

# Using CDBG Funds to Pay for Litigation Related to an Ongoing Project

July 21, 1995

Mr. Gene Lock  
City Attorney  
City of Houston Legal Department  
P.O. Box 1562  
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Dear Mr. Lock:

This is in response to a letter from Mr. Benjamin L. Hall, former City Attorney, dated October 21, 1994, requesting confirmation of the City's determination that Community Development Block Grant (CDBG) funds may be used to pay certain litigation costs which have been and will be incurred in defense of a CDBG-funded real estate development project called El Mercado del Sol (El Mercado). Three lawsuits have been filed against the City in connection with the El Mercado project. I apologize for the delay in responding to the request; the issue raised a variety of considerations.

According to the information in Mr. Hall's letter, El Mercado del Sol was intended to be developed by Mr. Charles W. Arnold as a Hispanic theme festival market. The City loaned Mr. Arnold \$535,000 in CDBG funds for acquisition of property and the design of the project. The CDBG funds were secured by a lien on the property and was subordinate to the construction financing which was provided by Mainland Savings Association. The developer was unable to lease all of the space in El Mercado, and consequently was unable to pay the construction debt. Mainland Savings failed in 1986 and was taken over by the FSLIC which foreclosed on the first lien, eliminating the City's secondary (CDBG) lien. The FSLIC was the successful bidder at the foreclosure. As a result of the failure of El Mercado, several tenants who had owned and operated businesses in El Mercado have filed suits against the City and the developer for loss of investment, lost profits, and loss of goodwill, as well as exemplary damages, prejudgment interest, and attorney's fees.

The FSLIC sold El Mercado to Mercado Partners II, a joint venture between Josephine E. Abercrombie Interests, Inc. and Equity Fund Advisors, Inc., in 1987. Mercado Partners II requested a \$5 million loan from the City to complete the project, with the balance of the \$13.2 million needed for completion to be provided by private sources. However, Mercado Partners failed to provide the private financing and it became clear that the project could not be completed. Additional CDBG funds ceased after approximately \$3.2 million of CDBG funds had been advanced for the project. As a result a third lawsuit was filed by Josephine E. Abercrombie Interests, Inc., and Mercado Partners II, seeking \$10 million in damages and title to the property. Following a statement by Equity Fund Advisors, Inc., that they never had any intention of providing the private financing, the City has filed a counter-claim against Abercrombie to recover all of the CDBG funds expended and the monetary value of the promised 306 jobs which never materialized.

The City has retained experts in the field of commercial real estate development, banking and finance, accounting, and CDBG regulations to defend these lawsuits. The City has also incurred expenses for document production, postage, and court reporters.

The City is correct in its conclusion that CDBG funds may be used to pay legal fees incurred in defense of lawsuits resulting from its administration of the CDBG program as long as the grantee has acted with due diligence in the administration of the program. The amount of CDBG funds used for this purpose may not exceed the proportion of CDBG funds expended for the project. For example, if CDBG funds totalled 30 percent of total funds expended for the project, then CDBG funds may be used to pay 30 percent of the legal fees. These fees are eligible administrative costs and are thus subject to the 20 percent cap.

The City should be cautioned that, in the event that the plaintiffs are successful in their lawsuit, CDBG funds can only be used to pay compensatory damages ( e.g., lost investment, lost profits, loss of goodwill, and prejudgment interest fees) and may not be used for punitive damages (e.g., exemplary damages).

I hope that the above information is helpful

Very sincerely yours,

Kenneth C. Williams  
Deputy Assistant Secretary for  
Grant Programs