the Authority is 99 percent owner and the LLC has no source of income, as far as we know, to pay the loan.

Comment 6 The Authority's claim that public funds were not used to purchase the properties is incorrect. The Authority paid closing expenses on behalf of the LLC totaling $28,838 for the purchases of 13 properties. Those expenses were paid from the Authority's Conventional Public Housing General Fund. Thus, public funds were used and put at risk. Further, we did not find any evidence the Authority established an account receivable showing the funds due back to the General Fund from the LLC.

We revised the recommendations to include requiring the Authority to repay the $28,838 from non-Federal funds.

Comment 7 The Authority provided information on many issues that affected the progress of the Laurel Oaks project. However, the Authority knew that it did not have an easement for the sewer line at the time construction commenced on the project. It continued to develop the project and substantially completed it knowing it could not be occupied without the easement. Because of the Authority's neglect, the project has remained unoccupied for approximately 5 years, public funds have been spent on needless litigation costs, and low-income families on the waiting list have been deprived of housing. The Authority's mismanagement of the Laurel Oaks project leads to questions about the ability of the Authority to administer development activities.

We did not revise this section of the Finding.

Comment 8 As stated in the Finding, the allocation plan used by the Authority was not acceptable. While it did provide for allocation of some costs, it did not allocate those costs to all cost centers. For example, it did not allocate any costs to DVI or Golden Belt, even though neither had any employees and their operations were completely dependent upon use of Authority resources. Further, the method used for allocating salaries was inappropriate. Salary costs, at least for non-management personnel, should be based on actual time worked, not an estimate by the managers. For example, maintenance staff should record their time on work orders. The work orders would then become the basis for charging their salaries and fringe benefits. Similarly, office staff should track their time spent performing duties for the various programs/entities.

Further, the IPA audit for fiscal year 2002 found the Authority failed to properly allocate certain general administrative costs. The costs were initially charged to the low-rent public housing program and then allocated to other programs via a monthly journal voucher. However, the Authority did not prepare journal vouchers to allocate costs for 6 months of the fiscal year. This resulted in the low-rent public housing program bearing additional costs of $98,139.

We did not revise this section of the Finding.

Comment 9

We recognize that the Board must rely at least to some extent on information and guidance provided by others, such as the Executive Director, IPA, and HUD. However, ultimately it is the Board's responsibility to ensure the Authority administers its programs in accordance with requirements. While the Board shares this responsibility with the Executive Director and other Authority management, neither the IPA nor HUD oversees the Authority's daily activities. The Board should not expect the IPA or HUD to identify all weaknesses or inappropriate activities, especially if the Authority does not inform them of certain activities.

Comment 10

While the Board may have established policies and procedures for the free flow of pertinent, timely and accurate information, those policies and procedures were ineffective. As will be discussed further in a subsequent report, the Board was not fully apprised of all Authority activities. It was evident throughout our audit and from our review of Board minutes that Board members often were not informed of activities. For example, while certain critical information was provided to the Finance Committee, it was never provided to the full Board. To further illustrate the lack of flow of information, following is an email we received from one Board member on June 30, 2004, the day after we received the Authority and Board comments:

> *"As of 2:15pm today, the Board has not received a complete & final response to the OIG Audit Report , released to the Board on June 12, although there is a press conference scheduled today at 4:00pm, leaving very little time for review or corrections. Below is an e-mail sent earlier in response to the "Board Response" drafted by Finance Committee Chair & Commissioner Robert Glenn. Since no other document has been produced to the Board, one can only assume that the original "Board Response" will be the draft used.*

As mentioned below and in the amended "Board Response" (attached), there should be a distinct difference between the "Board" (which is comprised of the 7 members appointed by the Mayor & City Council: Rogers, Glenn, Woods, Farrington, Rich, Niemann, & Robinson) and the Finance Committee of the Board (which is comprised of only a portion of the Board, usually 3; current members are Glenn-Chair, Rogers, & Niemann).

Although a committee is normally an arm of the Board and reports to the Board, the DHA Finance Committee has evolved to be a separate entity, normally making decisions, attending meetings, and receiving information by itself. It is rare that the Board knows about meetings and appointments before they happen and even more rare that the Board knows the full information and actions taken in those meetings and appointments.

Thus, at several points in the original "Board Response", it is inaccurate to substitute the "Board", when in fact, it was only the Finance Committee and possibly some other select Commissioners. One can only use their experience to base these claims, so below are the points of disagreement:

1. Statement: "The Board meets with the IPA [Independent Public Accountant] at the beginning and end of the audit process."

Response: To my knowledge, in the 3 years that I have served on the Board, the Finance Committee and Administration has met with the IPA and not the Board.

2. Statement: "The Board meets with HUD officials, in exit conferences, following site visits and audits..."

Response: To my knowledge, in the 3 years that I have served on the Board, the Finance Committee and Administration has met with HUD officials and not the full board. In most instances, the meetings are not preannounced and are only noted within an Administrative report in the Board package.

For instance, the Board was not informed of the OIG Exit Interview on June 17 (originally scheduled for June 10) and it was only through a mishap, that I, a Board member found out that meeting (i.e. The Board was not informed of the meeting by the Finance Committee or Administration). Even after the meeting, the Finance Committee did not report on the meeting until after

the local newspapers wrote about the meeting and there was a request about a report from that meeting. Even now, there has not been a full report of the meeting - only an incomplete synopsis.

3. Paragraph: "The Authority Did Not Adequately Disclose All Requested Information To Auditors"

Response: The Finance Committee met with the OIG auditors before and after the audit. The Board did not authorize the Committee to do so. Before the audit, it was the Finance Committee and not the Board, that advised the auditors that if there was any information needed that the auditors felt was not forthcoming, the auditors should call members of the Finance Committee. The Board did not know that there was or might have been a problem with information. In! fact, the Board rarely knew when the auditors were at the agency.

4. At the appropriate points, it also needs to be stated that the Board not only relies on the IPA, Administration, & Counsel but also on the Finance Committee. The Board relies on their experience as well as their frequent interaction with the Administration to provide a full, detailed picture of the Agency to the Board. If the information is not flowing from the Finance Committee to the Board, the Board is misguided, similar to not receiving information from the IPA, Administration or Counsel.

It is unknown if the final draft will incorporate these distinctions, as even an updated draft has not been provided by this time. If so, it only shows that by strategic planning, preparation and communication (an issue that has never been properly addressed by the Board), many of the problems the Agency faces can be avoided".

Comment 11 The Board also further elaborated on the individual segments of the Finding. These discussions were similar to those provided by the Authority to which we have already responded.

Comment 12 The Board also provided its proposed corrective action for each of the recommendations. The Board should discuss corrective actions with the responsible HUD officials.

Based on the Board's comments, we clarified the Finding to show that the Board did not adequately fulfill its fiduciary responsibilities to oversee Authority operations and that management disregarded HUD requirements and instructions. We also added a recommendation to request the Mayor of the City of Durham or the City Council, as appropriate, to replace Board members who did not fulfill their fiduciary responsibilities.