



**U. S. Department of Housing and Urban Development**

New York/New Jersey Office  
Jacob K. Javits Federal Building  
26 Federal Plaza – Room 3430  
New York, New York 10278-0068

**MEMORANDUM NO:** 2004-NY-1802

July 23, 2004

**MEMORANDUM FOR:** Rosalinda Lamberty, Director, Multifamily Housing, Buffalo HUB,  
2CHM

*Alexander C. Malloy*

**FROM:** Alexander C. Malloy, Regional Inspector General for Audit, 2AGA

**SUBJECT:** Groton Community Health Care Center, Inc.  
FHA Project Number 013-43055 and 014-10010  
Groton, New York

**INTRODUCTION**

We have completed a limited review of the Groton Community Health Care Center, Inc. (GCHCC) located in Groton, New York. We initiated this review as part of an Office of Inspector General inquiry into the default of Section 232 insured projects. Our specific objective was to determine whether GCHCC operated in accordance with its regulatory agreement. In violation of the regulatory agreement we found that GCHCC executed a note payable without prior approval from the U.S. Department of Housing and Urban Development (HUD).

**METHODOLOGY AND SCOPE**

We reviewed GCHCC's financial statements, bank records and disbursements, and selected a nonrepresentable sample of disbursements to test for reasonableness and proper support. We inquired about the nature of all short-term and long-term notes payable, and contracts with related parties. We also reviewed HUD regulations pertaining to Section 232 insured projects, the applicable Code of Federal regulations, and the regulatory agreements with GCHCC. We interviewed HUD's multifamily field office staff, as well as the contracted administrator and an employee of GCHCC. Generally, our audit period was January 2001 through December 31, 2002. However, when appropriate, we extended the audit period to include other periods.

**BACKGROUND**

GCHCC is a not-for-profit organization that operates an eighty bed skilled nursing facility and leases space to an independent family health care center in Groton, New York. Under a HUD regulatory agreement dated August 18, 1981, GCHCC had a Section 232 insured mortgage of \$2,642,700 with an interest rate of nine percent on the skilled nursing facility. Additionally, under a separate regulatory agreement dated December 7, 1994, GCHCC had a Section 241

insured mortgage of \$3,112,100, which also had an interest rate of nine percent. GCHCC defaulted on the two HUD insured mortgages in November 2001, which were assigned to HUD on January 14, 2002, and sold by HUD on December 7, 2002. HUD incurred a \$3,450,085 loss on the sale of the two notes.

### **RESULTS OF REVIEW**

Based on our testing, we determined that GCHCC disbursements generally were necessary, reasonable, adequately supported, and in accordance with the regulatory agreement. We also found that GCHCC operated at a loss for a number of years, and in an effort to reduce operating costs, renegotiated numerous contracts for services. While some renegotiated contracts were with a related party, the cost was less than that previously paid. However, we found that GCHCC executed a note without prior HUD approval in violation of the regulatory agreement.

We obtained informal written comments from GCHCC on June 23, 2004. GCHCC commented that the promissory note does not represent an encumbrance of the project since it was an unsecured repayment arrangement. We requested formal written comments to the final draft report, but we had not received any by the issuance date of this report.

#### **The execution of a note payable violated the regulatory agreement**

GCHCC executed a note payable in violation of the regulatory agreement. Section (4)(a) of the 1981 and 1994 regulatory agreements provide that “Mortgagor shall not without the prior written approval of the Secretary:... (a) Transfer, dispose of or encumber any of the mortgaged property...”

On June 12, 1998, GCHCC executed a 10% promissory note in the amount of \$326,830.70 with Cortland Memorial Hospital. GCHCC officials advised that the note represented the consolidation of delinquent accounts payable due Cortland Memorial Hospital. The note was to be paid in full by May 31, 2002. Payment on the note was suspended in April 2001, and was in default as of December 31, 2001. GCHCC made payments totaling \$271,007 on this note through 2001, as follows:

<u>Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total Payments</u>
1998	\$ 33,626	\$ 15,648	\$ 49,274
1999	72,490	26,058	98,548
2000	80,081	18,467	98,548
2001	<u>21,298</u>	<u>3,339</u>	<u>24,637</u>
Total	\$ 207,495	\$ 63,512	\$ 271,007
	=====	=====	=====

While the costs associated with the original accounts payable were incurred for eligible services, the regulatory agreement requires HUD’s approval for any action that would further encumber the project. The conversion of the accounts payable to a promissory note resulted in an additional encumbrance on the project. This resulted in the payment of \$63,512 in additional interest beyond that of the original liability. Additionally, we believe that if HUD’s approval had been sought for the execution of the promissory note, HUD would have been made aware of the

deteriorating financial condition of the skilled nursing facility that led to its default on the HUD insured loans.

### **RECOMMENDATIONS**

We recommend that you:

- A. Recover the unallowed interest payments of \$63,512 to mitigate the loss on the note sale<sup>1</sup>.
- B. Take action to ensure that the mortgagor is aware of all regulatory agreement provisions prior to approving participation in any future mortgage insurance programs.

In accordance with HUD Handbook 2000.06 REV-3, within 60 days please give us, for each recommendation in this report, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Additional status reports are required at 90 days and 120 days after issuance for any recommendation without a management decision. Also, please furnish us copies of any correspondence or directives issued because of our review.

Should you or your staff have any questions, please have them contact John Harrison, Assistant Regional Inspector General for Audit, at 212-264-8000, extension 3978.

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<sup>1</sup> No recommendation is being made with respect to any interest that may be made paid upon the resumption of payment because HUD's financial interest terminated with the sale of the mortgage note.