



The Commonwealth of Massachusetts
Office of the Inspector General

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February 1, 2007

Ms. Julie E. Taylor
Chairwoman, Board of Selectmen
Town of Berkley
One North Main Street
Berkley, MA 02779

Ms. Carolyn Awalt
Town Clerk - Treasurer
Town of Berkley
One North Main Street
Berkley, MA 02779

Subject: Chapter 40B Developer Profits – Meridian at Padelford, Inc.

Dear Chairwoman Taylor and Clerk/Treasurer Awalt:

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 Preserve at Padelford Woods project at Parson's Walk in Berkley which was developed by Meridian at Padelford, Inc. Highlighted below are our findings and recommendations based on this review of the Preserve at Padelford Woods development. We hope this information is useful to the town of Berkley (town) 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 Preserve at Padelford Woods 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 Preserve at Padelford Woods audit is enclosed for your review and use. A copy of this audit report was already previously provided to the developer (Rod Mitchell). On January 5, 2007, Mr. Mitchell indicated to this Office that he strongly disagreed with our audit findings and that he would respond in detail once his consultants and accountant had time to study the report. This Office delayed publication of this report to the town in anticipation of receiving these comments by January 19th. This target date was subsequently extended to January 26th. On January 29th this Office notified Mr. Mitchell that we would not delay publication beyond the end of January. We will share with the town any detail responses to this audit which we receive in the future from the developer.

In November 1999, the Norwood Cooperative Bank issued a Project Eligibility Letter (or Site Approval) to Mr. Paul E. Cusson (as managing member of Delphic Associates, LLC) for “Padelford Estates”; a forty-three (43) unit Chapter 40B housing development in Berkley, MA. The letter also indicated that the bank believed the project was eligible for financing under the New England Fund. In May 2000, the Zoning Board of Appeals (ZBA) for the town granted approval for the development through the issuance of a comprehensive permit to Delphic Associates, LLC (Delphic). In October 2000, Mr. Cusson introduced to the ZBA a new developer for the project “Meridian at Padelford, Inc” (Meridian). In essence, the comprehensive permit was transferred from Delphic Associates, LLC to Meridian at Padelford, Inc. By early November 2003, all 43 housing units were built and sold by the new developer. The certified public accounting firm of Hichar & Luca, Inc. performed an audit of the project’s financial statements on behalf of the developer. The accountant’s report was dated in November 2003. This financial report was submitted by the developer to CHAPA, the monitoring agent. CHAPA completed the cost certification and submitted its report to the town in June 2004.

CHAPA Review:

The financial statements provided by the developer to CHAPA reflected total development costs of \$10,109,440 and an associated profit of \$677,955 or 6.71% of total development costs. The CHAPA cost certification noted that the land acquisition price for this transaction was \$875,000 and that an appraisal reflecting the highest and best use for this site without the comprehensive permit was reviewed and that this appraisal reflected a value \$55,000 above the acquisition price indicated in the developer’s financials. The CHAPA report went on to state that *“since the acquisition amount was below the appraisal no further review of the acquisition amount was warranted”*. The cost certification also focused on certain related party transactions. Identified in the certification report was \$1,061,961 of costs which could be classified as general conditions, overhead, or profit paid to the general contractor which was a related party to the developer. The CHAPA report indicated that these costs equaled 12.7% of the total construction costs. This report went on to state that *“this percentage of profit appears below the maximum related party standard of 14% imposed by*

comparable programs at MassHousing and DHCD and appears within the range of what one would expect to pay to a third party contractor in performing these tasks". In order to provide a more conservative analysis, the CHAPA cost certification report included these related party costs as profit rather than as an allowable cost. The cost certification indicated that even with these costs shown as profit, the overall profit for the project is 16.13% which falls below the 20% maximum. In summary, the CHAPA cost certification found no issues relating to compliance with applicable dividend limitations to warrant further review.

OIG/Melanson Review:

In contrast to the CHAPA review, our investigation highlighted significant cost adjustments, especially with respect to land valuation and related party transactions, which result in excess development profits. The enclosed Melanson audit report identifies a net reduction to the developer reported total project expenses of \$1,421,515. This reduction in development costs results in an offsetting increase to the net profit for the development. The project's adjusted profit as a percentage of total development costs is calculated by Melanson at 24.17% versus 6.71% originally reported by the developer. The resulting excess profit for the development is determined as \$361,885 versus the zero excess profit previously submitted by the developer.

The cost adjustments (\$1,421,515) detailed in the Melanson report include a reduction to the land acquisition cost of \$667,200; a reduction of \$665,897 attributed to related party overhead/general conditions/profit in excess of the prescribed 14% guideline; and, a reduction of \$61,572 related to affordable unit marketing and lottery costs in excess of maximum guideline amounts. These three adjustments are discussed in detail below. The remaining adjustments highlighted in the Melanson report total \$26,846 and primarily represent costs for which supporting documentation was either insufficient or missing completely.

Comprehensive Permit Transfer:

As was stated earlier, Mr. Cusson of Delphic obtained the comprehensive permit from the Zoning Board of Appeals (ZBA) for the construction of 43 housing units on the south side of Padelford Street in Berkley, MA. In October 2000, Mr. Cusson introduced Meridian to the ZBA as the new developer of the Padelford Estates project. Although Delphic would not be the developer, Mr. Cusson indicated that he would remain as part of the development team and would be responsible for issues relating to the affordable homes. Mr. Cusson also informed the ZBA that Meridian had decided not to use Norwood Cooperative Bank but would secure their financing from the Community Bank. Aside from these changes, Mr. Cusson stated that all other aspects of the original application would remain the same.

Included as part of the comprehensive permit application package submitted by Mr. Cusson to the Berkley ZBA were; credentials for Mr. Cusson/Delphic, a project

financial pro forma, and a purchase and sale agreement demonstrating site control. As reflected on the Delphic website: Mr. Cusson the managing member of Delphic; is a consultant and developer with over 25 years of experience with M.G.L. c. 40B developments. Mr. Cusson is the author and publisher of the “Resources Reference Library” of the Housing Appeals Committee decisions and is also the Co-Author of CHAPA’s Standard Lottery Procedures. The CHAPA website reflects Delphic and Mr. Cusson in its consultant directory. The CHAPA website also references and provides a direct link to the Delphic website.

The pro forma financials, submitted by Mr. Cusson, reflected the following: total project sales of \$6,749,000; total project development costs of \$5,833,871; and, total project profit of \$915,129 (15.69% of total development costs). A land acquisition cost of \$375,000 was documented in the pro forma financials. Site control was demonstrated through an executed purchase and sale agreement between Pine Hill Park, the seller and Delphic the buyer. The purchase price reflected in the purchase and sale agreement was \$375,000 which was consistent with the amount reflected in the pro forma financials. The purchase and sale agreement also stipulated that the purchase was subject to the buyer obtaining all development approvals from the town of Berkley for a single family subdivision of not less than 25 house lots. The agreement also provided that should approval for the site be less than 25 lots, then the purchase price would be adjusted downward on a pro-rata basis.

In November 2000, approximately two (2) weeks after Mr. Cusson notified the town that Meridian would be the developer as opposed to Delphic; Meridian purchased the land from Pine Hill Park for the prescribed \$375,000. The following month Meridian paid Delphic \$500,000 in order to purchase the contract rights to the purchase and sale agreement between Delphic and Pine Hill Park and the contract rights to the comprehensive permit which the town had issued to Delphic in May 2000. Eventually when Meridian completed the project and submitted its cost certification to the monitoring agent (CHAPA), the acquisition cost for the land was reflected as \$875,000 (\$375,000 + \$500,000).

Land Valuation:

This Office finds it troubling that the transfer/sale of the comprehensive permit and the purchase and sale agreement is not mentioned anywhere in either the “independent” audit or the CHAPA review. The CHAPA report indicated that an appraisal reflecting the highest and best use for this site without the comprehensive permit was reviewed and that this appraised value of \$930,000 was \$55,000 above the reported acquisition price. The CHAPA report concluded that no further review of the acquisition price was warranted since the acquisition price of \$875,000 was below the appraisal. Melanson also reviewed the retrospective appraisal report issued by Saben & Associates. According to the appraisal report, the estimated value of \$930,000 was based on a “hypothetical 27 lot subdivision”. This is clearly not an appraisal based on the as-is fair market value without a comprehensive permit. This Office obtained from

the town the following building densities based on the then existing zoning for this parcel. *“Five (5) house lots would have been allowed in order to be in full compliance with the Town of Berkley’s Zoning Regulations. Had the owner been able to obtain a waiver from the Planning Board Regulation of the 500’ roadway an estimate of seven to nine house lots would have been allowed. Had the owner been able to obtain permits to utilize an existing street in the rear of the parcel for frontage, the estimate is that twelve (12) house lots would have been allowed.”*

Given that the original purchase and sale agreement price of \$375,000 was contingent on a build-out in excess of existing zoning as well as the fact that the incremental \$500,000 paid to Delphic was actually for the transfer of contractual rights to the comprehensive permit, Melanson adjusted the allowable land value down by \$667,200 to the 2000 tax assessed value of \$207,800. We believe this to be a fair representation of the as-is fair market value under then existing zoning. As a separate check this Office compared this valuation against the arm’s length purchase price articulated in the executed purchase and sale agreement between Delphic and Pine Hill Park. Assuming the approved maximum site density under existing zoning was the 12 units identified above (with the waiver and permit in place) then the purchase price which would have been paid under the purchase and sale agreement would have been the agreed upon pro rata amount determined as 48% (12/25) of \$375,000 or \$180,000.

Related Party Transactions:

CHAPA and Melanson both identified that Meridian Real Estate Services, Inc. (MRESI), the general contractor for the project, is a related party to the developer. The CHAPA review identified that \$1,061,961 of costs paid to MRESI could be classified as general contractor general conditions, overhead or profit and that this related party general contractor payment represented approximately 12.7% of the total construction costs. In comparison, the Melanson audit identified a total of \$1,653,324 in general conditions, overhead or profit paid to MRESI. The principal difference between the Melanson audit and the CHAPA review was that Melanson identified \$619,422 in charges which represented a 10% profit tacked on by MRESI to billings submitted by various subcontractors on the project. These payments to MRESI were not reflected in the CHAPA review. Based on this related party payment of \$1,653,324, Melanson calculated a 23.4 percent rate on total adjusted construction costs which exceeded the guideline rate of 14% by \$665,897. This difference is included as an adjustment in the Melanson audit report. The fact that Melanson was able to identify such a significant amount of related party payments than what had been reported through the cost certification process is extremely disconcerting. A simple comparison of the original pro forma to the cost certification financials would have raised “red flags” regarding these sensitive related party transactions along with other development costs.

Marketing and Lottery Fees:

Melanson identified that Meridian paid a total of \$120,972 in sales and marketing fees for the affordable units. All of this was paid to Delphic, the original applicant of the comprehensive permit. Melanson reviewed these payments against the Massachusetts Housing Partnership (MHP) guidelines of November 2005 which provide that the fee for marketing and lottery costs for affordable units should not exceed the greater of \$20,000, or 3% of the sum of actual affordable unit sales prices. Based on these MHP guidelines, Melanson determined that the fee for these services should not exceed \$59,400. As a result of this analysis, Melanson recorded an adjustment of \$61,572 for the excess affordable unit marketing and lottery costs paid to Delphic.

The CHAPA monitoring guidelines in effect during the Padelford Estates cost certification did not specifically address limits to affordable unit marketing and lottery costs. The MHP guidelines used by this Office as part of our investigation were published subsequent to the Padelford Estates cost certification. Although clear monitoring guidelines regarding these affordable marketing and lottery costs were not articulated at the time of the CHAPA review, the magnitude of these fees paid to Delphic for the Padelford Estates project are not only inconsistent but are clearly excessive when compared against similar payments we have seen for the other developments we have audited. The Preserve at Padelford Woods represents the fifth Chapter 40B cost certification audit performed by this Office. The affordable unit marketing and lottery costs for the Padelford project are approximately \$50,000 higher than the total for the other four projects combined. Once again, a basic comparison of the cost certification amount to the pro forma would have made this discrepancy obvious as the sales and marketing costs are approximately \$130,000 higher in the cost certification than in the pro forma financials.

Cost Certification Process Failures:

The cost certification process for the Padelford Estates development failed to provide a reasonable level of professional skepticism and oversight, which one should expect in an audit process. Basic analytical procedures were not evident. This Office found no mention of the transfer of the comprehensive permit in either the “independent” auditor’s report nor in the CHAPA cost certification review. A simple comparison between the original pro forma financials submitted by Mr. Cusson to the town and the financials submitted by Meridian at the end of the project would have (and should have) raised some fundamental questions.

As part of the transfer of the comprehensive permit, Mr. Cusson had indicated to the town that, aside from the developer change and bank financing, all other aspects of the original application would remain the same. A comparison of the two financial documents would have demonstrated significant discrepancies which should have led to detailed inquiries and follow-up. The actual sales for the project were more than \$4,000,000 or approximately 60% higher than originally estimated by Mr. Cusson. It is

not clear what caused such a dramatic increase in sale's revenue for the Padelford Estates project, however this Office understands that there may be developers who will intentionally understate their pro forma financials in order to make it easier to demonstrate that their projects are "uneconomic" if conditions are to be imposed on their development by the local municipality. Regardless of the cause, such a significant difference in revenue begs for independent scrutiny and inquiry as part of the cost certification process.

The total development costs reported through the cost certification process are approximately \$4,300,000 or 73% greater than amounts reflected in the pro forma financials. Higher reported development costs allow an unsupervised developer to extract additional profits above and beyond agreed upon limits. The significant differences in the various cost categories should have raised legitimate cause for concern and inquiry. Line item expense examples between the cost certification report and the original pro forma include the land value of \$875,000 versus \$375,000; management and admin expense of \$623,163 versus \$67,490; and sales and marketing costs of \$471,300 versus \$337,450.

As indicated above, Melanson identified payments made to Delphic by Meridian totaling \$620,972 (\$500,000 for sale of contract rights and \$120,972 for affordable unit marketing and lottery fees). None of these expense payments to Delphic were reflected in the pro forma financials originally submitted to the town as part of the comprehensive permit application, nor did we find any evidence that these changes were communicated to the town when the permit was transferred from Delphic to Meridian. These unexpected and excessive payments to an affordable housing "consultant" who originally held himself out as the developer appear to run counter to cost effective affordable housing initiatives. These unanticipated payments to Delphic could have instead been used to provide for additional affordable housing opportunities within the development. If these payments to Delphic had instead been used to buy down market rate units to affordable levels, at least nine additional affordable housing units could have been created. This would almost have doubled the affordability level for the development.

Recommendations:

Given the significant difference (+259%) in project profits highlighted through the Melanson report (24.17% of total development costs) versus the profit as reported by the developer in his cost certification (6.71% of total development costs) this Office makes the following recommendations in order to protect the interests of the town in future 40B developments:

- Before issuing a comprehensive permit, the town should validate the allowable acquisition value of the site against pertinent land appraisal(s). The allowable acquisition value should not exceed the as-is fair market value of the site under

existing zoning and without the benefit of the comprehensive permit. The appraisals should be compared 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.

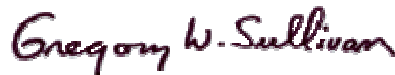
- The town should document and review in detail any future comprehensive permit transfer requests. Financial transactions associated with these transfers should be analyzed to ensure that profiteering does not take place at the expense of the town, its taxpayers and future affordable housing initiatives. To facilitate such analysis, the town and the “new” developer should be required to have a documented agreement (amended comprehensive permit and regulatory agreement) before the authorization to transfer the permit is granted. The agreement should specify what portions of these transfer costs will be considered allowable costs for computing the project’s excess profit. Potential allowable transfer costs may include payments for services (such as architectural plans, surveys, permit fees, etc.) incurred by the original applicant but which will benefit the “new” developer as part of the project’s continuation. The developer should provide detail support to the town for these transfer costs.
- 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 town 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 higher development costs provide an opportunity/incentive for higher profits to be retained by a developer as opposed to being made available to the town for additional affordable housing initiatives, it is imperative that the town understand these related party costs. This includes understanding the associated overhead, general conditions and profit built into these relationships. The town should negotiate with the developer reasonable related party costs which will be included in the projects allowable costs and these agreements should be memorialized in the comprehensive permit and the regulatory agreement.
- The town should consider inserting itself in the cost monitoring process for the project and may even want to assume the role of monitoring agent. The town also should be a party to the selection process for the public accounting firm which will perform the detailed cost certification audit and should review the audit procedures to be performed in order to ensure that all concerns are addressed through the audit. These procedures should include review and comparison of income and expense categories reported in the cost certification to the original estimates reflected in the pro forma financials. Explanations for any material differences should be obtained from the developer and independently verified by

the auditor. All these arrangements should be incorporated in both the comprehensive permit and the regulatory agreement.

- In order to help guarantee responsible project unit revenue sales estimates, the town should consider imposing conditions through the comprehensive permit and the regulatory agreement that would allow the town to retain or share in the sales revenues above the pro forma estimates.
- In addition to gaining an understanding of the related parties (and associated costs) which will be involved in any future Chapter 40B development, the town should also be aware of all planned consultant activities. This understanding should be developed as part of the comprehensive permit process. The town, possibly through an affordable housing committee, local housing authority, or other local entity, should consider assuming some of the consultant duties, such as marketing and lottery agent for the affordable units. Various state agencies have recently adopted guidelines which provide opportunity for liberal financial reward to Chapter 40B consultants. If the town serves in any of these capacities, it will be able to use this generous income to help create additional affordable housing opportunities than would otherwise be possible.
- In order to help guarantee project completion according to the agreed upon plans and also to protect the town'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.

We 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 we can be of other assistance, please do not hesitate to call me.

Sincerely,



Gregory W. Sullivan
Inspector General

Enclosures

CC: Ms. Patricia M. Mitchell, Meridian at Padelford, Inc.
Mr. Rod Mitchell, Meridian at Padelford, Inc.
Mr. Aaron Gornstein, Executive Director, CHAPA
Mr. Thomas Gleason, Executive Director, MassHousing
Ms. Tina Brooks, Undersecretary, DHCD
Mr. Steven Bachand, Chairman, Berkley Zoning Board of Appeals