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OFFICE OF THE STATE COMPTROLLER

August 22, 2005

Ms. Judith A. Calogero
Commissioner
NYS Division of Housing and Community Renewal
Hampton Plaza, 38-40 State Street
Albany, NY 12207

Re: Mitchell-Lama Buyout Program
Report 2004-S-5

Dear Ms. Calogero:

According to the State Comptroller's authority as set forth in Article V, Section 1 of the State Constitution and Article II, Section 8 of the State Finance Law, we have audited the Division of Housing and Community Renewal's (DHCR) process for reviewing and approving housing companies' applications to buy out of the State Mitchell-Lama Program for the period of January 1, 2000 through April 30, 2004.

A. Background

The Mitchell-Lama Housing Program was created in 1955 to encourage and promote the building of affordable housing throughout New York State. Housing developments built under this program are owned and managed by private housing companies and are supervised by either a New York City or New York State agency: The New York City Department of Housing Preservation and Development (HPD) supervises 126 Mitchell-Lama developments in New York City, while the New York State Division of Housing and Community Renewal (DHCR) is responsible for 211 developments in the State Mitchell-Lama Program (Program), 92 of which are located in New York City. The rules governing the Program are embodied in the New York State Private Housing Finance Law (PHFL).

To encourage developer participation in the Program, New York State financed low-interest, long-term mortgage loans for up to 95 percent of total development costs. In addition, local municipalities granted real property tax exemptions. In return for these incentives, the owners were required to operate under DHCR supervision and adhere to guidelines that limit profits and regulate rents. In a provision added to the PHFL in 1957, the housing companies became eligible to "buy out" of the Program (the technical term for the process is "dissolution") after meeting certain conditions. They must remain in the Program for a minimum of 20 years and prepay the mortgage. When a housing company buys out, it is no longer subject to DHCR regulations or any of the profit

or rent limitations imposed by the Program. If the housing development is not subject to rent stabilization laws after the buyout, the owner can raise the rents as high as the market will bear (i.e., “fair market” rates).

The combination of low interest rates, an upward swing of real estate prices, and the maturing of initial mortgages has made the prospect of buying out of the Program more attractive. As of April 2004, a total of 60 developments had bought out of the Program, and about 13 others had submitted formal notices to DHCR of their intent to do so.

DHCR is responsible for administering the buyout process of the Program, assuring full disclosure to all residents and the public of the proposed buyout plans. Throughout this process, DHCR is expected to ensure that the housing company has taken all of the required actions before its dissolution in accordance with Article 2, Section 35(2), and Article 4, Section 96(1), of the PHFL; and Part 1750 of the New York Code, Rules and Regulations (NYCRR). As part of its responsibility for effecting a smooth transition to non-Mitchell-Lama status, DHCR has established and published internal procedures for processing buyout applications (Procedures).

There are several steps in the buyout process. The housing company must submit a buyout application to DHCR at least 365 days prior to the anticipated date of dissolution. The application includes a “Notice of Intent” to buy out, along with such information as certified financial statements, a report on the physical condition of the building(s), current rental data for each apartment, and mortgage information. These items are then reviewed by various units within DHCR. DHCR is required to notify the applicant within 180 days if any additional information is required. When this has been done, DHCR authorizes the housing company to proceed with the public information notice phase, during which tenants are notified about the pending buyout. This notice must be provided at least 90 days prior to the anticipated date of dissolution and a public meeting is to commence at least 60 days prior. Following the public information meeting, the housing company is to provide DHCR with any other required documents and fee payments (e.g., a list of the requirements to prepay the mortgage; or a detailed payment schedule of any and all outstanding operating expenses, taxes, and indebtedness). DHCR then issues a certification of dissolution to the Secretary of State, stating that the housing company has met the PHFL requirements. DHCR then issues a “Certificate of No Objection” to the housing company.

B. Audit Scope, Objective and Methodology

We audited DHCR’s process for reviewing and approving housing developments’ applications to buy out of the Program during the period of January 1, 2000 through April 30, 2004. The objective of our performance audit was to determine whether DHCR has ensured that the housing companies have complied with the buyout requirements before permitting them to withdraw from the Program.

From the population of 20 housing developments that bought out of the Program during our audit period, we selected for review a judgmental sample of eight developments: Marble Hall, Phipps Plaza West, Cosgrove Gardens, Tower Apartments, New York Eye and Ear, Briarcliff Manor, Phillipse Towers, and Penbrooke Meadows. The eight developments selected represented locations throughout the State. A portion of them had bought out in each year of our audit period:

two in the year 2000, two in 2001, one in 2002, and three in 2003. DHCR officials told us they could not locate the complete buyout files for three of these - Briarcliff Manor, Phillipse Towers, and Penbrooke Meadows - we selected three others from the initial group of 20: Hillside Hospital, Huguenot Towers I, and Huguenot II. DHCR eventually located the files for Briarcliff Manor and Phillipse Towers and made them available to us; however, they are not included in our review. DHCR officials were unable to locate the third file, for Penbrooke Meadows. They indicated to us that it could be re-created, but this task would take some time.

To accomplish our objective, we interviewed DHCR officials. We reviewed and analyzed pertinent laws, regulations, policies, procedures, reports, and records. We also reviewed the process used by DHCR to verify the accuracy of the information provided by the housing companies. We contacted tax assessors of the municipalities where the housing developments are located, as well as the housing companies, to verify the information in DHCR records. In addition, we attended a public hearing on Mitchell-Lama buyouts and obtained information from New York City HPD officials on the buyout process used by them in the New York City Mitchell-Lama program and compared it with the one followed by DHCR.

We conducted our audit in accordance with Generally Accepted Government Auditing Standards. Such standards require that we plan and perform our audit to adequately assess those procedures and operations included within the audit scope. Further, these standards require that we understand DHCR's internal control structure and compliance with those laws, rules and regulations that are relevant to DHCR's procedures and operations that are included in our audit scope. An audit includes examining, on a test basis, evidence supporting transactions recorded in the accounting and operating records and applying such other auditing procedures as we consider necessary in the circumstances. An audit also includes assessing the estimates, judgments and decisions made by management. We believe our audit provides a reasonable basis for our findings, conclusions and recommendations.

In addition to being the State Auditor, the Comptroller performs certain other constitutionally and statutorily mandated duties as the chief fiscal officer of New York State, several of which are performed by the Division of State Services. These include operating the State's accounting system; preparing the State's financial statements; and approving State contracts, refunds, and other payments. In addition, the Comptroller appoints members to certain boards, commissions and public authorities, some of whom have minority voting rights. These duties may be considered management functions for purposes of evaluating organizational independence under Generally Accepted Government Auditing Standards. In our opinion, these management functions do not affect our ability to conduct independent audits of program performance.

C. Results of Audit

We found that DHCR is effectively ensuring that the housing companies have complied with the buyout requirements before permitting them to withdraw from the Program. We have, however, made some recommendations that we believe could further improve the process. Tenants should be given formal notice of a pending buyout earlier in the process than is currently required to allow them more time to explore their housing options. DHCR could also better document the waiver of buyout requirements. A written record of the required public information meetings should be

prepared and any agreements reached by DHCR and/or the tenants with the housing companies prior to a buyout should be formulated in writing.

1. Tenant Notification

Housing developments that were occupied before 1974 and buy out of the Program can be subject to rent stabilization laws. Those buildings occupied after 1973 or located in areas of the State not subject to rent stabilization, generally are no longer subject to regulation once bought out. According to the New York City Housing and Vacancy Survey, vacancy rates for affordable housing in New York City fell below four percent in 2002. Because of the tight housing market, Program tenants would benefit from being informed about a pending buyout at the start of the buyout process so they would have as much time as possible to explore their housing options. This is particularly important for tenants in buildings that would no longer be subject to rent regulation.

Housing companies are required to inform DHCR, through a Notice of Intent, of their intention to buy out of the Program no earlier than 365 days prior to the anticipated date of dissolution. However, tenants need not be officially informed about the pending buyout until after DHCR reviews the information that the housing company submits and finds it to be sufficient. DHCR then authorizes the housing company to proceed with the next phase - the public information notice, in which the tenants are given written notice about the buyout and informed that a public information meeting will be held.

Our review found that tenants at each of the eight housing developments had been provided with the public information notice at least 90 days before the buyout date, as required by the NYCRR. As shown in the following table, it took an average of 15 months for the eight housing companies whose records we reviewed to complete the buyout process (from the date the Notice of Intent was submitted to DHCR to the date the Certificate of No Objection was issued). However, the tenants did not receive an official notification of the buyout until an average of eight months into the buyout process (eight months between the date the Notice of Intent was submitted and the date the public information notice was provided).

Housing Development	Location (County)	Number of Months Into Buyout Process Before Notice Given to Tenants	Total Number of Months to Complete Buyout Process
Cosgrove Gardens	Rockland	6	9
Marble Hall	Westchester	14	17
Hillside Hospital	Queens	9	25
Phipps Plaza West	New York	12	18
New York Eye & Ear	New York	10	16
Huguenot Towers I	Westchester	3	9
Huguenot II	Westchester	3	9
Tower Apts (Hertel)	Erie	7	16
Averages		8	15

While the 90-day tenant notification requirement was met, earlier notification would give

tenants more time to explore alternative housing options, particularly in situations where rents may increase to fair market rates. DHCR officials observed that requiring notification to tenants earlier in the buyout process could be premature, since owners might subsequently withdraw their applications or substantially modify them. Officials expressed concern that alerting tenants too early could cause tenants to vacate before they have complete information.

Buyout rules and regulations issued by the New York City HPD, which is responsible for 126 Mitchell-Lama housing developments in New York City, require the housing company to notify the tenants of its buyout intentions at or about the same time that it informs HPD - 365 days prior to the anticipated date of dissolution. We believe this is a “best practice” that DHCR should consider implementing.

Further, as indicated in the NYCRR, the buyout process is to begin no less than 365 days prior to the anticipated date of dissolution. It begins on the date the housing company submits the Notice of Intent to DHCR and ends on the date DHCR issues the Certificate of No Objection to the housing company. This 12-month period allows for full disclosure to the public, enables DHCR to review documentation, and allows time for tenants who may be faced with displacement or a major rent increase to consider their alternatives.

As noted in the prior table, three of the eight housing companies whose files we reviewed completed the buyout process in three months less than the minimum 365-day requirement. Documents in DHCR’s files indicate that 2 of these 3 had requested and were granted waivers by DHCR from the 365-day requirement. There was no documentation that the third had either requested or received a written waiver.

DHCR officials indicated that they granted the waiver to the third housing company in view of the fact that after the buyout it continued as an affordable housing development under the jurisdiction of the New York State Housing Finance Agency (HFA) and the Federal Department of Housing and Urban Development with the tenants protected from rent increases and evictions. However, they were unable to locate a written confirmation of the granting of such a waiver.

2. Waivers

The NYCRR permits the DHCR Commissioner to waive or modify any of the requirements “for good cause.” A waiver exempts a housing company from the obligation to fulfill one of the requirements. The Procedures require the housing company to submit written requests for waivers to DHCR. They also indicate that DHCR must issue a letter to the housing company, indicating whether the waiver was granted or denied, and must include a short statement of the reason(s) for the decision.

We found a lack of consistency regarding written documentation and justification for waivers. When we reviewed the records for the 8 housing developments, we found that 7 had made 24 such requests. Of these 24, we identified the following:

- In 16 of the 24 requests, the housing companies had not indicated their reasons for requesting the waivers. The NYCRR permits waivers, but we could not determine DHCR's basis for granting them where the reasons for them are not given. To help DHCR determine whether to grant the waivers, we recommend that companies be required to document the reasons for their requests.
- Records indicate that DHCR granted 14 of the waiver requests and denied three. However, for the other seven requests, the files contained no letters from DHCR to the housing companies indicating whether the waivers had been granted or denied.
- DHCR issued a letter indicating why it granted just 7 of the 14 waiver requests.

DHCR officials told us that it is not always necessary to prepare a written response to a waiver request. For example, when a waiver of a time-limit requirement is requested, the passage of the time period in question without response renders the request moot, not necessitating a formal response. This may be true; however, we believe all requests for waivers, statements granting and denying waivers, and the explanations for those decisions, should be put in writing to ensure they are disclosed and justified.

3. Public Information Meeting

The NYCRR requires the housing company to conduct a public information meeting with the tenants and their representatives prior to the buyout. A DHCR representative is required to attend the meeting and, according to procedures, prepare a report of tenant comments made at the meeting.

The public information meeting is an important phase in the buyout process, because it gives the tenants and the public an opportunity to ask questions and receive answers. A written account of the meeting strengthens DHCR's ability to monitor any agreements or compromises the tenants and owners agreed to during the gathering. It also makes DHCR officials aware of requests for additional information that were made at that time.

We found that the file of just one of the eight housing developments contained such a written account that summarized the discussion at the public information meeting. Without a write-up of the public information meeting, DHCR might approve a buyout without knowing what agreements had been made between the owner and the tenants. DHCR officials agree that a written report of the public information meeting should be maintained by them.

4. Missing Files

Some approved buyouts end up in litigation, as happened with one of the developments whose records we reviewed. Thus, complete files on the buyout process should be maintained in the event subsequent review and testimony is needed. In addition, the Procedures require the housing company to submit certain documents for review by DHCR. Because the judgement of whether the

housing company has met the buyout requirements can be based on these documents, good internal control practices dictate proper maintenance.

As we discussed in the Audit Scope, Objective, and Methodology section of this report, DHCR had difficulty locating two of the eight housing company files we initially selected for our examination and was unable to locate a third file. We were also advised that a fourth housing company's file could not be located and should not be considered by us for review. According to DHCR officials, the buyout files have been centrally located in their Office of Legal Affairs since December 2000. Until that time, they said, the information was scattered among different DHCR units. The three missing files predated December 2000. DHCR officials believe that with centralization, missing files will no longer be a problem.

5. Post-Buyout Agreements

To be approved for a buyout, the housing company must adhere to NYCRR requirements. Some of these requirements relate to conditions the housing company must meet after the buyout has been completed. However, under current regulations, DHCR no longer has jurisdiction over the housing company once the buyout is complete. Therefore, DHCR currently does not have the authority to follow up on post-buyout agreements.

For example, the housing company is to arrange for a Physical Condition Survey of the building or buildings by an independent firm prior to the buyout. The survey is to ensure that the physical condition of the building(s) is sound enough to secure their long-term viability and to protect their occupants. It is to include a list of DHCR-approved repairs, along with the associated costs, that are to be made either immediately or over a five-year period. To cover repair costs, DHCR requires the housing company to set up an escrow account before the buyout is completed. DHCR officials state that in most cases the housing company's attorney is the fiduciary agent for the escrow account. Since DHCR does not, nor is it required to, verify that subsequent repairs have been completed we contacted the eight housing company representatives for an update. Seven of eight housing company representatives responded to our inquiry stating that repairs had been or would be made, but they did not provide the supporting materials we requested, such as bills, that would serve as documentation. Therefore, we were not able to verify the repairs had been made, as agreed.

In addition, since the housing company's attorney has a duty to its client (the housing company), we believe there is at least an appearance of a conflict of interest in having the attorney acting as the fiduciary. The attorney can not have both a duty to the housing company and to the tenants. Therefore, DHCR should require the fiduciary agent for a buyout repair escrow account be someone other than the attorney for the housing company.

In another example, rents paid by Mitchell-Lama tenants are not to be used for any purpose other than the ordinary operations of the project, without the prior written approval of the Commissioner. Prior to its July 11, 2002, buyout, Tower Apartments had about \$1.4 million in reserve. However, the owner had asked DHCR for permission to use approximately \$1 million of the reserve, explaining that he needed the funds to rehabilitate other Buffalo-area housing he owned.

His request was granted in October 2001. (He also used part of the funds in December 2003 to repay a loan he had received through HFA's Energy Conservation/Tenant Health and Safety Improvement Program.)

Generally, reserve funds should be released only for the improvement or repair of the building while the housing company is still in the Program. DHCR officials assert that the owner agreed not to increase rents more than 3 percent after the buyout, and we saw a promissory note he wrote to HFA promising to repay the funds and abide by the limitation on rent increases that had been mentioned in the public information notice to tenants. However, the files contained no legal agreement to limited rent increases. Since DHCR cannot monitor housing companies after a buyout, it would not know whether such a promise had been kept. If tenants did complain that their rent was increased more than 3 percent, it is not clear what actions DHCR could take against the owner. Also, without a legal agreement, an owner could not be prevented from changing his mind and deciding not to buy out even though he had already received the funds.

DHCR officials responded to us that, once a development has bought out of the Program and is no longer under DHCR supervision, DHCR is free of the responsibility to oversee it. However, it would seem prudent that since commitments are made as part of the buyout, the owner's agreement to meet them should be legally documented to protect the tenants.

Recommendations

1. *Amend the NYCRR to require housing companies to notify tenants of a pending buyout at the same time they submit the Notice of Intent.*

(DHCR officials replied that they will take steps, either by regulatory amendment or modification of existing administrative procedures, to insure that tenants receive notice of a dissolution application.)

2. *Ensure that the buyout process is completed in no less than 365 days from the anticipated date of dissolution unless a written waiver is requested and granted.*

(DHCR officials agree with the recommendation.)

3. *Ensure that information regarding waivers (requests, denials or approvals, reasons, etc.) is committed to written form and placed in the appropriate files.*

(DHCR officials disagree with the recommendation. They state that when the passage of time alone renders a waiver request moot, all parties are aware of this fact and there is no need to document the denial in a formal written decision. Also, where a file contains a waiver request that clearly sets forth the reasons for the request, there is no need for DHCR to reiterate the reasons in its letter granting the waiver.)

Auditors' Comments - While DHCR is correct for some situations, we could not identify the reasons for 9 of the 14 waivers that DHCR granted. In these instances, it would appear that DHCR granted the waiver without a request. Further, DHCR Procedures require that the Office

of Legal Affairs issue a letter to the applicant granting or denying waivers, “with a short statement of the reasons therefor.” Thus, to ensure that all requests for waivers, statements granting and denying waivers, and the explanations for those decisions are disclosed and justified, we believe officials should put them in writing.

4. *Require DHCR personnel to prepare a written report of the public information meeting, including tenant comments and descriptions of necessary follow-up activities.*

(DHCR officials agree with the recommendation.)

5. *Ensure that buyout files are maintained properly.*

(DHCR officials agree with the recommendation. They add that new procedures for processing voluntary dissolutions were instituted in December 2000 and were only applied thereafter.)

6. *Require that the fiduciary agent for a buyout repair escrow account be someone other than the attorney for the housing company.*

(DHCR officials disagree with the recommendation. DHCR officials assert that they expect the housing company attorney to properly implement the escrow agreement, as he or she is under fiduciary duty to do so, and is otherwise subject to penalties.)

Auditors’ Comments - We believe that having the attorney for the housing company acting as the fiduciary for the escrow account creates an appearance of a conflict of interest. Therefore, DHCR should require the fiduciary agent not be the housing company’s attorney.

7. *Formulate legal documents that articulate agreements reached between the owner and DHCR before completing the buyout process.*

(DHCR officials agree with the recommendation to the extent that legal documents should insure that any commitment made by the owner prior to the buy out is enforceable by those whom it was intended to benefit.)

A draft copy of this report was provided to DHCR officials for their review and comment. Their comments have been considered in preparing this final report, and are included as Appendix A.

Within 90 days after final release of this report, as required by Section 170 of the Executive Law, the Commissioner of DHCR shall report to the Governor, the State Comptroller, and the leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein, and where recommendations were not implemented, the reasons therefor.

Major contributors to this report were Howard Feigenbaum, Myron Goldmeer, Sheila Jones, Arthur Lebowitz, Tania Atria, Gatangalie Shiwkumar, Yamilette Ronda-Velez and Marticia Madory.

We wish to thank the management and staff of the Division of Housing and Community Renewal for the courtesies and cooperation extended to our auditors during this audit.

Very truly yours,

Frank J. Houston
Audit Director

cc: Robert Barnes, Division of the Budget

George E. Pataki
Governor



Judith A. Calogero
Commissioner

New York State Division of Housing and Community Renewal

Hampton Plaza
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March 11, 2005

Mr. Frank J. Houston
Audit Director
Office of the State Comptroller
Division of State Services
State Audit Bureau
123 Williams Street – 21st Floor
New York, NY 10038

Dear Mr. Houston:

Thank you for the opportunity to respond to your audit report (2004-S-5) on the Division of Housing and Community Renewal's process for reviewing and approving housing companies' applications to buy out of the State Mitchell Lama Program.

We appreciate the assistance of the Comptroller's Office in their attention to areas for improvement within our process and for the modifications they made in the final report on areas where we disagreed. Below are our comments to the recommendations made in the final report.

1. *Amend the NYCRR to require housing companies to notify tenants of a pending buyout at the same time they submit the Notice of Intent.*

We understand the concerns of the Comptroller's Office and agree that tenants should receive notice of a dissolution application at its inception. As a practical matter, owners generally inform tenant leaders prior to filing a Notice of Dissolution and tenants nearly always know about the application without formal notice. Nevertheless, DHCR will take steps to insure that such notice is received, either by regulatory amendment or modification of existing administrative procedures.

2. *Ensure that the buyout process is completed in no less than 365 days from the anticipated date of dissolution unless a written waiver is requested and granted.*

We agree with this recommendation, as it is our current policy.

3. *Ensure that information regarding waivers (requests, denials or approvals, reasons, etc.) is committed to written form and placed in the appropriate files.*

We disagree with this recommendation. Often applicants make pro forma requests for waivers which are premature, do not include any grounds for the requests, and ultimately

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become moot in the course of processing the application because the buyout is not completed in less than 365 days. In these circumstances, since it is the passage of time alone that renders these requests moot, all parties are aware of this fact and there is no need to document the denial in a formal written decision. Finally, where a file contains a waiver request that clearly sets forth the reasons for the request, and DHCR grants the request for the reasons stated in the letter, there is no need for DHCR to reiterate all of the reasons in its letter granting the waiver.

4. *Require DHCR personnel to prepare a written report of the public information meeting, including tenant comments and descriptions of necessary follow-up activities.*

We agree with this recommendation, as it our current policy and any deviations from it were inadvertent.

5. *Ensure that buyout files are maintained properly.*

While we agree with this recommendation, the auditors were well aware during the audit that new procedures for processing voluntary dissolutions were instituted in December 2000 and were only applied to dissolutions filed thereafter. The new procedures were intended to centralize the process. The three files that were initially missing all predated the new procedures, and in any event, soon after they were requested, DHCR was able to locate two of them and provide them to the auditors.

6. *Require that the fiduciary agent for a buyout repair escrow account be someone other than the attorney for the housing company.*

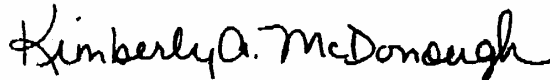
We disagree with this recommendation which has been raised for the first time in this final report. We understand the concerns of the Comptroller's Office, however, we believe that as a general rule it is not unreasonable to expect the housing company attorney to properly implement the escrow agreement, as he or she is under a fiduciary duty to do so, and is otherwise subject to penalties..

7. *Formulate legal documents that articulate agreements reached between the owner and DHCR before completing the buyout process.*

We agree with the recommendation to the extent that legal documents should insure that any commitment made by the owner prior to the buy-out is enforceable by those whom it was intended to benefit. However, such documents cannot provide for enforcement by DHCR after the buy-out is complete, since at that time DHCR no longer has jurisdiction over the property under the Private Housing Finance Law.

Please include our response as an appendix to your final report.

Sincerely,



Kimberly A. McDonough
Director of Internal Audit

cc: Judy Calogero, David Cabrera