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

In the Matter of:

STEVE VOGDS, ROBERT J. WERRA, WESTGREEN ASSOCIATES, LTD., AND AMERICAN REPUBLIC REALTY CORPORATION, a/k/a AMRECORP

Respondents

HUDALJ 90-1483-DB(LDP)
HUDALJ 90-1484-DB(LDP)

Decided: February 8, 1991

Donald P. Lan, Jr., Esquire
Robert W. Strauss, Esquire
For the Respondents

Frank Elmer, Esquire
For the Government

Before: THOMAS C. HEINZ
Administrative Law Judge

INITIAL DETERMINATION

Statement of the Case

This proceeding arose pursuant to 24 C.F.R. Sec. 24.700 *et seq.* as a result of actions taken by a Regional Administrator of the Department of Housing and Urban Development ("the Department" or "HUD" or "the Government") on December 26, 1989, and December 27, 1989, imposing upon each of the Respondents a twelve-month Limited Denial of Participation ("LDP") in all HUD programs within the geographic jurisdiction of the Fort Worth, Texas, Regional Office. These actions were based on decisions by the Regional Administrator of the Forth Worth office in two separate cases that Respondents had violated HUD regulations while participating in housing transactions subject to Department review. Respondents appealed those decisions and requested oral hearings. After the parties filed responsive pleadings and the cases were consolidated, an oral hearing was held in Dallas, Texas, on September 5 and 6, 1990.

The Department alleges Respondents have violated HUD regulations by the following conduct:[1]

1. In June, 1989, Respondent Westgreen Associates, Ltd. ("Westgreen"), the owner of a Wichita Falls, Texas, apartment complex (the "Project"), and Respondent Amrecorp Realty, Inc. ("Amrecorp"), a partner of Westgreen, improperly used funds generated by the Project to make an unauthorized payment of $203,779 to Amrecorp.

2. Since October of 1988, Westgreen has failed to make payments on its mortgage;

3. In 1987 Westgreen and Amrecorp improperly forgave payment of $29,866 due the Project from Amrecorp;

4. In 1987 Westgreen and Amrecorp improperly used Project funds of $1,291 to pay partnership expenses of Westgreen and Amrecorp; and

5. Westgreen or Amrecorp failed to file timely and complete annual financial reports for the years 1983, 1984, 1985, and 1986, as well as several monthly reports as required.

Although the LDP's against Respondents expired as of December 26, 1990, Department policy requires issuance of a decision discussing the merits of the case.

Findings of Fact

1. Respondent Robert J. Werra ("Werra") is Chairman and President, and Respondent Steve Vogds ("Vogds") is Vice-President of Amrecorp, a Delaware corporation. (Tr. 140, 167; Answer)[2] Westgreen is a Wisconsin limited partnership of which Amrecorp, Werra, and Vogds are general partners. (Tr. 40, 143-144, 170, 210-212; Gx. 35)

2. Westgreen owns Westgreen Apartments, a 172-unit apartment complex located in Wichita Falls, Texas. (Tr. 40, 143-144; Gx. 35)

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[1]Over Respondents' objections, the Department at hearing introduced evidence for the purpose of proving several additional violations not charged in the Complaint. That evidence involved: (a) alleged improper commingling of accounts and other accounting deficiencies; (b) alleged improper use of Project funds to pay lawyers and accountants in defense of this proceeding; and (c) allegedly inadequate maintenance of Project property. Inasmuch as the Department did not move to amend the Complaint to include these allegations or move to conform the pleadings to the evidence, the issues raised by this evidence are not ripe for review and are not discussed herein.

[2]The following reference abbreviations are used in this decision: "Tr." for "Transcript"; "Gx." for "Government's Exhibit"; and "Rx." for "Respondent's Exhibit."

3. Amrecorp managed the Project as agent for Westgreen from the time Westgreen bought the Project until June 1, 1990. (Tr. 42, 129, 158, 212; Gx. 29)

4. The Project is subject to a Deed of Trust Note ("the Note") and a Deed of Trust, both dated March 18, 1982. The Note was insured by HUD under Section 221 (d)(4) of the National Housing Act. (Tr. 40-41, 143; Gx. 11)

5. Operation of the Project was subject to a Regulatory Agreement for Multi-Family Housing Projects dated March 18, 1982. ("the Regulatory Agreement")(Gx. 3)

6. Westgreen purchased the Project in 1982, and by agreement dated October 18, 1982, agreed to assume (subject to the limitations stated therein) and to be bound by the Note, the Deed of Trust, and the Regulatory Agreement referred to above. (Tr. 41-42; Gx. 5)

7. Under the terms of the Note, as modified on December 14, 1982, Westgreen was required to make monthly payments of interest only until November, 1983, at which time monthly payments of interest plus a portion of the principal were due totalling $32,725.26. (Gx. 2, 11) The Note was to mature October 1, 2023. (Gx. 2, 11)

8. The Deed of Trust incorporates the Regulatory Agreement and provides, *inter alia*, that:

> all rents, profits and income from the property covered by this Deed of Trust are hereby assigned to the holder of the Note for the purpose of discharging the debt hereby secured. Permission is hereby given to Grantor, so long as no default exists hereunder, to collect such rents, profits and income for use in accordance with the provisions of the Regulatory Agreement; [Gx. 1][3]

9. The economy of Wichita Falls, Texas, is heavily dependent on the oil industry. (Tr. 142) In the years immediately preceding Westgreen's acquisition of the Project, oil prices had been increasing significantly year after year. (Tr. 142) However, after Westgreen purchased the apartment complex, oil prices declined markedly, thereby

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[3] The Regulatory Agreement includes similar provisions:

> 12. As security for the payment due under this Agreement to the reserve fund for replacements, and to secure the Secretary because of his liability under the endorsement of the note for insurance, and as security for the other obligations under this Agreement, the Owners respectively assign, pledge and mortgage to the Secretary their rights to the rents, profits, income and charges of whatsoever sort which they may receive or be entitled to receive from the operation of the mortgage property, subject, however, to any assignment of rents in the insured mortgage referred to herein. Until a default is declared under this Agreement, however, permission is granted to Owners to collect and retain under the provisions of this Agreement such rents, profit, income, and charges, but upon default this permission is terminated as to all rents due or collected thereafter.[Gx.3]

adversely affecting the rental apartment market as tenants lost their jobs and vacated their apartments. (Tr. 146-147)

10. Because the Project had a negative cash flow, Amrecorp, in its capacity as general partner of Westgreen, paid the bills necessary to keep the property operating from 1983 through early 1986. (Tr. 150) These cash advances totalled $952,670. (Gx. 28) During this period Amrecorp also deferred its fees for management services and bookkeeping/data processing and was not reimbursed for payroll. For 1983 through 1986 these expenses totalled $284,051. With the addition of interest and other fees, by the end of 1986 Westgreen owed Amrecorp $1,704,494 for cash advances and unreimbursed expenses. (Gx. 28; Tr. 151-153, 206)[4]

11. In early 1986 Amrecorp management decided the company could no longer provide additional capital to the Project. Faced with inadequate cash flow to maintain the Project as a going concern, and based on hopes that the local economy would soon improve, Westgreen and its lender entered into a modification agreement in April of 1986 that deferred payments on the principal and a portion of the interest due on the note for 30 months ending September 1988. The amount of the deferred interest totalled $416,817.90. According to the terms of the modification agreement, the Project was to pay back this deferred interest over a period of three years beginning October 1988. (Tr. 43, 153-4; Gx. 6)

12. Contrary to expectations, during the 30 months from April of 1986 until September of 1988, the Wichita Falls economy did not significantly improve, and by September of 1988 the Project was not generating enough cash to pay all operating expenses plus the much increased monthly mortgage payment which was to begin in October of 1988. Westgreen made its last mortgage payment on the Project in September of 1988. It has been in default ever since. (Tr. 54; Gx. 20)

13. After the Project defaulted, Westgreen unsuccessfully attempted to negotiate another modification agreement with its lender. (Tr. 155)

14. On February 10, 1989, the mortgagee advised the Project that the entire principal sum and accrued interest under the Note was due and payable, and further, that the Note and Mortgage were going to be assigned to HUD. (Gx. 21)

15. Except during the term of the 1986 loan modification agreement when it essentially broke even, the Project never generated enough rental income to pay the monthly mortgage as well as all the operating expenses. (Tr. 149, 151-152, 154, 274-276; Rx. 8, 10, 12, 14; Gx. 6)

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[4]Although the income, expense, and other financial numbers cited in this decision are all supported by record evidence, many of these numbers vary somewhat from document to document in the record. The variations are minor and do not affect the outcome of the case.

16. In contrast to the first four years (1983-1986) of Amrecorp's management of the Project, during 1987, 1988, and up to June 1, 1989, when Amrecorp stopped managing the Project, Amrecorp made no more significant cash advances to the Project, and the Project reimbursed Amrecorp for most of its payroll, management, and bookkeeping/ computer expenses. During this period these expenses totalled $213,979, of which $193,014 was paid as accrued. (Gx. 28)

17. From October 1988 through June 1989, while in default on its mortgage, Westgreen had net rental income of $348,902.45 and total operating income of $161,697.24. (Rx. 18, 20) Because the Project made no mortgage payments during this period, and had operating income greater than operating expenses, it accumulated cash. By June 1, 1989, the Project had $200,160.59 in cash on hand. (Gx. 23)

18. During June 1989, after Amrecorp had given up management responsibilities for the Project on June 1, 1989, and while in default on its Note, Westgreen disbursed $203,779.09 to Amrecorp out of Project funds. In the words of Westgreen's accountants, this payment was made to "Paydown Advance." (Gx. 23) In a September 11, 1989, letter to HUD, Respondent Vogds said that the "funds were used to pay Amrecorp for money advanced to the property to meet operating obligations." (Gx. 25)

19. Since at least 1987, the Project has had no "surplus cash" as defined in the Regulatory Agreement. (Tr. 44; Gx. 3)

20. In 1987 Amrecorp forgave the Project from paying $35,311 of the interest due from the Project on owner advances. When combined with operating advances of $4,965 Amrecorp made to the Project during that year, the net amount the Project owed Amrecorp for advances declined by $29,866. (Gx. 28)

21. In 1987 Westgreen mistakenly paid owner expenses of $1,291, which amount was paid back in 1990 upon Government demand. (Tr. 313-315; Rx. 38)

22. Respondents failed to file timely annual financial reports for 1983 through 1986. (Tr. 60, 89-82, 95)

23. In 1989 Westgreen was required to send monthly accounting reports to HUD by the 10th of the month following the month covered by each report. Westgreen's reports for January through March of 1989 were not sent to HUD until after an April 28, 1989, demand from HUD. (Gx. 14)

24. HUD became assignee of the Westgreen mortgage in 1989 and now has before it an insurance claim in excess of $3.8 million. (Tr. 87-88)

Subsidiary Findings and Discussion

Respondents Werra and Vogds are "principals" of Amrecorp as defined at 24 C.F.R. Sec. 24.105 (p), as well as "affiliates" of Westgreen, as defined at 24 C.F.R. Sec. 24.105 (b). All four Respondents are "participants" within the meaning of 24 C.F.R. Sec.

24.105(m), and Amrecorp is both a "principal" is its own right and an "affiliate" of Westgreen. (24 C.F.R. Secs. 24.105(b),(p)) A Regional Administrator of HUD may impose an LDP upon a participant and the participant's affiliates if the participant engages in any of the conduct proscribed in 24 C.F.R. Sec. 24.705. In the instant case, the Regional Administrator issued the LDPs based on Respondents' alleged failure to comply with the Regulatory Agreement covering the operation of the Project, in violation of 24 C.F.R. Secs. 24.705(a)(2),(4), and (9).

The June 1989 Payment of $203,779 to Amrecorp by Westgreen

The Government argues that the June 1989 payment of $203,779 by Westgreen to Amrecorp was an unlawful distribution of Project funds in violation of the Regulatory Agreement.[5] Respondents argue that the payment was not a distribution but rather constituted lawful reimbursement of reasonable operating expenses that had accrued while Amrecorp was managing the Project. Neither argument is correct. Although the payment indeed was for reasonable operating expenses and hence should not be deemed a "distribution" as defined by the Regulatory Agreement, it was nevertheless unlawful because Respondents used funds in which the Government has a security interest to reimburse Amrecorp for unsecured advances of cash and services.

Paragraph 6 of the Regulatory Agreement provides in part:

> Owners shall not without the prior written approval of the Secretary:
>
> ...(b) Assign, transfer, dispose of, or encumber any personal property of the project, including rents, or pay out any funds except from surplus cash, except for reasonable operating expenses and necessary repairs...
>
> (e) Make, or receive and retain, any distribution of assets or any income of any kind of the project except surplus cash and except on the following conditions:
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> (1) All distributions shall be made only as of and after the end of a semiannual or annual fiscal period, and only as permitted by the law of the applicable jurisdiction;

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[5]The Government makes the same argument regarding a $199,890 disbursement by Westgreen to Amrecorp in June of 1990 which was the subject of a motion to amend the Complaint filed by the Government in August of 1990. Amrecorp returned the June 1990 payment to the Project in August of 1990, thereby making the issue moot. The Government's motion to amend the Complaint was accordingly denied on August 27, 1990. Therefore, the pleadings raise no issues concerning the June 1990 disbursement, the Government's argument on brief in that regard is irrelevant, and this decision does not address the June 1990 disbursement.

> (2) No distribution shall be made from borrowed funds, prior to the completion of the project or when there is any default under this Agreement or under the note or mortgage;
>
> (3) Any distribution of any funds of the project, which the party receiving such funds is not entitled to retain hereunder, shall be held in trust separate and apart from any other funds; and
>
> (4) There shall have been compliance with all outstanding notices of requirements for proper maintenance of the project. [Gx. 3, p.2]

The Regulatory Agreement defines "distribution" as

> any withdrawal or taking of cash or any assets of the project, including the segregation of cash or assets for subsequent withdrawal within the limitations of Paragraph 6(e) hereof, and excluding payment for reasonable expenses incident to the operation and maintenance of the project. [Gx. 3, p.5]

From 1982 to June of 1989 Amrecorp incurred expenses in connection with the operation of the Westgreen Project slightly in excess of $501,800. (Gx. 28) Most of that amount was for unreimbursed payroll, management fees, and bookkeeping/computer services. Nothing in the record shows that any of these expenses were unreasonable in amount or character when incurred. Although it may be considered unreasonable for a Project in default to pay accrued reasonable expenses, a reasonable expense does not become unreasonable simply by the passage of time. *See, In re EES Lambert Associates,* 43 B.R. 689, 691 (Bkrtcy.N.D.Ill. 1964). Therefore, the June 1989 withdrawal of Project cash should not be characterized as a prohibited "distribution" within the meaning of the Regulatory Agreement. In short, the Regulatory Agreement appears on first reading to permit Westgreen's transfer of more than $200,000 to one of its owners even though Westgreen was in default on its mortgage and had no surplus cash at the time of the transfer. But that is not the end of the matter.

The June 1989 payment to Amrecorp not only reimbursed Amrecorp for accrued operating expenses, it also to the same extent reimbursed Amrecorp for some of the advances Amrecorp had made to the Project over the years. During virtually the entire period Amrecorp managed the Project, Amrecorp subsidized the operation by providing cash to pay some expenses (including the mortgage), paying some expenses outright (e.g., payroll) and providing services for which it was not paid (such as management and bookkeeping). Even after Amrecorp management decided to stop putting cash into the Project and the lender agreed to reduce the monthly mortgage payment for 30 months, Amrecorp still continued to incur some expenses on behalf of the Project for which it was not reimbursed, albeit at a markedly reduced rate. The following table summarizes, as of July 31, 1989, the advances that Amrecorp made to the Project in its capacity as a general partner and an owner of Westgreen.

Westgreen Associates
General Partner Advances

	PAYROLL/ MGMT FEE/ BKKPING/ ETC.	TAX/ INS.	EXPNS. PAID BY GENERAL PRTNRS.	MORT. PYMT.	FROM PROPTY	NET OPER. ADVANCES
1983	51,354	847	384,300	332,100	(23,439)	360,862
1984	84,160	839	574,143	489,144	(192,100)	382,043
1985	85,804	2,856	416,167	327,507	(72,445)	343,722
1986	75,874	603	159,908	83,431	(15,431)	144,477
1987	81,243		81,243		(69,500)	11,743
1988	82,370		82,370		(62,000)	20,360
1989	46,833		46,833		(253,500)	(206,667)
	507,638	5,144	1,232,181	1,744,967	(688,415)	1,056,552

This table is a slightly revised and truncated version of a table supplied by Respondent Vogds in a September 11, 1989, letter to HUD. (Gx. 25) That letter and table reveal that Respondents lumped Amrecorp's cash advances to the Project together with unreimbursed expenses, plus the value of services Amrecorp had furnished to the Project, and treated all three the same. Westgreen's accounting records confirm the content of the September 11, 1989, letter and table. In the words of counsel for Respondents, "Westgreen's General Partner Payable account (4210.000) in the Westgreen Associates' general ledger includes all cash advances made by Amrecorp to the Project in its capacity as an Owner, as well as the accrued management and bookkeeping fee earned by and payroll made by Amrecorp as the management agent for the Project. (T. 252-256.)" (Brief, p. 10) When Westgreen transferred $203,779[6] to Amrecorp in June 1989, the account for Amrecorp's advances to the Project, that is, the General Partner Payable account, was reduced by a like amount. (Rx. 19, p. 19) Therefore, when Westgreen's accountants said the purpose of the June 1989 payment was to "Paydown Advance," they meant what they said and what they said was accurate. (Gx. 23; Rx. 23, 24, 25, 26, 27, 28, 29, 30) This evidence discredits the testimony of Steve Johnson, the accountant from the accounting firm of Deloitte and Touche who prepared Amrecorp's annual audits. Mr. Johnson incorrectly testified that the June 1989

[6]In the above table, the amount of this payment is shown as $206,667 as the table is based on Gx. 28 rather than Gx. 25, which shows the amount of the payment as $203,779. The precise amount of the payment is immaterial for the purposes of this decision.

payment was not a repayment of an advance. (Tr. 357) His testimony was also undermined by language in his own 1989 audit of Westgreen operations.

> Amrecorp has made advances to the Project. During 1989, Amrecorp Realty Inc. ceased accruing interest on these advances due to the uncertainty of collecting the amounts. Accordingly, the Project incurred no interest expense on these advances during 1989. Amounts due to the owner/affiliate decreased by $208,993 during 1989, primarily due to reimbursement to the owner/affiliate of operating expenses paid by the owner/affiliate on behalf of the Project. [Gx. 24, p. 9]

There is no difference in substance between (a) a cash advance or loan from an owner that a Project uses to pay a Project operating expense, (b) an advance for expenses paid outright by the owner, or (c) an advance for services rendered to the Project by the owner that would have required contemporaneous payment by the Project if provided by an outside vendor rather than the owner. In each case, the Project receives something of economic value from the owner and incurs an obligation to pay it back. For the purposes of this case, Respondents improperly attempt to distinguish between cash advances on the one hand and advances for owner-provided services and owner-provided expense payments on the other. That is a distinction without a difference; the net effect is the same, a fact clearly manifested by Respondents' own long-standing uniform accounting treatment of these different species of advance. Not only are all three types of advance lumped together in Westgreen's accounts, Respondents treated all advances, not just cash advances, as interest-bearing loans until either 1987 or 1989.[7]

Respondents concede, as they must, that Amrecorp could not be lawfully reimbursed for cash advances. (Brief, p. 32) *See, Thompson v. United States*, 408 F.2d 1075, 1079 (8th Cir. 1969). But they contend that reimbursement of accrued operating expenses to an owner is permitted by a project in default. Even if we concede the legitimacy of Respondents' contention for purposes of argument, the record does not prove that the June 1989 payment was indeed used only to reimburse Amrecorp for accrued operating expenses. Respondent Vogds told the Government in a September 11, 1989, letter "that the funds were used to pay Amrecorp for *money* advanced to the property to meet operating obligations." (Gx. 25)(Emphasis added) Furthermore, the accounting records do not demonstrate that the June 1989 payment was used exclusively to reimburse Amrecorp for services rendered to Westgreen and for expenses incurred on behalf of Westgreen rather than for cash advances. Westgreen paid Amrecorp in 1989 for all of Amrecorp's operating expenses incurred on behalf of Westgreen, plus $203,779

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[7]The 1989 audit of Westgreen prepared by Mr. Johnson states that Amrecorp ceased accruing interest on the advances in 1989. (Gx. 24, p. 9) However, Exhibit C of Gx. 28 not only shows no interest charges on the accrued advances for 1989, but also none for 1988 and 1987 as well. In addition, that document reveals an unexplained interest credit of $34,831 in 1987 against accrued unpaid accumulated interest on the unpaid advances.

to "Paydown Advance." Advances for 1988 and 1987 totalled $20,965, none in cash.[8] That leaves more than $181,000 to be credited against previous years' advances. (Gx.28) In 1986 advances totalled $151,535, of which $75,425 was in cash, and the accounting evidence fails to reveal whether or not any part of the remaining $181,000 was credited against the 1986 cash advance. The same is true for 1985, 1984, and 1983. In any case, it makes no difference whether or not some or all of the June 1989 payment was used to repay cash advances; all advances are the same. It is as unlawful for a Project in default to reimburse (without HUD's permission) advances of owner-provided services and owner-provided expense payments as to reimburse owner-provided cash advances.

HUD Handbook 4370.2 (April, 1974) clearly and unequivocally prohibits Westgreen's June 1989 payment of $203,779 to Amrecorp while the Project was in default.

> 8. REPAYMENT OF OWNER ADVANCES.
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> ...b. If the project is current under the mortgage, advances made for reasonable and necessary operating expenses may be paid from project income without HUD approval. Project management, however, must exercise prudent judgment as to the timing of the repayment. Advances should not be repaid when the repayment would cause a delinquency or default under the mortgage or impose a financial hardship on the project.
>
> c. *If the project is delinquent under the mortgage, loans and advances made by the owner to meet necessary and reasonable operating expenses may not be repaid from project income unless written approval has been given by HUD....[Emphasis added]*

However, the Government did not demonstrate that Respondents had notice of these handbook provisions before making the payment at issue. Mr. Paul Ivanoff, Amrecorp's comptroller, testified at the hearing that he was not familiar with HUD handbooks. (Tr. 340) Mr. Steve Johnson, an audit partner with the independent accounting firm of Deloitte and Touche who did not participate in the decision to make the June 1989 payment to Amrecorp, testified that although he refers to HUD handbooks when making his annual audit of Respondents' accounts, he did not recall reading the paragraph from the handbook quoted above. (Tr. 356-357) The transmittal sheet dated April 1, 1981, in Handbook 4370.2 states, in part, that the "Area and Service Offices *should* provide all project owners and managing agents within their jurisdictions with sufficient copies of this issuance." (Emphasis added) But no Government representative testified that HUD Handbook 4370.2 was sent to Respondents or even that it was sent to all project owners and management agents in the ordinary course of business. Therefore, the record does not prove that Respondents had actual notice of the

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[8] According to Gx. 25 (the table above), advances for 1987 and 1988 totalled $32,103.

provisions of HUD Handbook 4370.2 paragraph 8 before making the June 1989 payment.

The Government mistakenly argues that in this case the handbook requirements are mandatory and have the force of law. (Tr. 341; Brief, p. 11) To support that argument the Government cites only one case: *Thorpe v. Housing Authority of Durham*, 393 U.S. 268 (1969), where the Supreme Court construed the obligations of a local housing authority to one of its tenants in an eviction proceeding. The Court held that a circular that originally supplemented and later became incorporated in HUD regulations pursuant to HUD's general rule-making powers was intended to be mandatory rather than advisory. *Thorpe* does not stand for the proposition that the provisions of HUD handbooks automatically have the force and effect of law.

Federal agencies must publish in the Federal Register all "substantive rules of law and statements of general policy adopted by the agency." (5 U.S.C. Sec. 552.)

> Except to the extent that a person has actual and timely notice of the terms thereof, a person may not in any manner be required to resort to, or be adversely affected by, a matter required to be published in the Federal Register and not so published. [5 U.S.C. Sec. 552(a)(1)]

Absent actual notice of handbook provisions, or a contract or duly promulgated regulation making HUD handbook provisions mandatory, those provisions cannot be construed as mandatory. The record does not show that HUD Handbook 4370.2 has been published in the Federal Register, or that Respondents contracted to abide by its terms, or that HUD has promulgated a regulation making its provisions mandatory. In short, Respondents cannot be sanctioned with an LDP based on a "violation" of HUD Handbook 4370.2, despite the fact that they clearly acted contrary to the prohibitory language of paragraph 8 in that handbook. Nevertheless, the LDP will be affirmed based on the Regulatory Agreement and pertinent case law.

The June 1989 payment was made with rental income that accumulated after the Project stopped making mortgage payments in October of 1988. When the owners of the property signed the Regulatory Agreement, they assigned, pledged, and mortgaged all their rights "to the rents, profits, income and charges of whatsoever sort which they may receive or be entitled to receive." (Gx. 3) Until default, Westgreen had permission to collect rents, profit, income, and charges. That permission automatically terminated upon default under the terms of the Regulatory Agreement. (Gx. 3, para. 12) Neither the Regulatory Agreement nor the Deed of Trust nor any of the cases cited by Respondents on this point provides that the assignment of rents is limited only to post-default rents after payment of operating expenses. The assignment of rents was absolute. *See, In re Garden Manor Associates*, 70 B.R. 477 (Bkrtcy.N.D.Cal. 1987) HUD may exercise its right to apply *all* Project income to discharge the mortgage loan. *See, In re EES Lambert Associates*, 43 B.R. 689, 691 (Bkrtcy.N.D.Ill. 1964).

When Westgreen took cash accumulated after default to pay Amrecorp for accrued operating expenses, the effect was to use funds in which the Government holds a security interest to pay an unsecured debt. That cannot be permitted. In the words of the 8th Circuit Court of Appeals in *Thompson v. United States*, 408 F.2d 1075 at 1080-81 (8th Cir. 1969):

> To interpret the language of the regulatory agreement to validate these withdrawals would deny the claim of the party having security in the assets of the project in favor of defaulting entrepreneurs who happened to have immediate control over the checkbook.

The purpose of all the advances Amrecorp made to Westgreen, not just the cash advances, was to sustain the Project in its infancy and keep it operating when it did not generate sufficient cash to pay all operating expenses as well as its mortgage. Respondents were motivated by a desire to protect their interests, not the interests of the Government. When confronted with the same situation, the trial court in *Thompson* said:

> While the partnership was not required to advance funds to the project, it is clear that in the absence of such advances the project would never have been able to get off the ground. The advances were made by the partnership not to protect the insurance company (the mortgagee) or the Government or to enhance the security but to promote the interests and expectations of the partners. The Government never guaranteed the partnership that the...operation would be successful or profitable, and the Government never assumed the risk of loss should the project fail, except that the Government was willing to insure a loan which had for its security only the property itself, there being no personal recourse against the borrower.

Thompson v. United States, 272 F.Supp 774, 787 (E.D.Ark. 1967), *aff'd*, 408 F.2d 1075 (8th Cir 1969), quoted in *United States v. American Nat. Bank & Trust Co.*, 573 F.Supp. 1319 (N.D. Ill. 1983). In the instant case, Amrecorp is the manager and an owner of the Project that risked making unsecured advances to the Project in an attempt to increase the Project's chances of success. The Project failed. As a result, counting interest, Amrecorp now stands as an unsecured creditor of the Project in the amount of more than $1,700,000, including the $203,779 in dispute. As for the Government, it is now faced with an insurance claim in excess of $3,800,000, and stands as a secured creditor of the Project. The Government's lien on Project assets is superior to Amrecorp's unsecured claim. If the property is foreclosed, Respondents will suffer large losses. Their attempt to reduce their losses on the Project at Government expense is understandable, but unlawful.

In sum, Westgreen's June 1989 payment of $203,779 to Amrecorp violated the assignment of rents provisions in the Regulatory Agreement and Deed of Trust as well as case law prohibiting reimbursement of owner advances by a defaulting Project subject

to a Regulatory Agreement. Those violations constitute an attack on the public fisc, are serious, and establish cause for issuance of an LDP against Respondents under 24 C.F.R. Sec. 24.705(a)(2),(4), and (9).

Westgreen's Failure to Make Mortgage Payments

The Government contends Westgreen's failure to make mortgage payments is grounds for an LDP. By defaulting on the Note and Deed of Trust, Westgreen unquestionably has failed to "honor contractual obligations or to proceed in accordance with contract specifications" in violation of 24 C.F.R. Sec. 24.705(a)(4), thereby giving cause for HUD to issue an LDP. However, the decision to issue an LDP is discretionary, not mandatory. *See*, 24 C.F.R. Sec. 24.700. Mitigating circumstances must be considered. There is no evidence in the record that the default was caused by anything but an unexpectedly poor local economy, nor is the default tainted by any indications of bad faith or malfeasance on the part of Respondents. On the contrary, the evidence shows Respondents went to considerable lengths and considerable expense to avoid default. Amrecorp advanced the Project more than $1,260,000, negotiated one work-out agreement with the lender and attempted to negotiate another. Furthermore, despite the fact that the language of the regulations is broad enough to permit issuance of an LDP based on a mortgage default, the Government cites no case wherein the Department has done so. Mitigating circumstances in this case argue against it. I therefore decline to affirm the LDP issued against Respondents based on the mortgage default.[9]

The 1987 Alleged Distribution of $29,866 to Amrecorp

In 1987 Amrecorp forgave a portion ($34,831) of the interest due from Westgreen on advances Amrecorp had made to Westgreen. When combined with the 1987 advance to Westgreen of $4,965, the net result was a decrease of $29,866 in the total amount Westgreen owed Amrecorp from $1,704,494 to $1,674,628. (Gx. 28, Exhibit C) The transaction benefited the Project, and no cash changed hands, yet the Department inexplicably and mistakenly argues this transaction constituted an unlawful distribution of Project assets to Amrecorp. The evidence suggests the Department's argument rests on an unfamiliarity with the basic principles of accounting.[10]

The 1987 Payment of $1,291 in Partnership Expenses by the Project

Both the Government and Respondents agree that in 1987 Westgreen improperly paid $1,291 to Deloitte & Touche for preparation of a tax return for the owner partners.

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[9]This disposition of the mortgage default issue obviates a discussion of Respondents' contention that HUD contractually agreed not to pursue an LDP based on a default. (Brief, p. 33)

[10]The record does not reveal why Amrecorp forgave Westgreen this small portion of the interest which had accrued to more than $450,000 by 1987. In any event, the Department has not suggested there was anything wrong with Amrecorp forgiving Westgreen from paying a part of the interest it owed Amrecorp.

By check dated June 16, 1990, Amrecorp repaid this amount to Westgreen. (Tr. 313-315; Rx. 38) If Amrecorp had failed to reimburse the Project for this unlawful distribution, it would have thereby created cause for issuance of an LDP by HUD. However, Amrecorp paid the money back, rendering the issue moot.

Failure to File Timely and Complete Annual and Monthly Reports

The Department complains that Respondents did not timely file their annual financial reports for 1983 through 1986, and that certain monthly reports were not timely or completely submitted. Respondents essentially admit the charges, but they argue as to the annual reports that the Government has waived its right to complain by waiting so many years to do anything about it. And as to the monthly reports, Respondents argue that filing a handful of monthly reports several days late and one monthly report that was inadvertently unsigned, does not make Respondents unworthy of continuing in HUD programs. These arguments are only partly sound, because no statute of limitations applies to this case, and despite Respondents' argument to the contrary, the Government has not waived its right to take action concerning the untimely filed annual reports. Nevertheless, the Department's complaints regarding the annual and monthly reports have all the earmarks of unnecessary, makeweight charges. To be sure, these complaints may technically satisfy the requirements of cause to issue an LDP, but they are not sufficiently serious, standing alone, to justify a 12-month LDP.

Conclusion and Determination

Upon consideration of the entire record in this matter, I conclude and determine that good cause exists to affirm the imposition upon each of the Respondents of a twelve-month Limited Denial of Participation by the Regional Administrator of the Department in Fort Worth, Texas, on December 26 and December 27, 1989.

Thomas C. Heinz

THOMAS C. HEINZ
Administrative Law Judge

Dated: February 8, 1991