

UNITED STATES OF AMERICA  
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT  
OFFICE OF ADMINISTRATIVE LAW JUDGES

<p>United States Department of Housing and Urban Development,  Plaintiff,  v.  Crestwood Terrace Partnership  Defendant.</p>	
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HUDALJ 00-002-CMP  
Decided: January 30, 2001

R. Edwin Brown  
For Defendant

Lillyanne Alexander and  
Maura R. Malone  
For the Government

Before: Constance T. O'Bryant  
Administrative Law Judge

**INITIAL DECISION**

This matter arises out of a complaint brought by the Department of Housing and Urban Development ("the Government" or "HUD") on April 27, 2000, seeking civil money penalties against Crestwood Terrace Partnership ("Respondent") pursuant to 24 C.F.R. Part 30. The Government seeks civil money penalties for Defendant's failure to

submit, within the time specified by HUD and in a form acceptable to HUD, financial statements for Crestwood Terrace Apartments (“the Project”) for fiscal years 1995, 1996, and 1997, in violation of 12 U.S.C. § 1735-f-15 (c ) (1) (B) (x) and 24 C.F.R. Part 30.

### **PROCEDURAL HISTORY**

The Complaint was filed with this Office on April 27, 2000 and was set for hearing by Order dated May 30, 2000. On August 29, 2000, Defendant filed a Motion For Sanctions and To Dismiss. The Motion was denied. On September 20, 2000, the Government filed a Motion for Partial Summary Judgment. That motion was granted, in part. By Order dated September 21, 2000, the undersigned found that there was no genuine issue of material fact concerning facts alleged in paragraphs 7, 8, 9, 10, and 11 of the Complaint, and concluded

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that Defendant knowingly failed to submit audited financial statements for fiscal years 1995, 1996 and 1997. The Order denied the Government’s contention that summary judgment should be granted on the issue of whether Defendant’s failure to file audited financial statements constituted “material” violations under 12 U.S.C. §1735f-15(c)(1)(B)(x).

An oral hearing was held on September 26, 2000, in Washington, D.C., limited to the issues of: (1) whether each violation was a “material” violation under the regulations; (2) whether a civil money penalty should be imposed, and (3) if so, the appropriate amount of the penalty. The parties filed post-hearing briefs. The last brief was filed on November 28, 2000.

### **FINDINGS OF FACT**

Pursuant to the ruling on the motion for summary judgment, as modified at the hearing, the following facts were established and conclusions reached:

Defendant is a for-profit partnership and owns Crestwood Terrace Apartments, a multi-family housing project located in Gaithersburg, Maryland. The project was built and financed with the proceeds of a loan insured against default by HUD under Section 221 (d) (4) of the National Housing Act (“the Act”). In exchange for receiving the benefits of a loan insured by HUD, the partners of Crestwood executed a Regulatory Agreement with HUD on December 27, 1971. In the Regulatory Agreement Defendant agreed to certain controls over the management and operation of the Project. Paragraph 9 (e) of the Regulatory Agreement reads as follows:

(e) Within sixty (60) days following the end of each fiscal year the Secretary shall be furnished with a complete annual financial report based upon an examination of the books and records of mortgagor prepared in accordance with the requirements of the Secretary, certified to by an officer or responsible Owner and, when required by the Secretary, prepared and certified by a Certified Public Accountant, or other person acceptable to the Secretary.

Crestwood Terrace Apartment's fiscal year ended each year on December 31, therefore, the audited financial statements for the Project were due within 60 days after December 31st of each year.

Defendant submitted financial statements for 1995, 1996, 1997; however, the reports were not submitted on or before the expiration of the 60-day period. Defendant's 1995 report was filed on April 14, 1997, as was the 1996 report. The 1997 report was filed on November 24, 1999. (G's Ex.2,3,4).<sup>1</sup>

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<sup>1</sup>The references to the Government's exhibits are designated as "G's Ex. #"; to the transcript of the hearing on September 26,2000, as "Tr.#" and to the Defendant's Response to Request for Admissions as "Admissions #".

Further, the 1995, 1996, and 1997 financial reports submitted by Defendant were not audited statements. They were not prepared and certified to by an independent public accountant or a certified public accountant.<sup>2</sup> Nor were the reports certified to by an officer or responsible owner as required by the Regulatory Agreement. Admissions 9, 14.

The requirements of the Secretary for financial reports and supporting data submitted after 1992 were set forth in HUD's Handbook for Financial Operations and Accounting Procedures for Insured. See Chapter 3, HUD's Handbook 4370.2 Rev -1 (5/92). The requirements included the provision that the financial statement be audited by an Independent Public Accountant ("IPA"). The stated purpose for the audit was to have the IPA render a professional opinion on the reliability of the financial statement as an accurate reflection of the project's condition and performance.

Defendant's officers had actual knowledge of the specific requirements that financial statements be filed within sixty (60) days following the end of each fiscal year, and that the statements be certified to by an officer or responsible owner. These were expressly provided in the terms of the Regulatory Agreement. Also, Defendant was obligated to keep informed of the Secretary's requirements, and thus knew or should have known of the Handbook provision that the financial statements be certified to by an independent public accountant or other person acceptable to the Secretary.

Having previously found that the Defendant knowingly violated its Regulatory Agreement with HUD, I turn now to the issue of whether Defendant's failure to furnish the Secretary with an audited financial report was a "material" failure.

## **DISCUSSION**

Under 12 U.S.C. §1735f-15(c)(1)(B)(x), a civil money penalty may be imposed upon any liable party, for:

the knowing and material failure to furnish the Secretary, by the expiration of the 60-day period beginning on the 1st day after the completion of each fiscal year, with a complete annual financial report based upon an examination of the books and records of the mortgagor prepared and certified to by an independent public accountant or a certified public accountant and certified to by an officer of the mortgagor, unless the Secretary has approved an extension of the 60-day period in writing.

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<sup>2</sup>Mr. Charles Player who was hired by Defendant to prepare the reports testified that the statements were "compilation reports." They did not meet the Secretary's requirements for a financial statement which had been certified to by an IPA. (Tr. 107-125).

Thus, a civil money penalty may be imposed only if the evidence shows that Defendant both “knowingly” and “materially” violated the Act and regulations.

Defendant contends that its failure to submit an audited financial statement to HUD for each of the years in question -1995, 1996, and 1997 - was not a “material” failure and that HUD failed to prove it to be so within the meaning of 12 U.S.C. §1735f-15(c)(1)(B)(x). It argues that it was in substantial compliance with the requirements by filing yearly financial statements in the form of compilation reports, and that HUD accepted their compilation reports for more than 20 years after the Agreement before it required an audited financial statement. (Tr. 136.) Further, it argues that there was no testimony that the financial statements it did submit were ever reviewed by HUD, and no testimony of any harm or damage to HUD or to the housing program resulting from its failure to submit timely and audited reports. Finally, it argues that there is no evidence of complaints to HUD over the nearly 30 years covered by the Agreement regarding the property as to any problem with the project, delinquency of payments on the property, and/or failure to maintain the property.

“Materially” is defined in HUD’s civil money penalty regulations at 24 C.F.R. §30.10 as meaning “in some significant respect or to some significant degree.” The Secretary of HUD has stated how the materiality issue should be determined. In his Order on Secretarial Review, *In the Matter of Associate Trust Financial Services, HUDALJ 96-008-CMP*, September 15, 1997, the Secretary ordered that in civil money penalty cases materiality is to be determined by application of a “totality of the circumstances” standard, which is to be determined in turn by consideration of the eight regulatory factors at 24 C.F.R. §30.80 -- factors required to be considered in determining the amount of civil money penalty. In this regard, I share the concern of my colleague about the logic of deciding whether to impose a civil money penalty by considering the factors used to determine the size of a penalty if a penalty were to be imposed. See *American Rental Management Company, et al.* (HUDALJ 99-01-CMP, May 26, 2000.) Nevertheless, the Secretary’s Order in *Associate Trust* constrains me to do just that, and I do so below.

There are eight factors which are required to be considered under the regulations at 24 C.F.R. §30.80. Pursuant to the Order of the Secretary in *Associate Trust* the record need not contain sufficient evidence to satisfy all of the factors -- a finding on one will support a finding of materiality. On that basis, materiality is easily established in Defendant’s case.

The eight factors required to be considered under 24 C.F.R. §30.80 are: gravity of the offense; history of prior offenses; ability to pay the penalty; injury to the public; benefits received; potential benefit to others; deterrence of future violations; and degree of culpability. As to these, two of the factors stand out as clearly shown by the evidence - benefits received and deterrence. As the discussion below will show, Defendant benefited by up to \$10,000 in each of the years it failed to file an audited financial statement. Further, the goal of deterrence will be served by finding liability and imposing a penalty in the case.

Similarly situated

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Defendants must be put on notice that failing to comply with the requirements of a regulatory agreement with HUD will be costly to them.

Accordingly, I find that Defendant's failure to file an audited financial statement as required by its regulatory agreement with HUD in each of the three years was a "material" failure under 12 U.S.C. §1735f-15(c)(1)(B)(x). I, therefore, find that Defendant knowingly and materially committed the violations as alleged in the Complaint. I find further that Defendant's violations warrant a civil money penalty.

### **CIVIL PENALTY**

The Government seeks the maximum civil money penalty for each of the violations alleged. It seeks \$25,000 for the one violation committed before October 24, 1996, and \$27,500 for each of two violations committed after October 24, 1996 (12 U.S.C. §1735f-15(c)(2)).<sup>3</sup> It argues that the maximum penalty for each violation is necessary to ensure Defendant's future compliance with HUD requirements and to preserve the integrity of HUD programs.

The Defendant argues that no penalty should be imposed because the Government has failed to prove that Defendant's submission of compilation reports rather than *audited* reports harmed the Government in any way. It cited uncontradicted testimony that the Project is well-managed, well-maintained, in good physical condition, occupied by satisfied tenants, and financially solvent. In addition, Defendant makes the same arguments it did against the violations being found to be "material" violations: that there is no evidence of complaints to HUD over the nearly 30 years covered by the Agreement regarding the property as to any problem with the project, delinquency of payments on the property, and/or failure to maintain the property; that it was in substantial compliance with the requirements by filing yearly financial statements in the form of compilation reports; that HUD accepted the compilation reports for more than 20 years after the Agreement before it required an audited financial statement (Tr. 136.); and that there was no testimony that the financial statements it submitted were ever reviewed by HUD. It characterizes the penalty sought as "outlandish and exorbitant" and evidence of overreaching by HUD. I am not persuaded by Defendant's argument that no penalty should be imposed. I conclude that the Government has established some harm and/or potential harm to HUD or to the housing program resulting from Defendant's failure to submit timely and audited reports. However, I conclude that the maximum penalty is not warranted by the facts in this case.

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<sup>3</sup>The maximum penalty increased effective with violations committed after October 24, 1996. *See* 61 Fed. Reg. 50208 (1996) (codified at 24 C.F.R. Part 30).

To determine whether a civil money penalty should be imposed for the violations, 24 C.F.R. §30.80 requires consideration of the eight factors discussed above and such other

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matters as justice may require. Again, they are: gravity of the offense; history of prior offenses; ability to pay the penalty; injury to the public; benefits received; potential benefit to others; deterrence of future violations; and degree of culpability.

Gravity of the offense:

Although the Defendant submitted financial reports, the fact that the reports were not audited is significant. HUD uses owner's audited financial statements to assess risk to its insurance fund. As stated in HUD's Handbook for Financial Operations and Accounting Procedures for Insured (Chapter 3, HUD's Handbook 4370.2 Rev -1 (5/92)) purpose for the audit was to have an independent public accountant render a professional opinion on the reliability of the financial statement submitted as an accurate reflection of the project's condition and performance. The requirement of an audit increases the reliability of the information included in the statement. And, the information in the financial statement is important for HUD to perform proper regulatory oversight of HUD-insured projects (Tr. 25-26, 28, 37-38), and to protect its insurance fund by adequately assessing risk and monitoring early disbursements from the projects. (Tr. 25-26, 28, 37-38). However, I conclude that the gravity of the offense is mitigated by HUD's acceptance from Defendant of unaudited reports for all of the years it was obligated to file them prior to 1995. Further, HUD has not shown that any information included in the reports that were filed was either inaccurate or misleading.

History of Prior Offenses:

Defendant has no history of prior offenses established on the record before me.<sup>4</sup>

Ability to Pay the Penalty:

The burden is on the Defendant to establish that it is not able to pay the amount of fine sought. Defendant has not denied its ability to pay the penalty sought by HUD, and its ability can be inferred from testimony at the trial. Mr. Brown, the sole surviving partner of Crestwood Terrace Partnership, testified that the Project contains 108 units valued at \$60,000 per unit. The total value is four times the mortgage balance of about \$1,000,000. (Tr. 133-135). Accordingly, I find that Defendant has the ability to pay the penalty sought.

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<sup>4</sup>I decline to infer, as the Government urges, that Defendant has a history of prior knowing and material violations from the testimony of Charles Player that he had been retained by the Defendant over the last 20 years as an accountant and had been requested each year to create a compilation report which was then submitted to HUD *in lieu of* an audited financial statement. See Tr.86.

Injury to the public:

In considering the factor of injury to the public, as assessment of the harm caused to the integrity of HUD's programs and the costs of enforcement and litigation that resulted therefrom should be made. See *Associate Trust* at 9, and *American Rental* at 14, 17-18.

The evidence supports finding injury to the public in the cost to the government of enforcement and litigation in this case. HUD expended housing and enforcement center staff time communicating with Defendant to force Defendant's compliance with the regulatory agreement and to litigate the matter. The testimony shows that only after repeated requests for compliance failed was the matter referred for litigation. (Tr. 27-28).

Further, the evidence supports finding damage done to the integrity of HUD's programs. HUD uses the audited financial statements to assess risk to its insurance fund. (Tr. 25). HUD requires that the financial statements be audited to assure that the information contained in them is reliable. It follows then, that without an audited financial statement HUD was not able to reliably assess the overall performance of Defendant's project.

Benefits Received:

Testimony elicited at trial shows that it would have cost Defendant between \$7,500 and \$10,000 to create and submit an audited financial report for each of the three years in question. This amount was over and above the cost of creating the compilation reports which were submitted. (Tr. 100, 118). Thus, by submitting a financial statement in the form of a compilation report rather than an audited financial statement, Defendant benefited by up to \$10,000 in each of the three years in question.

The Government contends that Defendant may have received even greater benefits than the amounts discussed above. It points to testimony that Defendant received disbursements from its HUD-insured project at Crestwood Terrace Apartments of \$203,000 in 1995, (Tr.119); of \$100,000 in 1996 (Tr. 120); and of \$509,000 in 1997 (Tr. 120). It argues that an audited report may have shown these disbursements to have been improper. To conclude that Defendant benefited from improper disbursements would require speculation on my part. I decline to do so.



I find that Defendant benefited by at least \$22,500 and up to \$30,000 from its failure to file the three audited financial statements at issue in this case.

Potential Benefits to Others:

The Government's claim of potential benefits to the individual partners of Defendant does not address this factor and there is no evidence in the record of potential benefits to others in this case.

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Deterrence:

The goal of deterrence will be served by imposing a penalty in the case. Similarly situated Defendants must be put on notice that failing to comply with the requirements of a regulatory agreement with HUD will be costly to them.

The Government argues that only the maximum penalty would comport with HUD's stated purpose for the civil money penalty which is to deter future unlawful conduct. I reject this argument for, if it were true, administrative law judges and reviewing authorities would have no discretion but to impose the maximum penalty in every case and 24 C.F.R. 30.80 would be meaningless. I agree with the Government's other contention, however, that to encourage compliance with the regulations within the industry, the penalty imposed must be substantially greater than the cost of compliance. Thus, the penalty for each violation in this case must be greater than the \$10,000 Defendant may have saved by submitting financial statements that were not audited.

Degree of Culpability:

Defendant is solely at fault for the failure to file the required audited reports. The testimony shows that the decision not to file an audited report was made for profit reasons. At the trial Defendant argued that the \$7,500 to \$10,000 it would have paid to obtain an audited financial statement was put to better use through reinvestment in the Project -- that to have paid for an audit would have meant that there would be less money available to the Project. This argument could be made by any mortgagor; however, mortgagors cannot be allowed to pick and choose the provisions of an Agreement or regulatory requirement with which they will or will not comply. On the other hand, consideration must be given to the mitigating fact that HUD had accepted Defendant's unaudited financial statements for all the years prior to 1995. By 1995 it was not unreasonable for Defendant to have concluded that the unaudited reports were in substantial compliance with HUD's requirements.

For the reasons discussed above, Defendant Crestwood Terrace Partnership, is to pay a total civil money penalty of \$40,500 -- \$13,500 for each violation established under the Complaint.

**ORDER**

1. It is hereby **ORDERED** that Crestwood Terrace Partnership pay a civil money penalty in the amount of \$13,500 for failing to file with HUD an audited financial statement for Crestwood Terrace Apartments for fiscal years 1995;

2. It is hereby **ORDERED** that Crestwood Terrace Partnership pay a civil money penalty in the amount of \$13,500 for failing to file with HUD an audited financial statement for Crestwood Terrace Apartments for fiscal years 1996;

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3. It is hereby **ORDERED** that Crestwood Terrace Partnership pay a civil money penalty in the amount of \$13,500 for failing to file with HUD an audited financial statement for Crestwood Terrace Apartments for fiscal years 1997; and

4. It is hereby **ORDERED** that within 10 days of the date on which this Initial Decision becomes final, Defendant shall pay \$40,500 to the Secretary of the United States Department of Housing and Urban Development.

This Initial Decision shall become final within 30 days of issuance unless appealed to the Secretary within that time pursuant to 24 C.F.R. §26.50.

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CONSTANCE T. O'BRYANT  
Administrative Law Judge