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DEFENSE INFRASTRUCTURE

Army Has a Process to Manage Litigation Costs for the Military Housing Privatization Initiative

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Why GAO Did This Study

In 1996, Congress enacted the MHPI, which provided the Department of Defense with a variety of authorities that may be used to obtain private-sector financing and management to repair, renovate, construct, and operate military family housing. The Army has invested \$1.97 billion and the private sector has invested \$12.6 billion in the initial development of MHPI projects at 44 installations.

The Senate report accompanying a proposed version of the National Defense Authorization Act for Fiscal Year 2014 mandated GAO to examine the Army's litigation costs related to MHPI, specifically any litigation costs not accounted for during the MHPI's annual budget process. This report examines the extent to which the Army has implemented its process to manage funds for litigation not accounted for in the budget and identifies any effects that the litigation and audit costs have had on managing the MHPI projects.

To conduct its work, GAO examined the Army's process for managing litigation, interviewed Army officials, and analyzed documents to determine whether litigation and audit costs have had any effects on managing the MHPI projects.

GAO is not making recommendations in this report. DOD provided technical comments on a draft of this report, which were incorporated as appropriate.

View [GAO-14-327](#). For more information, contact Brian Lepore at (202) 512-4523 or leporeb@gao.gov.

DEFENSE INFRASTRUCTURE

Army Has a Process to Manage Litigation Costs for the Military Housing Privatization Initiative

What GAO Found

The Army has a standard process to manage litigation costs of its Military Housing Privatization Initiative (MHPI) projects that are not accounted for in the annual budget process. Army officials indicated that there is one case between four Army MHPI projects and Pinnacle Property Management (Pinnacle) that met the dollar threshold criteria and that would have been approved through this process. However, Army officials did not use the standard process because the Army determined that it needed to limit access to Pinnacle litigation information to avoid disclosing any information material to the litigation strategy. As a result, the Army used an alternative process to review and approve litigation costs for Pinnacle that is consistent with MHPI operating agreements. Had the standard process been followed, litigation and litigation cost information would have been shared with the MHPI projects construction company, Clark Realty Capital (Clark), and four different offices within the Army. Army and Clark officials decided to use the alternative process allowed by the MHPI's operating agreements so that fewer personnel would be aware of ongoing litigation information involving Pinnacle. The alternative process allows the Army and Clark to directly approve specific actions on behalf of the MHPI project, such as approving litigation and audit expenses, and allows sharing information with only Clark and one Army office.

According to Army officials and our analysis of these four MHPI projects' accounts, Pinnacle litigation expenses have not prevented the projects from meeting their normal operating requirements, such as conducting maintenance or paying for utilities. Rents collected from these four MHPI projects funded the normal operating requirements for these projects as well as the Pinnacle litigation and audit expenses. Rents collected in excess of operating expenses normally are available for other purposes such as construction; capital, repair, and replacement of buildings; and future reinvestment. However, because litigation expenses were also paid from the rents collected at the four MHPI projects involved in the litigation, some funds have not been available for these purposes. Nevertheless, Army officials said that the Pinnacle litigation and audit costs have had no effects on the four projects' ability to move forward with construction as planned so far or to meet any scheduled capital repair projects because these projects were developed within anticipated funding levels.

The Army property-management agreements provide that the party that substantially prevails in a legal action may recoup their legal expenses. Army officials stated that they expect the MHPI projects to prevail in the litigation and recoup most, or even all, the costs of conducting the litigation.

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Abbreviations

Clark	Clark Realty Capital
DOD	Department of Defense
MHPI	Military Housing Privatization Initiative
Pinnacle	Pinnacle Property Management

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April 3, 2014

Congressional Committees

The Department of the Army uses private-sector partners to help manage military family housing at 44 installations in the United States, including management of accounts paying for construction, repairs, renovations, and any litigation costs. In 1996, Congress enacted the Military Housing Privatization Initiative (MHPI),¹ which provided the Department of Defense (DOD) with a variety of authorities that may be used to obtain private-sector financing and management to repair, renovate, construct, and operate military family housing. The Army's goal for the MHPI is to significantly improve the quality of housing offered to military members and their families so the Army can continue to attract and retain military personnel. Section 2803 of the National Defense Authorization Act for Fiscal Year 2013 was intended to strengthen the oversight of the MHPI by implementing a series of measures for financial integrity and accountability, and requires the Secretary of Defense to submit expanded reports to Congress on expenditures and receipts related to the MHPI. Furthermore, section 2806 of the National Defense Authorization Act for Fiscal Year 2014 added a requirement that these expanded reports specifically include any unique variances associated with litigation costs.

The Senate report accompanying a proposed version of the National Defense Authorization Act for Fiscal Year 2014² mandated GAO to examine the Army's litigation costs related to the MHPI, specifically any litigation costs not accounted for during the MHPI's annual budget process.³ In this report, we (1) examine the extent to which the Army has implemented its process to manage funds for litigation not accounted for during the MHPI projects annual budget process, and (2) identify any effects that the litigation and audit costs have had on managing the MHPI projects.

¹National Defense Authorization Act for Fiscal Year 1996, Pub. L. No. 104-106, §§ 2801-2841 (1996), codified as amended at 10 U.S.C. §§ 2871-2885.

²S. Rep. No. 113-44, at 223-224 (2013).

³Army officials interpret this to mean any litigation costs that exceed the lesser of 5 to 10 percent of the operating budget for an MHPI project or \$250,000 over budget.

To examine the extent to which the Army has implemented its process to manage and document the use of MHPI projects' funds for litigation not accounted for during the MHPI's annual budget process, we obtained and reviewed Army guidance used to manage MHPI projects' funds for litigation expenses and documentation the Army has received from its partners to justify litigation and audit expenses. We also interviewed Army officials from the Office of the Deputy Assistant Secretary of the Army (Installations, Housing & Partnerships), the Office of the Assistant Chief of Staff for Installation Management, the Office of the Army General Counsel, and MHPI project asset managers who have knowledge of MHPI guidance and practices used in managing MHPI projects' funds spent on litigation.

To determine whether Army litigation and audit costs have had any effects on managing the MHPI projects, we discussed with Army officials any litigation and audit expenses not accounted for during the MHPI annual budget process to determine whether these costs had adversely affected any of the accounts used to manage the MHPI projects involved in litigation. We also obtained and analyzed MHPI project-management account documentation to determine whether litigation and audit costs had any effects on MHPI project accounts. Specifically, we obtained and analyzed the MHPI projects' budgeted operating expenses from calendar years 2009 through 2013 to determine whether the projects had to reduce their operating expenses due to litigation. To assess the reliability of these cost data for Army MHPI projects involved in litigation not accounted for during the MHPI annual budget process, we met with Army officials to discuss these data and the processes and controls that were used to maintain the data. We determined that these cost data are sufficiently reliable for our purpose of reporting budgeted operating expenses for calendar years 2009 through 2013.

We conducted this performance audit from July 2013 to April 2014 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Military Housing Privatization Initiative

Congress established the MHPI in 1996 to provide an alternative funding mechanism to ensure adequate military family housing was available when needed by renovating existing inadequate housing and constructing new homes on and around military bases. The Department of the Army currently has 34 MHPI projects at 44 installations in the United States. Since these projects began, the Army has invested \$1.97 billion and the private sector has invested \$12.6 billion in the initial development of the military housing projects.⁴ In a typical privatized military housing project, the developer⁵ is a limited liability company or partnership that has been formed for the purpose of acquiring debt, leasing land, and building and managing a specific project or projects. The limited liability company is typically composed of one or several private-sector members, such as construction firms, real-estate managers, or other entities with expertise in housing construction and renovation. In those cases where a military department has made an investment in the limited liability company, the department may also be a member of the limited liability company.⁶ In a typical privatized military housing project, a military department leases land to a developer for a term of 50 years. The military department generally conveys existing homes on the leased land to the developer for the duration of the lease.⁷ The developer is responsible for constructing new homes or renovating existing houses and then leasing this housing, giving preference to service members and their families. Although the

⁴Dollar figures throughout this report have not been adjusted for inflation.

⁵Section 2875 of Title 10, U.S. Code, authorizes the military departments to invest limited amounts of appropriated funds or property in an “eligible entity.” In this report, we use the term “developer” and “eligible entity” synonymously to describe the special-purpose limited liability company or partnership that carries out a privatization project or projects. A limited liability company is a company in which the liability of each shareholder or member is limited to the amount individually invested. A limited partnership is a partnership composed of one or more persons who control the business and are personally liable for the partnership’s debts (called general partners), and one or more persons who contribute capital and share profits but who cannot manage the business and are liable only for the amount of their contribution.

⁶The secretary of a military department may decide the department will invest cash or housing, or in some cases, lease land to the developer.

⁷Typically, title to the houses that are conveyed and any improvements made to these houses during the duration of the lease automatically revert to the military department upon expiration or termination of the ground lease.

developers enter into these agreements to construct or renovate military housing, the developer normally enters into various contracts with design builders and subcontractors to carry out the actual construction and renovation. The developer also typically hires a property-management firm to oversee the day-to-day operations of the MHPI project, such as ensuring that maintenance is provided to houses in accordance with the approved budget.

Army MHPI Project-Litigation Costs Involving Pinnacle Were Not Accounted for during MHPI Annual Budget Process

According to Army officials, the only litigation that has caused the expenditure of funds not accounted for during the MHPI's annual budget process for operating costs to-date is litigation involving Clark Realty Capital (Clark) and Pinnacle Property Management (Pinnacle).⁸ Clark Pinnacle Family Communities oversees some of the highest-profile installations in the Army's MHPI program. The company is a joint venture between Clark, based in the Washington, D.C., area, and Pinnacle, based in Seattle. Starting in 2002, in collaboration with the Army, Clark Pinnacle led the development of four projects in six locations totaling more than 11,000 homes at a value of about \$2 billion. The four projects are

- Presidio of Monterey, and Naval Post Graduate School, California;
- Fort Irwin, Moffett Federal Airfield, and Parks Reserve Forces Training Area, California;
- Fort Benning, Georgia; and
- Fort Belvoir, Virginia.

Although the agreements at the projects vary, generally Clark is the managing partner of the MHPI entities⁹ and handled the construction and development. Pinnacle was the property-management firm actually conducting day-to-day property-management activities (e.g., maintenance) at the projects once they were completed. According to Army officials, Clark, through a series of internal audits, determined in 2010 that Pinnacle allegedly was involved in substantial and systemic fraud in the management of the privatized housing at Fort Benning, and

⁸According to Army officials, as of August 2013 there have been two other potential large lawsuits that met the dollar threshold criteria to be approved; however, in one case, the Army did not approve the projects to pay for the litigation costs, and the other case was undertaken by a law firm on a contingency fee basis (at no cost to the projects).

⁹The MHPI entities refer to the four projects (Presidio of Monterey, Fort Irwin, Fort Benning, and Fort Belvoir) as owned by the Army and Clark Pinnacle and managed by Clark.

ultimately found similar alleged fraud in the management of the privatized housing at Fort Belvoir. As a result, Clark initiated audits of the two California MHPI projects managed by Pinnacle and began to uncover alleged circumstances similar to those at Fort Benning and Fort Belvoir.

Litigation against Pinnacle

In 2010, Clark asked the Army for permission to remove Pinnacle as property manager at Fort Benning and Fort Belvoir because of alleged willful misconduct by Pinnacle employees, and for approval to initiate related litigation on behalf of the MHPI entities against Pinnacle; the Army agreed. Subsequent to the initiation of the Fort Belvoir and Fort Benning litigation, Pinnacle attempted to unilaterally amend the terms of the California property-management agreements to make it harder to remove them as property manager. In response, the California MHPI entities then brought suit in California court against Pinnacle seeking a declaratory judgment that the agreements had not been effectively amended by Pinnacle. Pinnacle then filed a cross-suit seeking to uphold the amendments. According to Army officials, the Army wanted Pinnacle removed as the MHPI projects' property manager due to the alleged fraud and mismanagement. Additionally, Army officials stated that they have been motivated by concerns for resident safety because it has been alleged that Pinnacle engaged in falsifying records regarding maintenance and repairs that Pinnacle employees were responsible for performing at all four project locations.

An Army official stated that Pinnacle has attempted to obtain information on the amount of funds the MHPI projects have spent on litigation and other litigation strategy-type information, such as documents provided to the Army by Clark, both through discovery and through a Freedom of Information Act request, which the Army (with Department of Justice assistance) successfully denied. According to Army officials, the relevant property-management agreements include a provision that a party who sues under the agreement and substantially prevails is entitled to recoup their legal fees from the losing party. Further, our review found that the MHPI projects' property-management agreements include a provision allowing the substantially prevailing party in litigation brought to enforce or interpret the agreements to be repaid for all court costs and for the reasonable fees and expenses of attorneys and certified public accountants. Because legal fees are potentially recoverable, they are material both to the litigation and to any potential settlement negotiations.

In June 2010, Pinnacle was removed as property manager at Fort Benning, and in December 2012 Pinnacle was removed from

management at Fort Belvoir. Pinnacle remains property manager at the two California projects pending resolution of the litigation described above.

The Army Followed a Process to Manage MHPI Litigation Funds Not Accounted for in the Budget That Limits Access to Litigation Information

The Army has a standard process to manage MHPI projects' funds for the costs of litigation not accounted for in the MHPI projects' annual budget process, but instead used an alternative process designed to limit access to information about the Pinnacle litigation. The alternative process is consistent with the relevant MHPI projects' operating agreements. The standard process has thresholds governing potential withdrawals or expenditures for Army MHPI project litigation expenses. In the standard process, Army officials generally make major decisions¹⁰ related to MHPI projects, including litigation costs, by following guidance in the Residential Communities Initiative Portfolio and Asset Management Handbook. For example, the Army treats litigation not accounted for in the budget process as a major decision requiring higher-level approval within the Army when costs exceed either 5 to 10 percent of the annual budget or \$250,000 over budget. In the standard process, Army officials generally seek approval of such major decisions from either the Office of the Assistant Chief of Staff for Installation Management or the Office of the Assistant Secretary of the Army (Installations, Energy and Environment). The process involves sharing litigation information and estimated costs between the developer and four offices within the Army (MHPI Project Office, Garrison Commander, Office of the Assistant Chief of Staff for Installation Management, and the Office of the Assistant Secretary of the Army [Installations, Energy and Environment]). However, according to Army officials, the standard process has not yet been used to approve any major decisions regarding litigation expenses, because the Pinnacle cases are the only cases that met the major-decision threshold criteria whose litigation expenses have been approved and would have gone through this process had decisions not been made to restrict access to information pertaining to this litigation.

Although the Pinnacle cases met the major-decision threshold criteria, according to Army officials, Army officials decided to use an alternative management process to review and approve litigation costs so they could

¹⁰A major decision refers to any decision that requires the review and approval of the Army. For example, the acquisition or disposal of real property or loans from project funds are considered major decisions.

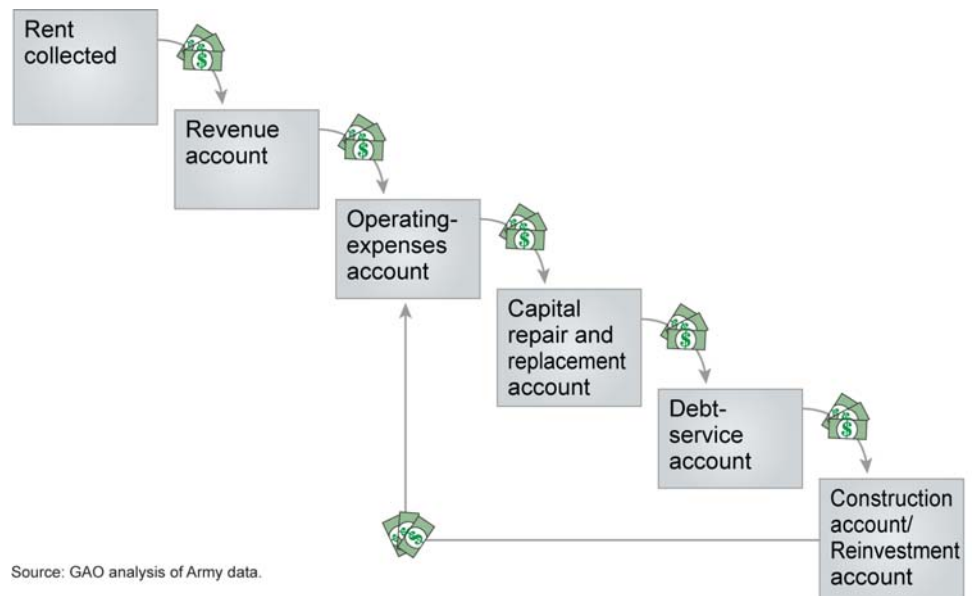
restrict information and confine decision making to a higher organizational level. This process is consistent with the MHPI projects' operating agreements for managing these projects and allows for Clark and only one Army office to review associated cost information. Specifically, these agreements do not specify any internal deliberative process within the Army, but rather only require that Army agreement is obtained for certain major decisions. As a result, the Deputy Assistant Secretary of the Army (Installations, Housing & Partnerships), acting on behalf of the Army, can directly approve specific actions proposed by Clark senior leadership on behalf of the MHPI project, such as approving the litigation and audit budget and expenses. Additionally, Army officials stated that while the standard process was not followed, the alternative process did allow for information regarding the Pinnacle litigation to be periodically coordinated with high-level officials within the Office of the Assistant Chief of Staff for Installation Management. Army officials stated that they wanted to restrict access to the litigation and audit cost estimates because legal fees are potentially recoverable and as a result are material both to the litigation and to any potential settlement negotiations.

According to Army officials, throughout the litigation process, Army and Clark officials have regularly shared litigation documents and met to discuss the Pinnacle litigation. After the approval of the MHPI project's annual operating budgets, the Deputy Assistant Secretary of the Army (Installations, Housing & Partnerships) and counsel in the Office of the Army General Counsel reviewed Clark's proposed budget for Pinnacle litigation and audit expenses for that year. Further, the Army and Clark met approximately quarterly with counsel representing the four MHPI projects in the Pinnacle litigation to discuss any significant developments in the cases, specific plans for the next quarter, and general plans for the rest of the year—including any anticipated changes in the legal and audit expenses previously budgeted for. Army officials stated that they also plan to conduct a full review of the costs at the end of the litigation to ensure that all charges by outside counsel were fair and reasonable.

Army MHPI Project Costs for the Pinnacle Litigation Have Not Prevented Housing Projects from Meeting Normal Operating Requirements

According to Army officials and our analysis of the project-management accounts for the four locations involved in the Pinnacle litigation, the expenditure of funds to pay litigation and audit expenses have not prevented the projects from meeting normal operating requirements, such as conducting maintenance or paying for utilities, from the time the litigation began in 2010. Within each MHPI project, the Army receives revenue and distributes the cash flow in a specified order to accounts, such as the revenue account; operating-expenses account; capital, repair, and replacement account; debt-service account; and construction and reinvestment accounts. Figure 1 shows the flow of funding within the Army MHPI projects.

Figure 1: Example of the Flow of Funds for Army MHPI Projects



Revenue account: The revenue account is funded by servicemember rent, which is typically based on the Basic Allowance for Housing allotments received. This funding is typically disbursed on a monthly basis to pay the budgeted amounts for the operating expense account; capital, repair, and replacement account; and debt-service account. According to Army officials, Pinnacle litigation and audit expenses were also paid from revenues that flowed into the MHPI projects.

Operating-expenses account: Each Army MHPI project has an account to pay for all operating expenses including maintenance, utilities, and other administrative costs. According to Army officials, they assist in the

development of and approve each MHPI project's annual budget for operating expenses. MHPI project asset managers for the four projects connected to Pinnacle litigation stated that their projects have not had to reduce their operating expenses during the Pinnacle litigation. Furthermore, MHPI project asset managers stated that any increases or decreases in budgeted operating expenses from year to year were due to fluctuations in housing occupancy and changes in utility and maintenance costs and not litigation expenses. Table 1 provides a summary of the four MHPI projects' budgeted operating expenses from calendar years 2009 through 2013. Although Pinnacle litigation and audit expenses were not incurred until 2010, this table shows budgeted operating expenses for 2009 to provide a comparison of expenses prior to the start of litigation.

Table 1: Budgeted Operating Expenses, by Military Housing Privatization Initiative (MHPI) Project, Calendar Years 2009 through 2013

Dollars in millions

Year	Fort Belvoir	Fort Benning	Fort Irwin	Presidio of Monterey
2009	\$15.7	\$22.5	\$19.5	\$17.9
2010	15.8	21.2 ^a	18.5 ^b	17.9
2011	17.2	21.9	19.6 ^c	17.1
2012	15.9 ^d	19.9 ^e	19.3	18.1
2013	17.5 ^f	21.4 ^g	18.8	18.1

Source: GAO analysis of Army data.

Notes: Dollars are in nominal terms.

^aFort Benning experienced a decrease in budgeted operating expenses from 2009 to 2010 due to decreases in its water, sewer, and gas utilities costs.

^bFort Irwin experienced a decrease in budgeted operating expenses from 2009 to 2010 due to decreases in its gas utilities costs.

^cFort Irwin experienced an increase in budgeted operating expenses from 2010 to 2011 due to increases in its water and sewer utilities costs.

^dFort Belvoir experienced a decrease in budgeted operating expenses from 2011 to 2012 by implementing several cost-saving measures in the areas of trash-removal services, extermination/pest control, and pool service.

^eFort Benning experienced a decrease in budgeted operating expenses from 2011 to 2012 due to decreases in its electricity, water, sewer, and gas utilities costs.

^fFort Belvoir experienced an increase in budgeted operating expenses from 2012 to 2013 due to increases in marketing and repair and maintenance expenses.

^gFort Benning experienced an increase in budgeted operating expenses from 2012 to 2013 due to increases in insurance, contract services, cleaning and decorating, and repair and maintenance expenses.

Capital, repair, and replacement account: This account includes funds for repair and replacement of older components of homes and community facilities. The Army requested an audit of the projects' financial data from

January 2009 through June 2012 and the audit results showed that no maintenance was deferred during this period.

Debt-service account: This account is used to pay the outstanding debt for the MHPI project. Based on our review of MHPI project account data, we found that all four MHPI projects have little or no balance in this account because debt is paid off throughout the year.

Construction account and Reinvestment account:

Construction Account—Before the start of an MHPI project, a plan is developed for construction, and needed funding levels are determined. This plan is reviewed annually based on actual and estimated costs to determine if any changes are needed to the development scope of the project. This account is used to pay for the initial development and construction of the MHPI project, which according to Army officials generally lasts during the first 7 to 10 years of project operations. As discussed earlier, the revenue account funds the budgeted amounts for the operating expense account; the capital, repair, and replacement account; and the debt-service account, and any funding not needed for these purposes flows to the construction account. However, because litigation expenses were also paid from the revenue account, officials stated that additional funding has not transferred into the construction account as otherwise would likely have occurred. Nevertheless, Army officials said that the Pinnacle litigation and audit costs have had no effects on the projects' ability to move forward with construction as planned because these projects were developed within anticipated funding levels. According to Army officials, currently all four of the projects are nearing the end or have recently completed the initial development period, and after the development and approval of a 5-year future plan, the construction account will be closed.

Reinvestment Account—According to Army officials, any funds remaining in the construction accounts when the projects reach the end of their initial development and construction phase are moved to the reinvestment account. This account is also used to hold the MHPI projects' excess cash flow that is not required after payment of the operating expenses, debt service, and other payments. Funds start to accumulate in the reinvestment account for future use in renovation or replacement of homes after the initial development and construction of the project ends. Since all four of the projects are still in or have recently completed this initial development phase—and based on our review of MHPI project account data—no funds have accumulated in the reinvestment accounts

as of February 2014. Due to the MHPI projects' incurring litigation and audit expenses, less funding will ultimately be available to transition from the MHPI projects' construction account to the reinvestment account unless litigation concludes prior to the transition, and funds are recouped assuming the projects prevail in the litigation with Pinnacle.

The MHPI projects' property-management agreements provide that the party that substantially prevails in a legal action may recoup their legal expenses. Army officials stated that they expect the MHPI projects to prevail in the litigation and recoup most, or even all, the costs of conducting the litigation.

Agency Comments

This report does not include any recommendations. We provided a draft of this report to DOD for comment. However, DOD did not provide written comments and provided technical comments, which we incorporated in our report as appropriate.

We are sending copies of this report to the appropriate congressional committees; the Secretary of Defense; the Secretary of the Army; and the Director, Office of Management and Budget. In addition, the report is available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (202) 512-4523 or LeporeB@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix I.



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Appendix I: GAO Contact and Staff Acknowledgments

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Staff Acknowledgments

In addition to the contact named above, Laura Durland (Assistant Director), Chaneé Gaskin, Stephanie Moriarty, Carol Petersen, Richard Powelson, Amie Steele, John Van Schaik, and Michael Willems made key contributions to this report.

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