



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) 727-9140
FAX: (617) 723-2334

March 5, 2007

Mr. John F. Carney
Chairman, Board of Selectmen
William J. Lee Memorial Town Hall
One Lafayette Street
Wakefield, MA 01880

Mr. Thomas Butler
Town Administrator
William J. Lee Memorial Town Hall
One Lafayette Street
Wakefield, MA 01880

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

Dear Chairman Carney and Administrator Butler:

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 Millbrook Estates project at Millbrook Lane in Wakefield which was developed by Millbrook Estates, LLC (Raymond S. & Ronald J. Falite). Highlighted below are our findings and recommendations based on this review of the Millbrook Estates development. We hope this information is useful to the town of Wakefield (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 reported 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 Millbrook 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 Millbrook Estates audit is enclosed for your review and use. A copy of this audit report was already previously provided to the developer (Raymond S. Falite). On February 21, 2007, Mr. Falite provided his comments on this report. This correspondence is also enclosed for your reference.

In May 2000 Raymond S. Falite and Ronald J. Falite (Millbrook Estates, LLC) received a site approval or project eligibility letter from the Stoneham Savings Bank for this proposed Chapter 40B housing development in Wakefield. The letter also indicated that the project was eligible for financing under the New England Fund Program of The Federal Home Loan Bank Board. The Zoning Board of Appeals (ZBA) for the town of Wakefield granted approval for the Millbrook Estates development in May 2001 and by mid November 2003 all 40 housing units were built and sold by the developer. The firm of P.F. Bruno & Co. (Certified Public Accountants) performed an audit of the project's financial statements on behalf of the developer. The accountant's report was dated February 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 town in January 2005.

CHAPA Review:

The financial statements provided by the developer to CHAPA reflected total development costs of \$7,603,606 and an associated profit of \$943,881 or 12.41% of total development costs. The CHAPA cost certification questioned the land acquisition price of \$787,987. The CHAPA report indicated that an appraisal was examined to substantiate this price. CHAPA concluded that the appraisal reflected sufficient value to support this price, if a post comprehensive permit use was assumed. The CHAPA report opined that *“while this methodology is inconsistent with the requirements of most comparable programs, there is no regulatory guidance or case history available at this time to provide clarification on this issue for this project.”* The CHAPA report went on to state:

*“Alternative analysis of this data reflected that inclusion of the full cost of the land as profit rather than a project cost in the calculation of allowable profit rendered a revised profit figure of 25.41%. This revised figure exceeds the range of acceptable profit for comparable programs and the amount identified in the regulatory agreement. 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 25.41% figure. Instead, since this site contained multiple existing dwelling units at the time of acquisition, it is likely that a substantial portion of the acquisition could be supported by pre-permitted values. **Therefore, further review of the pre-permitting acquisition value may be warranted** (emphasis added).”*

In addition to the concerns raised regarding land valuation, the CHAPA cost certification identified and proposed adjustments for three related party transactions. These related party adjustments reduced total allowable development expenses by \$410,202. With respect to these cost adjustments, the CHAPA report stated the following: *“Assuming no adjustments for the land value and making adjustments for the separate soft cost overhead fees, excess related party general contractor profit, and for all the profit from the related party HVAC work, the revised development profit figure is 18.82%. This amount falls within the allowable cap of 20%. Therefore no further review of the related party profit issues appears to be warranted.”* In summary, the CHAPA cost certification did not identify any compliance issues with the applicable dividend limitations. Although land valuation was identified as a potential issue, no detailed pre permitting value reviews were conducted and included with the related party adjustments.

OIG/Melanson Review:

In contrast to the CHAPA review, our investigation highlighted significant adjustments, especially with respect to underreported sales revenue and related party expense transactions, which result in excess development profits. The enclosed Melanson audit report identifies an increase to the developer’s reported sales revenue of \$1,037,864 and a net reduction to total project expenses of \$719,163. The combined increase in revenue and the 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 39.23% versus 12.41% originally reported by the developer. The resulting excess profit for the development is determined as \$1,324,019 versus the zero excess profit previously submitted by the developer.

The underreported sales revenue adjustments (\$1,037,864) detailed in the Melanson report include sales of market rate units at below market rate prices (\$982,931) principally to entities related to the developers. Also included as underreported sales revenue is an adjustment for \$39,179 which is related to receipts for upgrades to various units received by the developers, but not reflected in the filed cost certification report. Another adjustment of \$15,754 included as part of the underreported sales revenue is primarily related to rental income received by the developers, which was not reflected in their cost certification report.

The project expense adjustments (\$719,163) highlighted in the Melanson report include a reduction of \$448,397 attributed to related party overhead/general conditions/profit in excess of the prescribed 14% guideline, and a reduction of \$49,912 of brokerage commissions paid to related parties in excess of the 5% guideline maximum. These two related party expense adjustments and the underreported sales revenue adjustments are discussed in detail below. The remaining adjustments highlighted in the Melanson report total \$220,854 and primarily represent costs for

which supporting documentation was not provided or for costs that were not related to this development.

Underreported Sales Revenue:

As noted above, our investigation identified significant adjustments totaling \$1,037,864 for underreported revenue associated with the Millbrook Estates development. A total of forty home ownership condominium units were developed. Ten of the units were sold to affordable buyers. The remaining thirty units were targeted to be sold at market rates. A detailed review of these market rate unit sales uncovered that 11 of these units, or more than a third of the total market rate units were sold at below market prices.

Developer-related rental units

Four of these below market priced units were sold to Millbrook Estates Realty Trust and another four were sold to Pine Tree Realty Trust. Through an investigative summons, this Office determined that both of these trusts are related to the developers. These eight units were sold to these related entities at favorable prices which Melanson calculated at \$749,523 below comparable arms length market rate unit sales. Melanson included this favorable difference in pricing as part of the underreported sales revenue adjustment. It does not appear that the town was ever notified that these units, which were intended to be homeownership opportunities, were instead purchased by developer-related trusts. The units were and continue to be held and rented out by these related trusts.

Other below market rate sale units

Another market rate unit was sold at below market price to William and Patricia Devine. This unit was sold for \$143,000. Melanson determined the average sales price for comparable units at \$281,922. The difference between the price paid by the Devine's and the average sales price for comparable units was calculated by Melanson at \$138,922 and was included as part of the underreported sales revenue adjustment. The relationship between the Devine's and the developers of Millbrook Estates is discussed in detail below. Two other market rate units were sold to Frank and Shirley Lisitano at below market rates. Melanson determined that these two units combined sold for \$94,486 less than the average sales price for comparable units. Melanson included this amount as part of the underreported sales revenue adjustment.

Other unreported revenue

Melanson identified an adjustment totaling \$39,179 for revenue received by the developers but not reported on their financial cost certification. This unreported sales revenue was related to upgrades to various housing units. Other unrecorded sales

revenue adjustments made by Melanson included: \$15,200 for rental income; \$500 for the purchase of a Maytag appliance; and \$54 for a miscellaneous condo adjustment. This revenue was received by the developers and was reflected in their general ledger, but these amounts were not reflected in the cost certification submitted by the developers to the monitoring agent.

Related cost monitoring deficiencies

This Office finds it alarming that such a significant understatement of project revenue can go undetected through the Chapter 40B cost monitoring process. The “independent” audit and the second tier review by the monitoring agent (CHAPA) made no mention of the below market sales. The fact that several units were sold at favorable pricing to a related party was never addressed through the cost certification process. There was no mention in either report that some of these home ownership units were actually being held and rented out by related developer trusts. The upgrade revenue and the rental income went undeclared through both levels of cost monitoring review. These issues underscore a broken cost monitoring process.

Land Valuation:

This Office finds it disconcerting that the CHAPA review did not perform an in-depth review of the pre-permitted acquisition value of the land. Even a slight reduction of 10% in the land value coupled with the related party adjustments identified by CHAPA would have resulted in a project with excess profits.

The following narrative will help provide a better understanding of the land valuation issue and should help the town in determining the appropriate course of action to close out this issue. The developer (Millbrook Estates, LLC) purchased two parcels of land from Aurora Devine, Trustee of Cresta Realty Trust on June 14, 2001. The first lot, consisting of land and residential rental buildings located at 363 Water Street, sold for \$535,000. The purchase and sale agreement for this parcel, executed on November 30, 1999, was contingent upon the buyer’s ability to obtain a comprehensive permit for the construction of not less than twenty (20) dwelling units upon the site. The second lot, located at 361 Water Street, consisted of land and buildings occupied at the time of sale by William and Patricia Devine. The purchase and sale agreement for this property, executed on April 14, 2000, stipulated a purchase price of \$242,000 and included several conditions. These conditions were primarily related to obtaining a housing unit in the Millbrook Estates development for William and Patricia Devine at below market price. The enclosed Melanson report provides additional details related to these unique conditions. In addition to the \$777,000 (\$535,000 and \$242,000) sale price for these two parcels, the developer paid \$10,987 in settlement costs, for a total reported land acquisition cost of \$787,987.

Based on the initial work performed by Melanson, an adjustment of \$433,800 was proposed in order to bring the reported land value amount of \$787,987 down to \$354,187 which represents the town's fiscal year 2000 assessed value plus the settlement costs identified above which are related to the purchase of the properties by the developer. This adjustment was made since as was highlighted in the CHAPA report, there was no independent appraisal available for the land prior to the issuance of the comprehensive permit and the contingencies in the purchase and sale agreements reinforced the fact that these transactions were not based on the as-is market value but rather the purchase and sale agreement was contingent on obtaining a comprehensive permit.

In an attempt to address this valuation issue, the developer provided appraisal reports dated December 4, 2006. These appraisals were completed by Brown Associates and have a retrospective effective date of December 2000. The appraised values of the 361 and 363 Water Street properties reflected in these reports are \$240,000 and \$970,000 respectively. Melanson withdrew their original land valuation adjustment of \$433,800 since the retrospective appraisals provided indicated that the total appraised value exceeded the reported land acquisition cost. This Office reviewed the new appraisals and verified the comparable pricing reflected in these reports. Based on this review we agreed with the decision made by Melanson to accept the reported land valuation of \$787,987.

However these retrospective appraisals are concerning. The appraiser could not inspect the properties since they had been razed several years earlier. The appraiser could not validate the overall condition and quality of construction of the properties, which were reported to him as average to good. The purchase price of \$535,000 for 363 Water Street along with the contingency clause for a comprehensive permit allowing at least 20 units raises serious concerns regarding the validity of the \$970,000 appraisal for this parcel. Since this Office is not in a position to validate the condition of the structures that were demolished as part of the new development, we share these concerns with the hope that they will be useful to the town which is in a better position to make these retrospective evaluations.

Related Party Overhead and Profit:

CHAPA and Melanson both identified that Falite Brothers, Inc. (Falite), the general contractor for the project, is a related party to the developer. Both CHAPA and Melanson identified \$1,048,679 of general contractor overhead and profit paid to Falite. CHAPA proposed adjustments totaling \$410,202 in order to bring these related party overhead and profit payments down from 23% of the construction costs to the guideline maximum of 14% of the total construction costs. Melanson also proposed a similar adjustment for these related party overhead and profit costs. The Melanson adjustment totaled \$448,397. This adjustment brought the related party overhead and profit charges down to 14% of the construction costs from 24.5%. The variance in cost adjustments is

related to the use of a different cost basis by CHAPA than that used by Melanson.

Related Party Brokerage Commissions:

In the cost certification, the developer reported costs totaling \$342,822 for brokerage commissions on the market rate units. Melanson reviewed these costs in detail and determined that \$128,460 of this amount was paid to various unrelated parties on the sale of thirteen market rate units. The remaining \$214,362 was paid to Falite in their capacity as the lead sales agent for the project.

The developer reported total sales revenue of \$7,331,487 for the market rate units. Included in this total was \$1,473,292 for the sale of eight market rate units to the two related party trusts discussed above. Due to the relationship between the developer and these trusts, Melanson for purposes of determining the reasonableness of the commissions paid deducted these related party sales from the total reported sales revenue to arrive at an adjusted market unit sales total of \$5,858,195. This Office supports this approach of eliminating these related party sales from the total sales base. By allowing related party commissions on related party sales, it could be viewed as an abuse since this type of transaction lacks actual business substance. Melanson then calculated 5% of this adjusted total to be \$292,910. Since this adjusted total was less than the brokerage commissions claimed by the developer in the cost certification, Melanson recorded an adjustment of \$49,912 for the excess commissions actually paid.

Melanson used the 5% commission rate recommended in the Massachusetts Housing Partnership guidelines of November 2005. This 5% rate as opposed to a 6% rate was used since there is an identity of interest between the development entity and the brokerage agency. The CHAPA monitoring guidelines in effect during this timeframe prescribed a range of commission rates between 4-6%. This Office understands that CHAPA would target the lower end of this range for related party commissions.

Cost Certification Process Failures:

The cost certification process for the Millbrook Estates development failed to provide a reasonable level of professional skepticism and oversight which one should expect in an audit process. The audited financial statements provided by the developer as part of the cost certification process lacked adequate disclosures of pertinent related party transactions. As was previously noted, entities related to the developer purchased several of the market rate units in the development at significant discounts from comparable market rate units sold to unrelated parties. The developer has an obligation to disclose all significant information appropriately in the financial statements. There was no disclosure provided in the audited financial statements that there were sales made to related parties, let alone that the sales were made at below market rates. This lack of full disclosure resulted in misleading financial statements. These misleading

financial statements shielded profits that should have been made available for expanding affordable housing initiatives in the town.

Also, as was previously noted, this Office finds it troubling that the CHAPA review did not provide an in-depth analysis of the pre-permitted land value in order to determine the validity of the land costs claimed by the developer. Land valuation is an important issue in most development projects and the municipalities deserve a comprehensive determination in order to ensure that their financial interests are recognized and protected.

In order to recover the excess profits identified in this report, the town should consider civil action proceedings against all parties involved in the Millbrook Estates development.

Recommendations:

Given the significant difference (+186%) in project profits highlighted through the Melanson report (39.23% of total development costs) versus the profit as reported by the developer in his cost certification (12.41% of total development costs) along with an excess profit determination of \$1,324,019 versus a reported excess profit of zero dollars and the still outstanding land valuation issue, this Office makes the following recommendations in order to protect the interests of the town in future 40B developments:

- The town should ensure that all market rate housing units are sold at independent arm's length market prices. Special scrutiny should be directed at any sales made to related parties including developer controlled entities or business associates such as previous land owners. This type of independent validation can be performed through a cost certification process controlled and/or focused by the town (see comment below).
- 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 address independent verification of all sales of housing units to ensure arms-length market transactions. All these arrangements should be incorporated in both the comprehensive permit and the regulatory agreement.

- 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.
- 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 ensure that included in the project agreements (comprehensive permit and regulatory agreement) are the requirements for a timely cost certification. Looking specifically at the Millbrook Estates project, the CHAPA cost certification report was issued to the town fourteen (14) months after the last unit was sold in the development. The town, the developer and the monitoring agent should agree to a reasonable timeframe for completion of this process. 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 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.

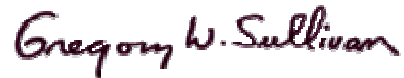
Wakefield – Millbrook Estates

March 5, 2007

Page 10 of 10

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,

A handwritten signature in black ink that reads "Gregory W. Sullivan". The signature is written in a cursive style with a prominent "G" and "S".

Gregory W. Sullivan
Inspector General

Enclosures

CC: Mr. Raymond S. Falite, Millbrook Estates, LLC
Mr. Ronald J. Falite, Millbrook Estates, LLC
Mr. Aaron Gornstein, Executive Director, CHAPA
Mr. Thomas Gleason, Executive Director, MassHousing
Ms. Tina Brooks, Undersecretary, DHCD
Mr. Michael Pierce, Chairman, Wakefield Zoning Board of Appeals

Millbrook Estates LLC.
9 Broadway
Wakefield, MA 01880
(781) 246-9320

February 21, 2007

RECEIVED

FEB 2 2007

Gregory Sullivan
Massachusetts Office of the Inspector General
John W. McCormack State Office Building
One Ashburton Place, Room 1311
Boston, MA 02108

OFFICE OF THE INSPECTOR GENERAL


Re: Millbrook Estates 40B/Wakefield

Dear Mr. Sullivan:

I am writing on behalf of Millbrook Estates LLC, in response to the letter and report you addressed to me on January 31, 2007. We would like to go on public record that we strongly disagree with the findings in your report and will follow up with a detailed response from our attorneys, Freeman, Davis & Stearns. That response will be issued to the Town of Wakefield in the near future.

We respectfully request that you include this letter with any materials you send to the Town of Wakefield and that you post this letter on your website with any other project-related documents available for public review.

Sincerely,


Raymond S. Falite