The Commonwealth of Massachusetts
Office of the Inspector General

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January 2, 2007

Mr. Ben Tafoya
Chairman, Board of Selectmen
Town of Reading
16 Lowell Street
Reading, MA 01867

Mr. Peter Hechenbleikner
Town Manager
Town of Reading
16 Lowell Street
Reading, MA 01867

Subject: Chapter 40B Developer Profits – 1375 Main Street Partners, LLC

Dear Chairman Tafoya and Manager Hechenbleikner:

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 Sumner Cheney project at Sumner Cheney Place in Reading which was developed by 1375 Main Street Partners, LLC. Highlighted below are our findings based on this review of the Sumner Cheney development. We hope this information is useful to the town of Reading 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 Sumner Cheney 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 Sumner Cheney audit is enclosed for your review and use. A copy of this audit

report was already previously provided to the developer (Patrick J. Wood). On December 8, 2006, Mr. Wood provided his comments on the report. This correspondence is also enclosed for your reference.

In October 2000; Middlesex Federal Savings, F.A. (Middlesex) issued a Project Eligibility Letter (or Site Approval) to Mr. Rocco Scippa (as manager of Rangeway Farms, LLC) for a Chapter 40B housing development at 1375 Main Street Reading, MA. The letter also indicated that Middlesex intended to fund the project through the New England Fund of The Federal Home Loan Bank of Boston. The Zoning Board of Appeals (ZBA) for the town of Reading granted a comprehensive permit to 1375 Main Street Realty Trust (an affiliate of Rangeway Farms, LLC) for the development of eight (8) housing units in June 2001. In January 2002 the land was sold by 1375 Main Street Realty Trust to 1375 Main Street Partners, LLC (Principal – Donald F. Van Dyne Jr.). By early October 2003 all 8 housing units were built and sold by 1375 Main Street Partners, LLC. The certified public accounting firm of Kenison & Associates performed a review (not 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 town in November 2004.

The financial statements provided by the developer to CHAPA reflected total development costs of $2,290,109 and an associated profit of $405,848 or 17.7% of total development costs. The CHAPA cost certification proposed adjustments for two related party transactions. One adjustment was to eliminate the interest paid ($29,673) on a related party loan. The other adjustment was to reduce the overhead and profit paid to a related party site contractor by $28,785. This adjustment brought the related party overhead and profit percentage from approximately 27% down to a guideline percentage of 14%. These two related party adjustments reduced allowable development costs by $58,458 to a revised total of $2,231,651 and increased the profits to an adjusted level of $464,307. The net effect of these CHAPA adjustments was that the developer exceeded the 20% profit limit by $17,976. The developer eventually paid the town for these excess profits.

In addition to the related party adjustments previously identified through the CHAPA cost certification, our investigation highlighted other cost adjustments which significantly increase the excess profits associated with this development. The enclosed Melanson audit report identifies a net reduction of $452,556 to the developer reported total project expenses. 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 46.7% versus the 17.7% originally reported by the developer. The revised excess profit for the development is determined as $490,893 versus the zero excess profit previously submitted by the developer.

The cost adjustments ($452,556) detailed in the Melanson report includes a

reduction in the land acquisition cost of $310,000 (this land valuation issue is discussed in more detail below). Similar to the CHAPA cost certification, the Melanson report highlights the related party adjustments. The adjustment for related party loan interest ($29,673) is the same in both reports. The Melanson audit reflects an adjustment of $24,541 to bring the related party overhead/profit down to 14% whereas; the CHAPA cost certification highlights a slightly higher adjustment of $28,785. This is due to differences in the cost base. Melanson proposed adjustments totaling $91,292 for claimed development costs which did not have adequate supporting documentation. Melanson also made an adjustment of $2,950 to reflect allowable development costs which had not previously been included in the financial statements submitted by the developer.

Although the CHAPA cost certification report and the "independent" auditor review did not document any land valuation issues, this Office understands that CHAPA and representatives from the town of Reading did have some discussions regarding this concern. The following chronology of events will help provide a better understanding of the land valuation issue and will provide the support for the associated cost adjustment reflected in the Melanson report.

CHRONOLOGY OF EVENTS

- October 19, 2000 – 1375 Main Street Nominee Trust (Trust) purchases for $270,000 the 40,000 square foot parcel at 1375 Main Street Reading, MA from the Estate of Marena Scoullar. The signatory for the Trust is Michael Hennessy as trustee.

- October 31, 2000 – Middlesex Federal Savings F.A. issues a Chapter 40B site approval letter to Rocco Scippa as Manager of Rangeway Farms, LLC (Rangeway) for development of twelve (12) townhouse units at 1375 Main Street Reading, MA.

- November 15, 2000 – The Trust enters into a purchase and sale agreement with Rangeway. The agreement provides for a sales price for the parcel of $600,000 but is contingent on the ability of Rangeway to obtain all permits and approvals for the development of twelve (12) residential condominium units.

- November 29, 2000 – Rangeway files a comprehensive permit application with the town of Reading.

- December 21, 2000 – The town of Reading opens the public hearing on the Rangeway comprehensive permit application.

- June 14, 2001 – The Reading Zoning Board of Appeals (ZBA) approves a comprehensive permit for the development of 8 condominium units (6 market rate units and 2 affordable units) at 1375 Main Street. The comprehensive permit

is issued to the Trust (owners of the land) as opposed to Rangeway (the applicant).

- January 18, 2002 – The Trust sells the parcel for $580,000 to 1375 Main Street Partners, LLC (Donald Van Dyne Jr. – Principal).

- December 16, 2002 – The ZBA decision of June 14, 2001 is recorded through the registry of deeds. Transfer of this permit from the Trust to Donald Van Dyne/1375 Main Street Partners, LLC is not documented through the town nor recorded at the registry of deeds.

Based on the events summarized above, 1375 Main Street Partners, LLC (Donald Van Dyne) purchased the parcel from the Trust for $580,000 after a comprehensive permit had been issued to the Trust by the town. Although we found no evidence that the town approved the transfer of the comprehensive permit from the Trust to 1375 Main Street Partners, LLC the actual development was done by Mr. Van Dyne through 1375 Main Street Partners, LLC. In addition to the $580,000 paid to the Trust, 1375 Main Street Partners, LLC paid $20,000 to the Reading Historical Commission. This payment was for the express purpose of forwarding historic preservation in Reading and was a condition in the comprehensive permit decision. This brought the total land acquisition cost claimed by the developer through the cost certification process up to $600,000.

As reflected in the Melanson report, the land acquisition cost has been adjusted down by $310,000 from $600,000 to $290,000. The adjusted land acquisition value of $290,000 represents the original arm's length purchase price of $270,000 paid by the Trust to the Scoullar Estate plus the subsequent $20,000 fee paid by 1375 Main Street Partners, LLC to the historical commission. The arm's length purchase price of $270,000 is in line with the then current real estate property tax assessment of $265,900. The adjusted land acquisition value represents fair market value under existing zoning without a comprehensive permit in place. The economic benefits of the comprehensive permit should accrue to the development and should not be used to substantiate an acquisition cost greater than the fair market value under existing zoning.

Through subpoena, this Office uncovered that the Trust and Rangeway are related parties. Rocco Scippa is a primary beneficiary of the Trust and is also the principal of Rangeway. In its comprehensive permit application to the town, Rangeway included a purchase and sale agreement (between itself and the Trust) for the subject parcel. In addition to demonstrating site control by Rangeway, this agreement reflected a significantly inflated land price between these related parties. Within one (1) month after purchasing the parcel in an arm's length transaction, the Trust entered into this related party purchase and sale agreement which bloated the purchase price by 115% ($270,000 to $600,000). It appears that the intent of this inflated related party purchase and sale agreement was to eventually shield the development's excess profits from the

town by establishing a deceptive land acquisition cost significantly higher than the as-is fair market value.

As part of our investigation we verified that the deed riders for the affordable units were properly recorded through the registry of deeds. We also verified that the affordable units were originally sold at the agreed upon predetermined prices. During our review, we noted that one of the affordable units resold approximately 2 years after the original purchase. The original sales price of this unit was $174,180. The affordable resale price was $234,200 and resulted in a $60,020 (34%) profit to the original affordable unit homeowner. During this same general timeframe, we noted that two of the market rate units also resold. The gross profit for these market rate units was $37,900 (9%) and $55,100 (14%), respectively. This disparity prompted a more detailed investigation as it seemed counter intuitive that affordable unit buyers would profit at rates significantly greater than market rate unit buyers.

Prior to the affordable unit resale (#6 Sumner Cheney Place), the original owners properly notified CHAPA of their intent to sell their unit. As the monitoring agent, CHAPA determined the resale price for this unit by obtaining a current market appraisal and then applying the discount rate (ratio of initial certified sale price to initial market appraised value) of 56.455% reflected in the deed rider. Although the deed rider reflected a discount rate of 56.455% and CHAPA used this rate in the calculation of the resale price, the discount rate was not originally calculated properly by the developer. The actual discount rate should have been calculated and recorded by the developer as 43.545% (ratio of initial certified sale price ($174,180) to initial market appraised value ($400,000)). This error resulted in the original owner earning approximately $53,000 more than what they should have earned on the resale. We also noted that the other affordable unit (#3 Sumner Cheney Place) also has the same error in the calculated and recorded discount rate. Due to this error, there is increased risk to the town of eventually losing this unit as part of the affordable stock. This erroneous discount rate applied against increasing market prices will eventually result in a resale price which is unaffordable to buyers at or below 80% of the median income level for the region. Either the town will have to find a way to help subsidize a future buyer or the unit will be lost from the town's affordable inventory stock.

Given the significant difference (+164%) in project profits highlighted through the Melanson report (46.7% of total development costs) versus the profit as reported by the developer in his cost certification (17.7% 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 the 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 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 town 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 Sumner Cheney project, the

CHAPA cost certification report was issued to the town more than a year after the last unit was sold in the development. The town 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 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.

- The town should work closely with the owners of the affordable unit at #3 Sumner Cheney Place to correct the error in the discount rate reflected in the deed rider.

- In order to help preserve the inventory of affordable housing units, the town should require deed riders which in addition to providing for affordability into perpetuity also require resale prices to be tied to median income changes as opposed to changes in market unit pricing.

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

Gregory W. Sullivan
Inspector General

Enclosures

cc: Mr. Donald Van Dyne, 1375 Main Street Partners, LLC
Mr. Patrick Wood, Esq., 1375 Main Street Partners, LLC
Mr. Aaron Gornstein, Executive Director, CHAPA
Mr. Thomas Gleason, Executive Director, MassHousing
Ms. Jane Wallis Gumble, Director, DHCD

Patrick J. Wood
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December 7, 2006

Gregory W. Sullivan, Inspector General
Commonwealth of Massachusetts
Office of the Inspector General
One Ashburton Place, RM 1311
Boston, MA 02108

Re: 1375 Main Street Partners, LLC
Re: Sumner Cheney Condominium
Sumner Cheney Place
Reading, MA

Dear Mr. Sullivan,

I am in receipt of your cover letter dated November 22, 2006 together with an enclosed "report" prepared by Melanson Heath & Company, PC, Certified Public Accountants, dated October 10, 2006.

The report suggests that 1375 Main Street Partners, LLC (the "developer") over stated development expenses by $452,556 resulting in excess profits of $490,893. The alleged over stated expenses consist of the valuation of the land acquisition in the amount of $310,000. The balance of adjustments consists primarily of undocumented vender expenses in the amount of $112,883 and purported unallowable interest charges in the amount of $29,673.

The developer would like to take this opportunity to respond to the report, as follows:

1. The developer included as an expense its actual cost paid to an unrelated 3rd party in the amount of $600,000 in early 2002 based on then published rules and regulations. Subsequently, in 2003 a rule was adopted whereby land could not be valued at more than its un-permitted appraised value. This rule is being applied retroactively thus the proposed adjustment. The developer takes exception to the propriety of application of such rule retroactively.

2. With respect to "undocumented expenses" for which there was no supporting paper work these expenses can be documented, if need be, by obtaining any missing documentary evidence from the respective vendors.

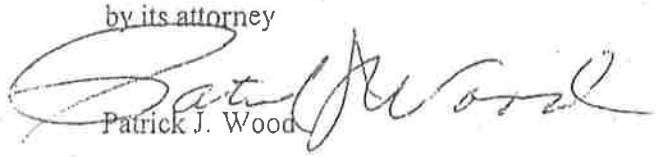
In the event that all the OIG'S proposed adjustments were upheld excluding the land valuation issue ($310,000) and expenses that can be documented ($112,883) there would be no excess profits as calculated and summarized below:

Total Project Expenses as reported by developer		$2,290,109
Proposed OIG Adjustments	$452,556	
Less: Land Acquisition variance	(310,000)	
Documentable expenses	(112,883)	
Adjusted proposed adjustments		29,673
Adjusted Project Expenses		$2,260,436
Allowable Profit Margin – 20%		$ 452,087
Profit margin reported by developer		405,848
Negative Excess Profits based on costs		($ 46,239)
Sales as reported by developer		$2,695,957
Less: Adjusted Project Expenses – from above		2,260,436
Profit based upon sales		435,521
Allowable Profit Margin – from above		452,087
Negative Excess Profits based on sales		($ 16,566)

It is to be noted that upon review by CHAPA as monitoring agent $17,976 was identified as possible excess profit. More importantly, long before the OIG commenced its 40B investigation(s) the developer, recognizing the spirit of creating affordable housing, in cooperation with town counsel reached a *final settlement* and dutifully paid the Town of Reading the referenced $17,976. It is the understanding of both parties that the matter of excess profits has been addressed and the parties have waived their right to further litigate.

Respectfully submitted,

1375 Main Street Partners, LLC
by its attorney



Patrick J. Wood