



The Commonwealth of Massachusetts
Office of the Inspector General

GREGORY W. SULLIVAN
INSPECTOR GENERAL

JOHN W. MCCORMACK
STATE OFFICE BUILDING
ONE ASHBURTON PLACE
ROOM 1311
BOSTON, MA 02108
TEL: (617) 727-8140
FAX: (617) 723-2334

November 13, 2006

Mr. Dean J. Mazzarella
Mayor, City of Leominster
City Hall
25 West Street
Leominster, MA 01453

Subject: Chapter 40B Developer Profits – Lancaster Estates, LLC

Dear Mayor Mazzarella:

In order to determine the effectiveness of the Chapter 40B cost certification oversight process and to ensure the reasonableness and accuracy of reported developer profits the Office of the Inspector General selected a sample of 10 completed home ownership developments initiated under provisions of the Chapter 40B legislation for detailed review and analysis. Included in this sample was the Lancaster Estates project at Lancaster Street/Route 117 in Leominster which was developed by Lancaster Estates, LLC. Highlighted below are our findings based on this review of the Lancaster Estates development. We hope this information is useful to the city of Leominster in planning and implementing future 40B housing developments. We plan to use the results of this audit along with the results from the other nine audits in order to identify opportunities for improving the Chapter 40B oversight process which in turn should help affordable housing initiatives throughout the commonwealth.

This Office contracted with the certified public accounting firm of Melanson Heath & Company, PC (Melanson) to perform the necessary agreed upon audit procedures. These detailed audit procedures were focused on verifying the income and expenses reported by the developers through the financial cost certifications submitted by them to the monitoring agents. The expenses claimed by the developers were reviewed by Melanson for conformity to guidelines prescribed by the Citizens' Housing and Planning Association (CHAPA), the monitoring agent for the Lancaster Estates project. Other guidelines from applicable subsidy programs and state agencies which help finance affordable housing developments were also consulted. A copy of the Melanson report for the Lancaster Estates audit is enclosed for your review and use.

In July 2001 the First Massachusetts Bank, N.A. issued a Project Eligibility Letter (or Site Approval) for the Lancaster Estates Chapter 40B housing development. The letter also indicated that the project was eligible for financing under the New England Fund Program of The Federal Home Loan Bank of Boston. The Zoning Board of Appeals (ZBA) for the city of Leominster granted approval for the development in June 2002 and by mid October 2003 all 50 housing units were built and sold by the developer. Joseph F. A. Grammel, CPA performed an audit of the project's financial statements on behalf of the developer. The accountant's report was dated in June 2004. This financial report was submitted by the developer to CHAPA, the monitoring agent. CHAPA completed the cost certification and submitted its report to the city in March 2005.

The financial statements provided by the developer to CHAPA reflected total development costs of \$8,200,399 and an associated project loss of \$6,308. The CHAPA cost certification identified concerns regarding the land acquisition price since there was no land appraisal available to ensure that the acquisition price did not exceed the highest and best value under existing zoning without a comprehensive permit in place. The appraisal which was provided reflected a post permitted value for the site. CHAPA performed alternative analysis of the data and determined that inclusion of the full cost of the land (\$1,400,000) as profit rather than a project cost in the calculation of allowable profit rendered a revised profit figure of 20.49%. As noted in the CHAPA cost certification, the revised figure exceeds the range of acceptable profit for comparable programs and the amount identified in the regulatory agreement. The CHAPA cost certification goes on to explain that *"If appraisal data indicating a pre-comprehensive permit value were available, it would appear unlikely that this would reflect a finding of no land value as is represented by the 20.49% figure. Instead, it is likely that some portion of the acquisition could be supported by pre-permitted values. In this case, any pre-permitted value in excess of approximately \$30,000 would be sufficient to limit total profits to less than 20%. Therefore, further review of the pre-permitting acquisition value may not be warranted."* The CHAPA cost certification did not highlight any other proposed adjustments.

Our investigation documented results similar to the CHAPA certification. The Melanson audit report identified adjustments which reduced project expenses and therefore increased profits by a total of \$1,039,950. The effect of these adjustments is to increase the profit percentage to 14.44% from the developer reported loss of -0.08%. These adjusted profits are below the 20% profit limit and therefore no excess profits are available for distribution to the town.

The total adjustment of \$1,039,950 is comprised of two elements. The land acquisition cost adjustment of \$1,038,200 is by far the largest component. This will be discussed in more detail below. The remaining \$1,750 adjustment is for costs that were not related to the Lancaster Estates project and should not have been included in the project financials.

The developer for Lancaster Estates should be commended. Melanson indicated to this Office that the books and records of the developer were well kept and complete. Aside from the land issue, which is more of a policy concern regarding the selling and transferring of land and the associated comprehensive permit, there were no other substantive cost issues with this development. At a macro level the per unit construction costs for this development were lower than the other developments audited. Although much of the construction was done through related entities, the profit, overhead and general requirements paid to these related parties totaled only 9% of the adjusted hard construction costs. This compares favorably with many of the other developers where we are seeing related party overhead, general conditions and profit charges well in excess of the generous 14% CHAPA guideline amount. The sales commissions and marketing costs associated with the Lancaster Estates market unit sales represented approximately 1% of the total market unit sales. This is the lowest sales and marketing expense we have noted for any of the projects audited to date. These competitive development costs help enable the expansion of affordable housing efforts.

As was highlighted in both the CHAPA cost certification and the Melanson audit report there was no independent appraisal available for the land prior to the issuance of the comprehensive permit. The comprehensive permit for this project was originally granted by the Leominster ZBA to 117 Lancaster Street Realty, LLC in June 2002. Mr. Jay Casey, the principal of the 117 Lancaster Street Realty, LLC filed the original comprehensive permit application in August 2001. The application indicated that the land which was to be developed was owned by Mr. Casey and would be transferred by him in his individual capacity to the LLC. The pro forma financials which were submitted with the application did not reflect any land value. There was a subsequent financial analysis which reflected an estimated land value of \$100,000. Two months after obtaining the comprehensive permit, Mr. Casey executed a purchase and sales agreement for the land with the Lancaster Estates, LLC for \$1,300,000. The agreement contained a clause stipulating that the purchase was contingent upon Lancaster Estates, LLC receiving approval from the Leominster ZBA to transfer the existing comprehensive permit issued to Mr. Casey on June 24, 2002, to Lancaster Estates, LLC. The ZBA approved this transfer on October 2, 2002 and the land sale was finalized on December 19, 2002. In addition to the \$1,300,000 paid to Mr. Casey, Lancaster Estates, LLC paid \$90,000 in brokerage fees and \$10,000 for a landscape easement, bringing the total reported land cost to Lancaster Estates, LLC up to \$1,400,000. Given that this sale was not based on the "As-Is Market Value" and given the lack of a pre-permit appraised value, Melanson reduced the reported land cost for this project by \$1,038,200 to the fiscal 2003 assessed value of \$261,800 plus the \$100,000 in additional costs highlighted above.

As was reflected above, even with this significant land acquisition cost adjustment, the Lancaster Estates project profits are still below the 20% guideline and therefore no excess profits are available to the city for use in other affordable housing initiatives. However based on this review, this Office makes the following recommendations in order to help the city protect its affordable housing development interests in future 40B projects:

- Developers should now be submitting land appraisals with their comprehensive permit applications. These appraisals should reflect the allowable acquisition value of the site which is the fair market value of the site excluding any value relating to the possible issuance of a comprehensive permit (the As-Is Market Value). The city should validate these appraisals against the most current real estate tax assessments for the site. Any differences in value greater than 5% should be investigated and resolved. Related party land transactions and the selling/transfer of land/comprehensive permits need special scrutiny.
- The city should review in detail any future comprehensive permit transfer requests. Financial transactions associated with these transfers should be analyzed to ensure that profiteering does not take place at the expense of the city, its taxpayers and future affordable housing initiatives. The city and the “new” developer need to have a documented agreement (amended comprehensive permit and regulatory agreement) before the authorization to transfer the permit is effected. The agreement should specify what portions of these transfer costs will be considered allowable costs for computing the project’s excess profit.
- As part of the comprehensive permit application process, the developers should identify all related party activities including any financing arrangements. For these related party arrangements it is incumbent upon the city to understand the breakout of expected related party expenditures (direct versus indirect costs). Since these related party transactions are entered into without the benefit of a competitive bidding process and since higher development costs provide an opportunity/incentive for higher profits to be retained by a developer as opposed to being made available to the city for additional affordable housing initiatives it is imperative that the city understand these related costs including the associated overhead, general conditions and profit built into these relationships. The city should negotiate with the developer reasonable related party costs which will be included in the project’s allowable costs and these agreements should be memorialized in the comprehensive permit and the regulatory agreement.
- The city should consider inserting itself in the cost monitoring process for the project and may even want to assume the role of monitoring agent. The city should be a party to the selection process for the public accounting firm which will perform the detailed cost certification audit and should also review the audit procedures to be performed in order to ensure that all concerns are addressed through the audit. These arrangements should be incorporated in both the comprehensive permit and the regulatory agreement.
- The city should ensure that included in the project agreements (comprehensive permit and regulatory agreement) are the requirements for a timely cost certification process. Looking specifically at the Lancaster Estates project, the CHAPA cost certification report was issued to the city 17 months after the last unit was sold in the development. This compares with a total of only 12 months

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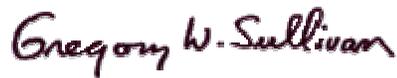
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for the project development, construction, marketing and sales cycles after ZBA approval for the comprehensive permit. The city and developer should agree to a reasonable timeframe for the developer to provide his financial statements to the monitoring agent. Consideration should be given to the assessment of reasonable penalties and the accrual of interest on any excess profits for late submissions.

- In order to guarantee project completion according to the agreed upon plans and also to protect the city's interest in potential excess profits, consideration should be given to requiring the developer to post adequate bonds or other forms of security. These arrangements should be clearly articulated in the comprehensive permit and the regulatory agreement.

I would be happy to arrange a meeting with you in order to discuss these findings and recommendations in more detail. If you have any questions or concerns, or if I can be of other assistance, please do not hesitate to call me.

Sincerely,



Gregory W. Sullivan
Inspector General

Enclosures

Cc: Mr. Eric Sullender
Mr. Aaron Gornstein
Mr. Thomas Gleason