

Memorandum

To: Grand Harbor and Oak Harbor Transition LLC Board of Directors

From: Grand Harbor and Oak Harbor Transition LLC Finance and Accounting Committee

Date: February 2, 2020

Grand Harbor Financial Issues

This report evaluates the financial aspects of Grand Harbor Community Association with respect to their financial arrangements with one or more wholly-owned subsidiaries of Icahn Enterprises Limited Partnership, which subsidiary or subsidiaries are or have been the Class B member of Grand Harbor Community Association, Inc., referred to in the recommendation as both “IEP” and the “developer”.

We reviewed the Grand Harbor Community Association, Inc. audited financial statements and related books and records for the period 2011 through 2018. It should be noted that the annual Audited Financial Statements exclude “internal control” and “reserve funding” from the audit opinion that the financial statements “present fairly” the financial position of GHCA.

Documents cited below can be found on the Indian River County (IRC) website ori.indian-river.org. The term BK refers to the record Book number, PG refers to the record Page number, and PB refers to the Plat Book number.

There are multiple references to the original Declaration of Covenants throughout this recommendation and this document can be found at (IRC BK 796 PG 163). We reviewed many of the financial documents and based our determinations on the information that was available to us up to the present time. There are five areas of financial concerns: (1) Bad Debt Reserve, (2) Due to Developer Account Payable, (3) Assessment Overcharges computed by the developer, (4) Failure to Maintain Reserve Funds for Proper Renewal or Replacement of the Grand Harbor Community Association property, and (5), Misapplication of Gate Security and Other Revenue to Reduce Developers Deficit Funding Obligation.

(1) Bad Debt Reserve - \$49,594

The developer charged annual operating losses totaling \$49,594 for the Grand Harbor Community Association against the bad debt reserve rather than retained earnings.

Due to concerns about residents' payments of monthly assessment charges, the GHCA Board approved an amendment to the Declarations of Covenants in November 2010, effective 1/1/2011 (IRC BK 2459 PG 1455). The amendment permitted the creation of a Bad Debt Reserve funded by residents to ensure the continued payment of operating expenses and it had a balance of \$121,419 by 12/31/2018. During the period 2011 through 2017, GHCA charged their annual deficit to this Bad Debt Reserve. In 2018, revenue equaled expenses and there was no loss charged to the bad debt reserve.

These annual losses are more appropriately charged to the Retained Earnings. The LLC requests that GHCA restore these items to the Reserve for Arrears account.

2017	6,410
2016	5,846
2015	8,484
2014	4,713
2013	9,511
2012	5,675
2011	<u>8,955</u>
Total	49,594

Please refer to the Reserve analysis presented in each Annual Audit Report 2011 to 2018. See "1 Attach – Comparative Analysis".

Required Action - Restore the bad debt reserve to its correct balance of \$171,013 at 12/31/2018 and continue to apply annual profit or loss to retained earnings in subsequent year. This is not a claim for reimbursement; rather it clarifies the

proper financial condition of GHCA at takeover and coordinates with issue (2) Due to Developer, below.

(2) Due to Developer - \$68,535

In 2017, Grand Harbor homeowners paid \$2,509,827 in base assessments and the developer paid zero assessments. That year, revenue from these homeowner assessments and security gate income exceeded community association expenses by \$71,440. The developer determined that they were entitled to the surplus overpayment and established an Account Payable, Due to Developer for \$71,464 in 2017. Please see “2 Attach 2017 Balance Sheet” and “2 Attach Developers Funding Worksheet”.

The developer’s spreadsheet for the deficit funding in lieu of base assessments for the years 2006 through 2018 shows that property owners paid \$30 million in assessment fees and the developer paid \$1.36 million in payments in lieu of base assessments during those 13 years. Please see “2 Attach Computations” file and “2 Attach Developer’s Funding Worksheet 2006 – 2018”.

Grand Harbor was developed in the 1980’s and the earliest residences were sold in 1988. The current Developer purchased the property in March 2004, and by that time, more than 1200 properties were sold to residents and property amenities were complete. It was a mature development and the Developer planned to build additional new homes. The developer acted in accordance with the “deficit funding in lieu of base assessments” provision of the Declaration of Covenants, Article X, Section 1. The term “deficit funding” is somewhat misleading as the developer creates an artificial “deficit”. The calculation of the base assessment encompasses all types of Units including developed units, Units under development, and units to be developed in the future as required by the Declaration of Covenants. The developer is obligated to pay base assessments for their units under all phases of development at the same cost as all other property owners. However, developer payments under this alternative deficit

funding provision are designed to be in lieu of the base assessment obligations of the developer.

As an example of the computation of “deficit funding” in lieu of base assessments, a community association determines its expected budget expenses will be \$1,000,000 and there are 950 property owner units and 50 unsold developer units. Therefore, each unit will be obligated for \$1,000.

Budget =	\$1,000,000
Property Owner Units =	950
Developer's Units =	<u>50</u>
Total Units =	1,000

$\$1,000,000 / 1,000 \text{ units} = \$1,000 \text{ per unit}$

Assessment fees collected from Property Owners = \$950,000 result in a \$50,000 deficiency ($\$1,000,000 - \$950,000 = \$50,000$) when income and expenses equal budgeted amounts.

It's clear that if the developer had paid its share of the assessments there wouldn't be a deficit if expenses equaled the planned budget costs. This is simply re-naming the developer's assessment obligation as a deficit. In this example, the payment in lieu of the developer's assessment obligation of \$50,000 is called “deficit funding”.

At the end of each year, the developer determines the amount of the association's expenses and the related homeowner assessment income and income from security gate passes. They compute the required developer payment at the end of the year end and post the account receivable 12/31/xxxx. The actual funding is paid in the subsequent accounting period.

In 2017, GHCA accountant computations to create the deficit funding in lieu of base assessments resulted in a surplus of \$71,440. The developer posted the surplus to an account payable to the developer and a reduction in income in the amount of \$71,919. This figure includes an erroneous adjustment of \$2,979 which was reversed in early 2018 ($68,535 + 2,929 = 71,464$). The \$28,565 in

developer payments paid in 2017 are the obligations from the prior year 2016 funding requirements. In 2018, the developer did not pay the \$15,885 in assessments in lieu of base assessments and instead charged the cost against the Due to Developer Account Payable. The developer is the Property Manager and controls the GHCA spending and accounting, and therefore the amount of any surplus or deficit for any given year.

The Covenants are silent as to the treatment of a surplus. Deficit funding in lieu of base assessments, if not properly calculated, has the effect of allocating a larger than appropriate percentage of total assessments to non-developer units. If IEP fails to properly recognize the correct number of units and to compute the base assessments properly, the amounts they spent on deficit funding in lieu of base assessments would be significantly less than the true obligation. Please see “Properties That Were Never Annexed” in Section 3 with reference to the developer’s aversion to properly annexing properties.

There is no document that directs the surplus to be given to the developer. The overpayment, versus actual cost, should be for the benefit of GHCA. The surplus of \$68,940 should be applied to Retained Earnings rather than an Account Payable to the developer.

Please refer to a copy of the 2 Attach 2017 Balance Sheet, “2 Attach Computations” file, and “2 Attach Developer’s Funding Worksheet 2006 – 20018” file.

Required Action – Restore the income of \$71,919 in 2017 and apply the surplus of \$68,940 to Retained Earnings. Collect the funding of \$15,885 for 2018 and any additional funding that the developer owes for 2019 and 2020. Recover any disbursements to the developer that may be made with respect to this Due to Developer Account Payable. Review subsequent years for similar types of transactions in 2019 and 2020 when the financial statements are completed.

(3) Assessments

Overcharged Assessment

2019	172,562
2018	179,703
2017	<u>108,113</u>
Total	460,378

When the developer computed the base assessments levied on homeowners, they understated the number of housing “Units” in the denominator of the computations. This understatement inflates the assessment charges paid by the property owners and reduces developer funding obligations for their payments in lieu of bases assessments.

Article X, Section 1 of the Declaration of Covenants states, “**Base assessments shall be levied equally on all Units**”. A unit is defined under Article I, Section 30 as “**Properties, Whether developed or undeveloped, intended for development, use and occupancy**” as residences or commercial property. It goes on to state, “**In the case of a parcel of vacant land or land on which improvements are under construction, the parcel shall be deemed to contain the number of Units designated for such parcel on the Conceptual PRD Plan or the site plan approved by Declarant, whichever is more recent**”.

A parcel is considered to come under the provisions of the Declaration of Covenants as either an original property described in Exhibit A of the original Declaration, or annexed property described in Exhibit B. The annexation process is described in the Declaration of Covenants Article VIII and was amended in October 1993 (IRC BK 994 PG278.) Once annexed, the property is considered a unit, subject to being treated as multiple units as described in the previous paragraph, once the site plan is approved.

The Board (controlled by the developer) prepares the annual budget and determines the costs, expenses, and reserves in order to determine the annual assessments for the properties located in Grand Harbor and Oak Harbor. The Declaration of Covenants Article X, Section 2 states the Base Assessment “**Shall be**

computed by dividing the budgeted Common Expenses by the total number of Units", i.e. the budget costs to be divided by the total units as defined in the covenants.

By understating the number of units in the denominator of this computation, IEP inflates the charges to the assessed homeowners and reduces their deficit funding contributions. Using the above example of deficit funding, if the developer disregards his 50 units, each resident will be assessed \$1,052.63 ($\$1,000,000 / 950 = 1,052.63$). Thus residents will pay the entire \$1,000,000 of costs ($950 \times 1,052.63$) and the developer will pay nothing in "deficit funding" **in lieu** of base assessments for his units.

(a) Determination of the Number of Units

Properties That Were Never Annexed

The Falls I and Falls II

The developer(s) may annex additional properties and did add additional properties over the years. In 2005 the developer introduced The Falls I and The Falls II. The developer failed to annex both of The Falls properties. Over the years, the developer has sold more than 40 of the 66 units, but retains a large number in inventory. IEP included 65 units in the assessment computation; there was a subsequent adjustment to the plat map and the number should be 66 reflecting that they broke lot 63 into 2 lots. (IRC PB 27 PG 24). These properties need to be properly annexed. (Attachment 3 reflects the result of the adjustments which the text below indicates should have been made.) They properly included 66 units in 2020.

The Reserve

The site plan for the Reserve at Grand Harbor was prepared in 2001 and provided for 86 units. The site plan was revised in July 2013 and provides for 100 units in the Reserve. IEP annexed the Reserve property in September 2005 (IR BK 1938 PG 130) and de-annexed the property in October 2005 (IRC BK 1943 PG 2239). In 2016, IEP recorded the Reserve Covenants (IRC BK 2989 PG 1180) and annexed

lots 1, 2, 57 and 59. They sold lot #3 (not annexed) in the fall of 2016 and deeded the property to the new owners in December 2019 (IRC BK 2992 PG 463).

There appears to have been a de facto annexation of the Reserve property by the developer in the fall of 2016. In order to promote the developer's interests, they selectively annexed only 4 lots in the Reserve. The developer has never formally annexed these Reserve properties with the exception of the four lots. This omission does not appear to be an oversight. They appear to purposely avoid annexing the Reserve properties in order to limit the number of units to their assessment computations. It seems clear that they were marketing the Reserve at Grand Harbor by 2016 at a minimum because they completed a lot sale by the end of 2016.

While we don't know the exact date that the non-event annexation didn't happen, we know IEP has continued to build and sell properties in the Reserve through the current period. There was a de facto annexation in 2016 that would allow the reserve properties to be included in the assessment computation. Therefore, 59 Units have been included in the adjusted assessment computations for 2017, 2018, and 2019. The developer included these properties in the 2020 budget. This failure to annex should be remedied as soon as possible.

Omitted Annexed Properties

The Falls III

IEP Annexed The Falls III in August 2017 (IRC BK 3067 PG 281), but failed to include the Units in the Budget computations in 2018 and 2019. The developer included the units in 2020. Therefore, 35 units were added to the budget computations for 2018 and 2019 for the adjusted budget computations. The developer included the correct number of 101 units for all of The Falls properties in 2020.

Laguna Village

IEP annexed Laguna Village in April 2018 (IRC BK 3108 PC 1537). The Laguna Village project is located adjacent to the River Village area, deep inside the original Grand Harbor footprint. A prior developer annexed River Village Estates

and River Village Towers I through River Village V in 2002 and 2003 (BK 1498 PG 2097 and BK 1637 PG 507). IEP installed the basic infrastructure for this Laguna Village property taking advantage of the Grand Harbor roads, security, etc., but never annexed the property. IEP had begun construction of 2 of the 23 units around 2017 and included 2 units in the budget assessment computation for 2018. The count was corrected to 23 units in 2018 and 2019 for the adjusted budget assessment computations. The developer was able to overcharge for property owners' assessments by failing to annex the property even though they began developing the property many years earlier. The developer reported the correct number of units in 2020.

(b) Rate Sheet Adjustments

As noted above, the Declarations of Covenants provides in Article X, Section 1 of the Declaration of Covenants states, "Base assessments shall be levied equally on all Units". There is no provision for base assessment "discounts" with the exception of the 17 Marina Special Units.

The 17 Marina Special Units were created in an Amendment to Declarations and Covenants dated May 8, 2007 (IRC BK 2221, PG 2233) following litigation as ordered by the Circuit Court with respect to the Marina and Somerset Assisted Living Facility (ALF). The amendment creates a special "discount" for the 17 "Special Marina Units" per the modified Article X, Section 1 (b). The agreement allows for the assessment for many items including maintenance, repair, roads, etc. It specifically prohibits assessments for (i) cable television, (ii) property management, (iii) recreational facilities, or (iv) some services that are provided by third parties. An amendment to Article XIII, Section 14 states that the ALF units are not units nor common property and will be assessed one unit for each 1,000 square feet of air conditioned improvements. They shall be obligated to share in costs associated with the maintenance, repair, replacement and insuring of the Area of Common Responsibility.

The Developer adjusted the number of units used to compute the Management fees in the rate sheet to only reflect "CO'd properties" per the budget spreadsheet from the developer. This appears to be incorrect.

Virtually ALL of the properties (except the 17 Special Marina Units) pay Management Fees including the Grand Harbor Club, the Oak Harbor Club, and the ALF. When IEP reduces the units in the denominator of this computation, it inflates the charges to all of the residents. Therefore, the charges were adjusted to reflect all of the users of this service. The denominator for Management Fees includes all units and adjusts for 17 Special Marina in the computation on the Rate Sheet.

Grand Harbor pays Comcast Cable on a per subscriber basis that is adjusted on an annual basis and the number of units used reflects the subscribers using this service.

(c) Overcharge Computation

The Overcharge Computation results from multiplying the adjusted number of Units by the adjusted Rate Schedule charges.

Please Refer to the Attachments

3 Attach 2017	3 Attach 2018 Units	3 Attach 2019 Units
3 Attach 2017 Rates	3 Attach 2018 Rates	3 Attach 2019 Rates
3 Attach 2017 Overcharge	3 Attach 2018 Overcharge	3 Attach 2019 Overcharge

(d) Road Reserve Adjustment

Article X, Section 7, requires the Board “***shall set the required capital contribution, if any, in the amount sufficient to permit meeting the projected capital needs of the Association, as shown on the capital budget***”. The capital contribution shall be “***included within and distributed with the budget and assessment, as provided in Section 2 of the Article.***” (i.e. the Base Assessment).

Homeowners sued the developer around the year 2000 and a court settlement in 2002 provided for a Road Reserve (IRC BK 1527 PG 1912). The annual base assessments include a contribution to the Road Reserve.

The Declaration of Covenants states all assessments will be applied equally and does not provide for any “discounts” on the assessments. IEP failed to assess the road reserve fee for Grand Harbor Club, Oak Harbor Club, and Somerset ALF. An adjustment to the amount in Attachment 3 was made to include the road reserve charge for these 3 properties in 2017, 2018, and 2019.

In addition, IEP failed to assess the road reserve fee on the Marina Units. The Marina agreement cited above specifically permits assessments for repair, maintenance and roads (See IRC BK 2221 PG 2238 – page 6, paragraph 6 (b)). An adjustment was made in Attachment 3 to include the road reserve charge for the 18 marina properties in 2017, 2018, and 2019.

In addition, an adjustment to the road reserve to reflect charges for the developer’s properties. The developer properties were not assessed due to the deficit funding in lieu of base assessments provisions of the Covenant.

Please refer to the 3 Attach Overcharge worksheets for 2017, 2018, and 2019 to find the computations for the Road Reserve adjustment.

Required Action – Recover the overcharges paid in 2017, 2018, and 2019 of \$108,113, \$179,703, and \$172,562. Properly annex the Falls I and Falls II properties, and the Reserve properties per the provisions of the Declaration of Covenants as amended.

(4) Failure to Maintain Reserve Funds for Proper Maintenance of the Grand Harbor Community Association.

The original Grand Harbor developer submitted the DRI to Indian River County in 1984 and the plan was approved in October of 1985. The project experienced numerous financial difficulties, came under control of the RTC (Resolution Trust Corp.), and was resold various times to different developers. IEP, the current developer, purchased the property in 2004.

The Declaration of Covenants Article X, Section 7, specifically requires the annual determination of capital budgets and related funding of capital projects. There is no record any developer has established the required capital budget. IEP has failed to establish meaningful reserves for the proper renewal or replacement of the property.

(5) Misapplication of Gate Security and Other Revenue to Reduce Developers Deficit Funding Obligation.

2006 to 2018 - \$414,374

Article X Section 1, states, ***“So long as the Declarant has an option unilaterally to subject additional property to this Declaration, in lieu of paying Base Assessments on its unsold Units the Declarant shall be obligated for the difference between the amount of assessments levied on all Units subject to assessment and the amount of actual expenditures required to operate the Association during the fiscal year.”***

When the developer computed their deficit funding in lieu of base assessment computation, they reduced their contribution by the security gate income that GHCA received. The Declaration is clear that the developer’s obligation is calculated as the difference between the actual expenses incurred during the year and the assessments received. There is no provision to reduce their obligation by other income such as the security gate income. Therefore, the other income including the security gate income should be refunded and credited to retained earnings of GHCA. Please see 2 Attach Developer Funding Worksheet 2006 – 2018.

Year	Other Income
2006	4,835
2007	7,346
2008	9,195
2009	5,457
2010	8,728

Grand Harbor and Oak Harbor Transition LLC Finance and Accounting Recommendations

2011	6,677
2012	28,398
2013	66,448
2014	47,283
2015	38,470
2016	61,857
2017	56,080
2018	<u>73,600</u>
Total	414,374

Require Action – Developer should refund the misclassified income that was improperly applied to reduce its deficit funding in lieu of base assessments. The 2019 and 2020 financial statements should be reviewed to determine the correct treatment of the security gate income.