

Office of
The City Attorney
City of San Diego

MEMORANDUM
MS 59

(619) 236-6220

DATE: June 20, 2008
TO: The Honorable Mayor and City Council
FROM: City Attorney
SUBJECT: "Loans/Re-loans" of CDBG Funds to the Redevelopment Agency

Since 1978, the City has "loaned" approximately \$40 million in Community Development Block Grant [CDBG] funds to the Redevelopment Agency (which includes the City's Redevelopment Agency, the Centre City Development Corporation, and the Southeastern Economic Development Corporation), hereinafter collectively referred to as the "Agency." The City, through a series of grants, transferred these CDBG funds to the Agency for various projects involving CDBG-eligible activities, documenting these transfers accordingly.

The Agency, however, treated these transfers of CDBG funds as a series of loans, booking them as debt owed to the City, for the purpose of generating tax increment dollars in the various redevelopment project areas. Although treated as loans by the Agency, the City has no documentation showing that these transfers were loans (i.e., no contracts, no notes, no deeds of trust). To date, it is estimated that these "loans" to the Agency have grown to approximately \$150 to \$200 million in principal and interest.

Over the years, the Agency has repaid small portions of its CDBG "debt" to the City, but in doing so, has coupled the repayment with a "re-loan" back to the Agency. One reason for these "re-loans" is to maintain the level of debt on the Agency's books, in order to continue generating the maximum amount of tax increment dollars for the Agency. Another reason for these "re-loans" is to move tax increment dollars from a project area that is generating high levels of tax increment dollars to a project area that is lacking such revenue to fund a particular project in that project area. However, redevelopment law prohibits the transfer of tax increment dollars directly from one project area to another. As a result, the Agency repays the City a portion of its CDBG "debt" with tax increment dollars from Project Area A and immediately structures a "re-loan" of these same funds to Project Area B.

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Because the Agency is repaying a portion of its CDBG "debt," the funds used to repay this "debt," regardless of their source, constitute CDBG program income (as defined in 24 CFR 570.500(a)), and thus, are subject to all applicable requirements governing the use of CDBG funds. (See 24 CFR 570.504) However, due to a lack of oversight or attention by the City and the Agency, no care was taken to ensure that the funds being "re-loaned" to the Agency were spent on CDBG-eligible activities. As a result, much of the CDBG program income funds "re-loaned" to the Agency were used for ineligible activities.

On August 30, 2007, the U.S. Department of Housing and Urban Development [HUD] sent a letter to the City informing the City of the results of HUD's on-site monitoring review of the City's CDBG Program, which occurred from July 23, 2007 through July 26, 2007. In the letter, HUD informed the City that HUD had six findings and three concerns. Finding #1 stated as follows:

[W]e have determined that the City may not be fully complying with CFR 85.25. Specifically, we are concern [sic] with CDBG loans to the Redevelopment Agency and "reloans". The City must provide HUD a summary of program income for Program Years 2003, 2004, 2005, and 2006.

Corrective Action:

The City must provide us a summary of the source and use of program income as well as interest earned. Please include documentation of funds returned and established City policies.

(See Exhibit A)

On September 21, 2007, the Mayor issued a memorandum to the City Council, informing the Council that the City had received the letter from HUD, that HUD had issued six finding and three concerns with the City's CDBG Program, that one of the findings pertained to "Deficient accounting procedures related to 'Program Income' received by the City of San Diego," and that City staff has had two meetings with HUD regarding these findings and concerns to clarify the nature of the problems and explore possible remedies to the deficiencies found by the review. (See Exhibit B)

On September 26, 2007, the City sent a letter to HUD in response to HUD's August 30, 2007 letter. In its letter, the City stated:

City staff is in the process of preparing a summary of the source and use of the program income as well as interest earned and will provide this information to HUD by December 31, 2007. The City will include documentation of funds returned and established City policies in its response to HUD.

(See Exhibit C)

On November 8, 2007, HUD sent a letter to the City in response to the City's September 26, 2007 response letter. In HUD's letter, HUD notified the City that Finding #1 would remain

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open until HUD received and reviewed the City's summary of the source and use of program income as well as interest earned. (See Exhibit D)

On November 19, 2007, Economic Development staff reviewed the findings and concerns listed in HUD's August 30, 2007 letter with the Audit Committee.

On November 27, 2007, HUD Office of Inspector General [OIG] sent a letter to the City, notifying the City of OIG's intent to conduct an audit of the City's CDBG Program. In the letter, OIG explained that the overall objective of the audit was to determine whether the City complied with applicable laws, regulations, and requirements of HUD's CDBG Program. (See Exhibit E)

On December 6, 2007, January 9, 2008, and January 16, 2008, the Budget and Finance Committee accepted various recommendations made by Economic Development staff, including the following: That City staff be directed to return to the Budget and Finance Committee in the future, following the completion of the HUD audit, with a report on the Redevelopment Agency loan issue.

On January 29, 2008, the City forwarded its response to HUD regarding Finding #1, which included the following: (1) Summary of Loans and Re-Loans to Redevelopment Agency (Program Years 2003-2006); (2) Summary of CDBG Program Income Fund and backup documents; and (3) Procedures for issuance and repayment of CDBG loans and re-loans. (See Exhibit F)

On April 3, 2008, OIG sent a letter to the City, stating the following:

[W]e plan to proceed to the audit phase of the assignment. Since there were several areas of concern identified during the survey, we also plan to perform a second audit on the City of San Diego's CDBG program. The objective of both assignments are to determine whether [the City] complied with applicable CDBG requirements; however, the current assignment will focus on the addressing [sic] the complaint issues and CDBG loans with the Redevelopment Agency, while the second audit will focus on other CDBG activity.

(See Exhibit G)

Throughout the course of OIG's investigation, City staff (i.e., the Economic Development Division and Auditor's Office) have received a great number of emails from the OIG investigators, requesting City staff to provide them a variety of documents for their review. For example, on April 21, 2008, OIG sent an email to City staff requesting six types of documents (applications, agreements, Mayoral/City Manager actions, monitoring reports, direct payment requests, and CDBG Project expenses) for thirty-five "projects" (i.e., "loan/re-loan" transactions), requiring the City to provide the documents no later than April 24, 2008. (See Exhibit H) The thirty-five "loan/re-loan" transactions selected by OIG for further investigation relate to fourteen Agency projects (See Exhibit I), which according to the OIG investigators, involve approximately \$12.5 million in CDBG funds.

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On May 7, 2008, HUD sent a letter to the City in response to the City's letter dated January 29, 2008, in which HUD informed the City that Finding #1 (regarding "loans" and "reloans" to the Agency) had been cleared by HUD:

With regard to Finding #1, the City's response included documents that showed a summary of the source and use of program income as well as interest earned. The information was submitted to HUD on January 28, 2008. *This finding is cleared as of May 1, 2008.* However, please note that documentation related to this finding could be reviewed again at a future scheduled High-Risk Monitoring.

(See Exhibit J)

On June 6, 2008, OIG sent a demand letter to the City in which OIG stated:

Since the City of San Diego's CDBG officials have not responded timely to past requests for the records pertaining to this audit, this letter constitutes a formal demand for receipt of all previously and subsequently requested supporting records and documents of the City of San Diego and its Redevelopment Agency, no later than the close of business on June 27, 2008.

In the letter, OIG requested the City to provide eight types of documents (listed A through H), most of which had previously been requested by OIG. (See Exhibit K)

On June 11, 2008, the City sent OIG a letter in response to OIG's demand letter dated June 6, 2008. In its letter, the City provided OIG the status of the City's response to each of OIG's requests, indicating that as of June 11, 2008, the City had no or no further documents to provide in connection with requests A, C, D, and F, and that the City was still gathering documents in connection with requests B, E, G, and H. (See Exhibit L)

OIG intends to conclude its field investigation into the "loans/re-loans" to the Agency by the second week of July 2008, at which time, OIG will turn its attention to drafting a report documenting the results of its investigation, which is expected to be completed by September 2008. OIG will likely include the City's failure to provide various documents in its report. The City's failure to properly administer and monitor the use of CDBG funds for these "loans/re-loans" to the Agency may result in a variety of penalties to the City, including the repayment to HUD of the CDBG funds in question.

MICHAEL J. AGUIRRE, City Attorney

By


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