AUDIT REPORT

PETERSEN HEALTH CENTER
MULTIFAMILY EQUITY SKIMMING

RHINELANDER, WI

The Operator Improperly Used Funds Required to Be Used for the Project

2005-CH-1016

SEPTEMER 16, 2005

OFFICE OF AUDIT, REGION V
CHICAGO, ILLINOIS

Issue Date September 16, 2005
Audit Report Number 2005-CH-1016

TO: Howard Goldman, Director of Minneapolis Multifamily Housing Hub, 5KHMLA
Margarita Maisonet, Director of Departmental Enforcement Center, CV

FROM: Heath Wolfe, Regional Inspector General for Audit, 5AGA

SUBJECT: The Operator Improperly Used Funds Required to Be Used for Petersen Health Center, Rhinelander, Wisconsin

HIGHLIGHTS

What We Audited and Why

We reviewed the books and records of Petersen Health Center (project). The project consists of three skilled nursing home facilities, Friendly Village, Horizons Unlimited, and Taylor Park, totaling 327 beds in Rhinelander, Wisconsin. The review was part of our efforts to combat multifamily equity skimming on the U.S. Department of Housing and Urban Development's (HUD) Federal Housing Administration insurance fund. We chose the project based upon its negative surplus-cash position since 1999, its default status, and indicators of diverted project funds/assets. Our objective was to determine whether the owner/operator used project funds in compliance with the regulatory agreement and HUD's requirements.

What We Found

Petersen Health Care of Wisconsin, Inc. (operator), the project's identity of interest operator, improperly used $728,801 in funds required to be used for project expenses from January 2003 through April 2005 when the project was in a non-surplus-cash position and/or in default of its HUD-insured loan. The inappropriate disbursements included $594,830 to P.P.F. Enterprises II, another identity of interest company, to pay estimated taxes of the partners of P.P.F. Enterprises (owner), the owner of the project; $80,385 in prepaid legal services; $47,890 for legal services not related to the project's operations; $3,000 for scholarships; $2,096 for Christmas presents; and $600 related to charitable activities. We provided the owner and operator schedules of the improper disbursements.

What We Recommend

We recommend that HUD's director of the Minneapolis Multifamily Housing Hub ensure that the owner and/or operator reimburse HUD's Federal Housing Administration insurance fund $728,801 for the inappropriate disbursements and implement procedures and controls to ensure funds required to be used for project expenses are used according to the regulatory agreement. We also recommend that HUD's director, in conjunction with HUD's Office of Inspector General, pursue double damages remedies if the owner and/or operator do not reimburse the insurance fund for the inappropriate disbursements.

We recommend that HUD's director of the Departmental Enforcement Center impose civil money penalties and pursue administrative sanctions against the owner, operator, and/or their principals/owners for the payment of inappropriate disbursements that violated the project's regulatory agreement.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided our discussion draft audit report to the owner's managing general partner and HUD's staff during the audit. We held an exit conference with the managing general partner on August 10, 2005.

We asked the managing general partner to provide comments on our discussion draft audit report by September 13, 2005. The managing general partner provided written comments dated September 13, 2005. The managing general partner disagreed that the operator improperly used $728,801 in funds required to be used for project expenses. The complete text of the written comments, along with our evaluation of those comments, can be found in appendix B of this report.

TABLE OF CONTENTS

BACKGROUND AND OBJECTIVES

Petersen Health Center (project) consists of three skilled nursing home facilities, Friendly Village, Horizons Unlimited, and Taylor Park, with 327 beds in Rhinelander, Wisconsin. The project was insured under section 232 of the National Housing Act, and its regulatory agreement was executed on May 24, 1995. The project's owner is P.P.F. Enterprises (owner). Petersen Health Care of Wisconsin, Inc. (operator) is the project's identity of interest operator. The project was in a non-surplus-cash position as of January 1999, and the owner defaulted on its U.S. Department of Housing and Urban Development (HUD)-insured mortgage as of July 2004. The owner's mortgage note was assigned to HUD on December 8, 2004, and HUD paid Cambridge Realty Capital LTD of Illinois $13,177,858 for the mortgage. HUD plans to sell the note through a note auction in November 2005.

The review was part of our efforts to combat multifamily equity skimming on HUD's Federal Housing Administration insurance fund. We chose the project based upon its negative surplus-cash position since 1999, its default status, and indicators of diverted project funds/assets.

Our objective was to determine whether the owner/operator used project funds in compliance with the regulatory agreement and HUD's requirements.

RESULTS OF AUDIT

Finding: The Operator Inappropriately Used More Than $725,000 in Funds Required to Be Used for Project Expenses

The operator improperly used $728,801 in funds required to be used for project expenses from January 2003 through April 2005 when the project was in a non-surplus-cash position. The inappropriate disbursements included $594,830 to P.P.F. Enterprises II, an identity of interest company, to pay estimated taxes of the owner's partners; $80,385 in prepaid legal services; $47,890 for legal services not related to the project's operations; $3,000 for scholarships; $2,096 for Christmas presents; and $600 related to charitable activities. The owner was also in default of its HUD-insured mortgage as of July 2004. The inappropriate disbursements occurred because the owner and operator lacked effective procedures and controls over the use of funds required to be used for project expenses. As a result, less funding was available for debt service, and funds were not used efficiently and effectively. Further, the owner's mortgage note was assigned to HUD on December 8, 2004, and HUD paid Cambridge Realty Capital LTD of Illinois $13,177,858 for the mortgage.

The Operator Improperly Distributed Nearly $600,000 in Dividends

The operator inappropriately disbursed $594,830 in dividend distributions to P.P.F. Enterprises II on July 14, 2004. P.P.F. Enterprises II then used the funds to pay the Wisconsin Department of Revenue and the U.S. Department of the Treasury for estimated taxes of the owner's partners. The State of Wisconsin provided the funds to the operator through Medicaid payments for expenses associated with the closing of Horizons Unlimited. The project was in a non-surplus-cash position and in default of its HUD-insured mortgage at the time of the disbursement. Further, the owner defaulted on its mortgage in July 2004.

The operator's controller said he thought the State of Wisconsin provided the funds to the operator to use for taxes the owner's partners would owe due to the owner discontinuing business. At the time of the disbursement, he was unaware the operator's lease with the owner bound the operator to the terms and conditions of the owner's regulatory agreement with HUD.

The Operator Inappropriately Used More Than $130,000 for Non-project Expenses

The operator inappropriately disbursed $133,971 in funds required to be used for project expenses from January 2003 through April 2005 that were not reasonable and necessary operating expenses of the project. The project was in a non-surplus-cash position and/or in default of its HUD-insured mortgage at the time of the disbursements. The following schedule summarizes the inappropriate disbursements.

Inappropriate disbursements	*Amount*
Prepaid legal services	$80,385
Non-project legal services	47,890
Scholarships	3,000
Christmas presents to doctors	2,096
Charitable campaign cash prizes	500
Charitable donation	100
Total	**$133,971**

The non-project legal services were for property refinancing and analysis of HUD's regulations. The disbursements occurred because the operator's controller said he believed the expenses were necessary and reasonable for the operation of the project.

HUD Assumed the Owner's Mortgage

The operator failed to make $2,043,401 in lease payments to the owner from July 2003 through December 2004. However, the owner did not pursue collection of the delinquent lease payments. The owner's lease agreement with the operator, dated June 2, 1995, required the operator to make lease payments sufficient for the owner to pay the project's mortgage payment, mortgage insurance premium, replacement reserves, real estate and personal property taxes, and property insurance. HUD approved the use of $1,082,194 from the project's reserve fund for replacement and sinking fund accounts to make mortgage payments from July 2003 through May 2004. HUD also authorized the suspension of the owner's payments into the reserve and sinking fund accounts from April 2001 through December 2004. Therefore, since the operator improperly used $728,801 in funds required to be used for project expenses from January 2003 through April 2005, the owner had $728,801 less in project funds to make mortgage, reserve fund for replacement, and sinking fund payments. HUD's staff at the Milwaukee Field Office of the Multifamily Housing Program Center were not aware of the inappropriate disbursements.

The owner's mortgage note was assigned to HUD on December 8, 2004, and HUD paid Cambridge Realty Capital LTD of Illinois $13,177,858 for the mortgage. The unpaid principal balance on the mortgage was $13,116,636.

As a result, the project's reserve at the time of HUD's assumption was $3,159, $160,341 below HUD's minimum requirement of $163,500 for the project. The project's reserve would have been more than $1 million if project funds had been available to make the mortgage, reserve, and sinking fund payments. HUD plans to sell the note through a note auction in November 2005.

Recommendations

We recommend that HUD's director of the Minneapolis Multifamily Housing Hub require the owner and/or the operator to

1A. Reimburse HUD's Federal Housing Administration insurance fund $728,801 for the inappropriate disbursements cited in this report.

1B. Implement procedures and controls to ensure funds required to be used for project expenses are used according to the regulatory agreement.

We also recommend that HUD's director of the Minneapolis Multifamily Housing Hub in conjuction with HUD's Office of Inspector General

1C. Pursue double damages remedies if the owner and/or operator do not reimburse the Federal Housing Administration insurance fund for the inappropriate disbursements.

We also recommend that HUD's director of the Departmental Enforcement Center

1D. Impose civil money penalties against the owner, the operator, and/or their principals/owners for the payment of inappropriate disbursements that violated the project's regulatory agreement.

1E. Pursue administrative sanctions against the owner, the operator, and/or their principals/owners for the inappropriate disbursements.

SCOPE AND METHODOLOGY

We performed the review at HUD's Milwaukee Field Office, the owner's/operator's offices, and the project from February through June 2005. To accomplish our objectives, we interviewed HUD's staff; employees from the project and the owner; the owner's managing general partner, who is also the operator's president; an employee from Ginoli and Company LTD, the independent public accountant who audited the project; the vice-president of Cambridge Realty Capital LTD of Illinois, with whom the owner entered into the HUD-insured mortgage for the project; and the chief, Nursing Home Section, Bureau of Fee-for-Service Health Care Benefits, Division of Health Care Financing, State of Wisconsin Department of Health and Family Services.

To determine whether the owner/operator used project funds in compliance with the regulatory agreement and HUD's requirements, we reviewed

- The regulatory agreements among HUD, the owner, and/or the operator;
- HUD's files and correspondence related to the project;
- HUD's Real Estate Management System and Financial Assessment Subsystem information related to the project;
- The owner's partnership agreement and modification;
- The owner's lease with the operator;
- The owner's mortgage and security agreements with Cambridge Realty Capital LTD of Illinois;
- The owner's and the operator's financial records;
- The owner's audited financial statements for the years ending December 31, 1999, 2000, 2001, 2002, 2003, and 2004;
- The operator's records of organization; and
- P.P.F. Enterprises II's partnership agreement.

We also reviewed Title 12, *United States Code*, sections 1715 and 1735; Title 31, *United States Code*, section 3801; 24 CFR [*Code of Federal Regulations*] 24 and 232; and HUD Handbooks 2000.06, REV-3; 4350.1, REV-1; 4370.2, REV-1; and 4381.5, REV-2.

The review covered the period from January 1, 2003, through December 31, 2004. This period was adjusted as necessary. We performed our review in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

Internal control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting,
- Compliance with applicable laws and regulations, and
- Safeguarding resources.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined the following internal controls were relevant to our audit objectives:

- Program operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.

- Validity and reliability of data – Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.

- Compliance with laws and regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

- Safeguarding resources – Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse.

We assessed all of the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Significant Weaknesses

Based on our review, we believe the following items are significant weaknesses:

- The owner and operator lacked effective procedures and controls over the use of funds required to be used for project expenses.

APPENDIXES

Appendix A

SCHEDULE OF INELIGIBLE COSTS

Recommendation number	Ineligible 1/
1A	$728,801
Total	$728,801

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or federal, state, or local polices or regulations.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation | **Auditee Comments**

P.P.F. ENTERPRISES
900 Boyce Drive, P.O. BOX 857
Rhinelander, WI 54501

September 13, 2005

Heath Wolfe, CGFM, CFS
Regional Inspector General for Audit, Region V
U.S. Dept. of Housing and Urban Development
77 W. Jackson Blvd., Room 2646
Ralph M. Metcalfe Federal Building
Chicago, IL 60604

Re: Petersen Health Care, Rhinelander, Wisconsin
FHA Project No. 075-43103

Dear Mr. Wolfe:

This letter is being presented to you as the response of P.P.F. Enterprises, a Wisconsin partnership ("P.P.F."), to the discussion draft Audit Report of HUD's Office of Inspector General for Audit (the "Draft Audit Report") which accompanied your July 22, 2005 letter to P.P.F. with respect to Friendly Village, Horizons Unlimited, and Taylor Park, three skilled nursing home facilities which are identified among HUD's records as described in the caption of this letter (the "Project").

This letter has been prepared on behalf of P.P.F. by the joint efforts of P.P.F., its general counsel, Reinhart Boerner Van Deuren, s.c. ("Reinhart") and its special counsel, Honigman Miller Schwartz and Cohn LLP.

BACKGROUND

Before specifically responding to the Draft Audit Report, we believe that it is important that we provide you with certain background information with respect to the history of these nursing homes, HUD's extensive involvement and the unique and unfortunate reimbursement programs which exist in the State of Wisconsin for facilities of this type.

In the exit conference conducted by OIG auditors, Heath Wolfe, John Martin-Mehrl and Bruce Bowen, it was explained that the audit was being conducted because of HUD's concern about the number of defaults that have been taking place in recent years with respect to nursing homes financed with HUD-insured loans. It was further explained that there were two goals of the audit: 1) to determine if the borrower remained in compliance with the applicable Regulatory Agreement; and 2) to get an understanding why so many projects have gone into default. It is unfortunate that the Draft Audit Report only addresses the Regulatory Agreement compliance

Ref to OIG Evaluation	**Auditee Comments**

issue and does not address the larger, more pervasive issue of the inflexibility of two large governmental bureaucracies: HUD and the State of Wisconsin.

This HUD-insured loan covers a large long-term care complex in Northern Wisconsin. At the loan origination, three institutional facilities were involved: Horizons Unlimited, a 198 bed facility serving the mentally retarded; Friendly Village, a 152 bed facility serving the frail elderly; and Taylor Park, a 100 bed facility serving the frail elderly. The initial purpose of the loan was to procure low interest financing so that the living environment for people being served could be upgraded; to expand services, such as ventilator care; and to add space for staff training and development that would further enhance services to those being served. The Title XIX Medicaid Program was the primary purchaser of services covering 85% of the residents with an occupancy that was at 95%.

A primary intent of this portion of the response is to show how extensive the operator, Petersen Health Care of Wisconsin, Inc. ("Petersen"), has worked to keep the operations functioning in Rhinelander, Wisconsin, with the interest of those being served at the forefront. Petersen has been operating the Project under a Lease approved by HUD (the "Lease").

From the time that the application process for the HUD-insured loan began in 1992 through the closing in 1995, Medicaid and Medicare reimbursement formulas were favorable and would support the renovation work planned by P.P.F. and clearly showed that the Project would be financially viable. Before HUD final endorsement and when most of the renovation work had been completed, it was apparent that this loan would be in difficulty. Changes began occurring in both reimbursement programs that would result in lower than anticipated revenues in the ensuing years. (Exhibit 1) In 1997, Petersen negotiated with the State of Wisconsin an agreement that would reduce the licensed beds of Horizons Unlimited while receiving favorable reimbursement. This strategy would help maintain revenues and keep the Project viable. Petersen solicited and obtained the involvement of the office of Tommy Thompson, Governor of Wisconsin. (Exhibit 2) Approval for this downsizing was granted by HUD on June 30, 1997. It is interesting to note that this approval was granted at the same time that the HUD final endorsement was occurring.

In December, 1997, Petersen met with officials of Wisconsin's Department of Health and Family Services to discuss the future of the Horizons Unlimited facility. A very specific question was asked, "What is the State's expectation of Horizons Unlimited in ten years?" The response given by the State was that the "expectation would be that the facility would close" within 10 years. That prompted spirited conversation about the impact to the entire organization. It was explained that three facilities are involved which are encumbered with one mortgage loan. If one of the facilities failed to exist, the operations of the other two facilities would be impacted severely to the point of closing themselves because of the inability of the operator to make lease payments to the owner large enough to meet the owner's debt service obligation. This conversation resulted in another downsizing agreement that reduced the capacity of Horizons Unlimited from 148 beds to 75 over a five year period. Included in this arrangement was the assurance of an additional $50,000 monthly payment to the operator to pass on to the property owner to use in prepaying the HUD-insured loan. HUD approved this agreement on July 2,

Mr. Heath Wolfe
September 13, 2005
Page 3

1999, with a 2nd Mortgage Modification Agreement. The net result was a prepayment of Three Million ($3,000,000) Dollars on the HUD-insured debt over a five year period. (Exhibit 3)

The operations of the two skilled nursing facilities were impacted in 1998 when there was a significant change in the Medicare payment system to skilled facilities. The philosophy of the U. S. Department of Health and Human Services changed from a "cost" base system to a modified price based system. This resulted in Petersen needing to abandon some of the programs and services acquired through the HUD-insured loan financed renovation. One example is a ventilator program that had to be eliminated. Through the HUD-insured financing, a unit at the Taylor Park facility was reconfigured to serve the complexities of ventilator care. The unit opened in late 1997. The Medicare funding changes so dramatically affected this program that it was no longer cost effective to maintain it and the program was discontinued in late 1999.

Petersen was able to meet its lease obligations through the years, primarily because of the downsizing contract impacting Horizons Unlimited. Petersen and Cambridge Realty Capital Ltd of Illinois ("Cambridge"), the originator and holder of the HUD-insured loan, kept HUD fully informed of the financial condition of the operations. However, it was becoming clear in 2002 and 2003 that the facilities' financial challenges were increasing. In the two skilled facilities serving the frail elderly, the cost of care exceeded what was being reimbursed from Medicaid. Petersen worked diligently to find solutions that would protect the viability of the company and protect the interest of HUD. Consistently since 2000, experts in reimbursement systems and long-term care trade associations have documented the severity of the under-funding of the Medicaid program. Some of these reports were discussed with the Milwaukee HUD office. (Exhibits 4 & 5)

In 2001, P.P.F. requested from HUD a suspension of deposits to the sinking fund and replacement reserves. This was granted on February 28, 2001. This enabled Petersen to maintain cash flow without adversely impacting the services being provided.

During 2002, Petersen kept Cambridge informed of the financial condition of the Project. Exhibits 6 & 7 are examples.

On March 5, 2003, Petersen and P.P.F. met with Christina Hamilton of U. S. Congressman Dave Obey's staff. The financial concerns were reviewed and assistance was sought in seeing if there was any assistance that could be given in helping get a restructuring of the HUD-insured loan. Petersen emphasized to the Congressman's staff the severity of the situation and the risk of closing a large nursing home complex and the loss of jobs. Included in the meetings was Michelle Burkett, a staff person to the House Appropriations Committee. Both of these individuals made inquiries to HUD on P.P.F.'s and Petersen's behalf to see if any restructuring could be done. They put P.P.F. and Petersen in touch with Ms. Nita Nigam at HUD's Washington headquarters. On March 18, 2003, Terrel Friese spoke to Ms. Nigam and she informed him that HUD would not do any "work out deals."

Mr. Heath Wolfe
September 13, 2005
Page 4

On June 16, 2003, Petersen and Cambridge met with HUD to explore potential solutions to the worsening financial condition of the operations. From that meeting it was decided that P.P.F. would pursue a 3rd Mortgage Modification with the intent of lowering the interest rate. Also, it was decided that P.P.F. would request access to the sinking fund to assist in meeting its debt service requirements. Approval for this was received on July 1, 2003.

On July 1, 2003 Petersen met with Mr. Mark Moody, Administrator, Department of Health Care Financing, State of Wisconsin, to discuss options available for better Medicaid reimbursement. It was stressed in the meeting the severe impact which a financial failure would have to residents and employees. Mr. Moody could not offer direct assistance but encouraged Petersen to develop a business plan that would address equity restructuring. The State may then consider financial assistance.

On August 25, 2003 an application for a 3rd Mortgage Modification was made by Cambridge to HUD.

There were numerous phone conversations and emails between Petersen, P.P.F., HUD's Milwaukee office, and Cambridge between the period of September 2003 and April 2004 regarding the status of the approval of the application for the 3rd Mortgage Modification. Numerous reasons for delays in approval were given including hurricane damage in Florida in the fall of 2003 and the extended medical leave of a Washington HUD staff person in the winter and early spring of 2004.

Because of not receiving HUD approval of the 3rd Mortgage Modification, Petersen met with Dave Lund, Bureau of Health Care Financing, State of Wisconsin, to discuss the consequences to the operation if refinancing at a lower interest rate does not occur timely. Again, emphasis was on the future of the operations and what would happen to the facilities, the residents being served, the employees, and the local economy if there was a financial failure of the three facilities. From this meeting, an agreement was reached to extend the downsizing agreement of Horizons Unlimited from February 2004 to December 2004. The State would continue paying the facility under the terms of the agreement reached in 1998, including the additional $50,000 per month payment to be applied as a partial prepayment of principal on the HUD-insured loan. This would have resulted in an additional $500,000 principal pay-down on the HUD-insured debt. The facility would further reduce its license capacity to 70 beds. An agreement was signed to that effect on November 26, 2003. (Exhibit 8)

On December 3, 2004, Cambridge and P.P.F. were notified of HUD's denial of the 3rd Mortgage Modification application. P.P.F. discussed this with a Milwaukee HUD office representative and learned that the requirements of the lender outlined in the application did not meet HUD criteria. A revised application would have to be submitted. In this conversation, P.P.F. mentioned to the HUD representative the agreement reached with the State on further downsizing and the advantageous reimbursement. HUD's representative informed P.P.F. that this would have to be incorporated in any future application to HUD. P.P.F. passed this on to Cambridge on December 4, 2003 via email. (Exhibit 9)

On December 24, 2003, P.P.F. sent Cambridge an email alerting it to the changes in Wisconsin concerning the future of facilities such as Horizons Unlimited. Also, the email raised the question of whether any further downsizing agreement should be included in the revised 3rd Mortgage Modification application. The email documents a previous conversation between P.P.F. and Cambridge where Cambridge felt that a downsizing agreement conversation needs to be a separate conversation and approach. In the same email is a statement of P.P.F.'s concern for the interests of HUD. (Exhibit 10)

On December 16, 2003, a revised 3rd Mortgage Modification application requesting an interest rate reduction was submitted to HUD with changes which HUD had requested in its December 3, 2003 letter.

In January, 2004, P.P.F. sought relief from HUD by requesting the release of monies on deposit in the sinking fund and replacement reserves to help make debt service payments.

Throughout the first five months of 2004, P.P.F. frequently communicated with the Milwaukee HUD office and Cambridge seeking the status of the 3rd Mortgage Modification approval. The reason consistently given for these inquiries dealt with sustainability of day-to-day operations.

The 3rd Mortgage Modification approval was given on May 3, 2004. (Exhibit 11) However, when this approval was received, P.P.F. was informed by Cambridge that there were certain conditions that needed to be met. Among such conditions was the requirement of obtaining HUD's approval for further bed reductions! An application would have to be resubmitted. Exhibit 12 is P.P.F.'s log of conversations that took place between Cambridge and Milwaukee HUD. A simple summary shows that a number of other problems developed that P.P.F. had no control over that would delay resubmitting yet another 3rd Mortgage Modification application. Chief to this was the concern that HUD may not approve another bed reduction and secondly problems that Cambridge was encountering with its "investors." Essentially, P.P.F. was at a "start over" point. A whole year had been lost due to circumstances beyond P.P.F.'s or Petersen's control.

Petersen met with Dave Lund, State of Wisconsin, Bureau of Health Care Financing, and explained the problems being encountered. Petersen also explained that the Downsizing Extension Agreement reached the previous November was invalid. After understanding that the process would have to restart, Mr. Lund informed Petersen that it seemed hopeless that the Petersen facilities would survive, that there was absolutely nothing else he could do to help and the only alternative would be to "settle up" the Downsizing Agreement as if it had expired on February 28, 2004, the original contract end date. An agreement to this effect was executed on June 30, 2004. (Exhibit 13)

It needs to be stated that Petersen submitted an extra $50,000 per month to Cambridge, on behalf of P.P.F., for March and April 2004, intended to be used to reduce the HUD-insured loan under the assumption that the Downsizing Extension Agreement would be approved by HUD. Since this did not occur, Cambridge returned the $100,000; Petersen reported this result

Mr. Heath Wolfe
September 13, 2005
Page 6

to the State of Wisconsin and a similar amount was withheld from Petersen's later reimbursement payments.

Another important activity that took place in early 2004 was Petersen's efforts to identify other entities that would be interested in partnering, acquiring, or investing in Petersen. A number of conversations took place with Ministry Health Care, owner of the hospital system serving Rhinelander. They were approached because of their positive presence in the community and what would appear to be the most seamless transition for residents and employees. Other entities contacted include Community Health Care of Wausau, WI; Evangelical Lutheran Good Samaritan Society, Sioux Falls, SD; and Good Shepherd Services of Seymour, Wisconsin. These organizations were approached because of Petersen's desire to link with entities that shared common values in business practices that would sustain a quality of care and a stabilized work force that had been developed by Petersen.

During 2003 and 2004, Petersen also pursued a relationship with the local technical college, Nicolet Area Technical College. What was being discussed and negotiated would be the leasing of vacated space in the Horizons Unlimited facility to the tech school for their allied health care curricuia, including nursing and certified nursing assistants. This would have been beneficial for the operations in that it would have provided training grounds for future employees for Petersen, thus reducing recruiting costs.

Petersen was unable to make lease payments beginning in July 2004. This caused P.P.F. to go into default. However, even with that, Petersen continued to explore permanent solutions for the financial condition of the company. A presentation was made to Mark Marotta, Secretary of the Department of Administration, State of Wisconsin in November 2004. A Concept Paper was presented that encapsulated many of the long-term care reform concepts that the State has been considering and forged them into a business plan for Petersen that would sustain the operations of the Project for several years. (Exhibit 14) This plan was summarily rejected by the State as evidenced in Secretary Helene Nelson's letter of December 27, 2004. (Exhibit 15) In fact, Secretary Nelson's letter suggested that P.P.F. and Petersen close completely the Horizons Unlimited facility and seek an entity to assist in reorganizing Petersen. The State, even though it recognizes Petersen as a good provider, was rejecting doing further business with Petersen due to its economic situation.

The inadequate Medicaid funding continues to be a problem in Wisconsin and for the Project. It has resulted in major political debates and battles. The Project does not stand alone in facing this crisis. The industry trade association has lobbied hard and strong to get the State to increase its financial commitment to the long-term care profession. (Exhibits 16 & 17)

What is the purpose of this exhaustive explanation of what had transpired over time in the history of this loan?

This response explains the second query made by the OIG auditors during the exit conference: Why are there defaults? All of this had previously been explained to the HUD auditor, but is conspicuously absent in the Draft Audit Report.

It is also intended to show that P.P.F. and Petersen worked diligently from the time the HUD-insured loan originated to make sure the Project was solvent and that services to people would continue. Petersen's chief motivation has been the interest of the people living in the facilities, the employees, and even HUD itself. What actually transpired was an operator being victimized by regressive payment reimbursement systems, slow moving bureaucracies, and ill advised professional advice.

In summary therefore, recognizing these circumstances, starting in 1998, with HUD's approval and cooperation, all applicable parties agreed to reduce the bed capacity of the Project under arrangements whereby extraordinary payments were provided by the State of Wisconsin which were used to make monthly prepayments of principal with respect to the HUD-insured loan. This process continued through February 2004 because HUD declined to approve any further bed reduction program and the holder of the HUD-insured loan could not (or would not) accept any further monthly prepayments of principal. Because HUD did so, the State of Wisconsin saw fit to accelerate the bed reduction action plan and made an extraordinary payment to Petersen. These actions of the State of Wisconsin further imperiled the already precarious economic viability of the Project. On the one hand, Petersen was compelled to reduce the number of licensed beds, resulting in dramatically reduced reimbursement revenue, and, on the other hand, HUD and Cambridge refused to modify the HUD-insured loan or to accept any more principal reduction payments. With reduced reimbursement revenue and no debt service relief, Petersen was unable to continue to make monthly payments under the Lease. At this juncture, Petersen consulted with its attorneys and its independent certified public accountant to decide how to deal with the extraordinary payment which it had received from the State of Wisconsin.

RESPONSES TO DRAFT AUDIT REPORT

Turning to the precise findings contained in the Draft Audit Report, we offer the following specific responses to the items raised under the category "Finding: The Operator Inappropriately Used More Than $725,000 in Funds Required To Be Used For Project Expenses."

P.P.F. disagrees that Petersen improperly used $728,801 in funds required to be used for Project expenses from June 2003 through April 2005 for, among other reasons, the following:

Comment 1

1. Initially we are confused about why the Draft Audit Report directs its attention to P.P.F. for actions alleged to have been taken by Petersen. If, as discussed below, HUD believes that Petersen's actions were improper, it appears more appropriate that the remedies available for breach of the Lease would be applicable.

Comment 2

2. P.P.F. questions whether the funds received by Petersen from the State of Wisconsin in July 2004, which funds were used to make a dividend distribution of $594,830 to Petersen's shareholders, constituted personal property of the Project as contemplated by Paragraph 6(b) of the Regulatory Agreement between P.P.F. and HUD (the "P.P.F. Regulatory Agreement"). In considering this issue, it is important to understand the context of ongoing discussions that took place

Mr. Heath Wolfe
September 13, 2005
Page 8

between Petersen Health Care and the Wisconsin Department of Health and Family Services, Division of Health Care Financing. Medical Assistance ("MA") payments made to nursing facilities are based on a prospective payment system that does not fully reimburse facilities for their MA-related costs. Downsizing discussions and eventual arrangements, such as those entered into by Petersen and the State of Wisconsin, commence in an environment where MA-related care costs were higher than the reimbursement amount. Consider the following:

(a) Any skilled nursing facility that enters into a downsizing agreement must comply with State of Wisconsin requirements as defined in Section 50.03 of the Wisconsin Statutes. The Department of Health and Family Services has statutory authority under these statutes to provide, direct or arrange for resident relocation planning, placement and implementation services in order to minimize the trauma and costs associated with the relocation of residents and to ensure the orderly relocation of residents. The extensive nature of facility downsizing including the loss of revenues associated with the required bed reductions results in arrangements whereby the State attempts to provide additional financial resources to the affected facility for certain time periods during the downsizing process.

In this regard, it is instructive to review the history of discussions with the State of Wisconsin regarding bed downsizing of the Project and the intentions and expectations of the parties regarding the monies received as part of the downsizing arrangements. This is key to understanding why the funds received by Petersen from the State of Wisconsin did not constitute personal property of the Project.

(b) Mr. David Lund, Chief, Nursing Home Section of the Division of Health Care Financing, Department of Health and Family Services ("Department") and Terrel Friese met on October 13, 2003 to discuss future strategies for the Petersen Health Care campus and Horizons Unlimited ("Horizons"), the Project's ICF/MR facility. Prior to this time, the Department and Petersen had entered into an agreement dated June 30, 1998 whereby Petersen agreed that, during the period from March 1, 1999 through February 28, 2004, it would return a total of 73 beds to the State of Wisconsin Resource Allocation Program which would permanently reduce the licensed bed capacity to 75 beds. The phased down rates that were agreed to as a result of the facility's downsizing were to be Horizons' cost plus, at the suggestion of Mr. Friese, a $600,000 annual allowance for nursing home mortgage reduction to be paid in equal monthly installments (i.e. $50,000 per month).

(c) The following thoughts/possibilities were discussed during the October 13, 2003 meeting:

- Combine Friendly Village and Horizons licensure using Horizons as a distinct part.
- Keep Horizons separate, but add some of the vacated Horizons space to Friendly Village for other specialty units such as Brain Injury.
- The possibility of licensing the whole complex under one license to help in covering costs.

(d) The pros and cons of the various ideas noted above were discussed. The sense was that the response of the Bureau of Quality Assurance to the licensure issues would determine which options, if any, were possible. For example, a distinct part approach was probably not viable due to the new ICF/MR initiative undertaken by the State and the fact that distinct parts need approval every four years.

(e) Mr. Lund pointed out another challenge with respect to future reimbursement changes: there will be a change in direct care reimbursement where some of what was previously "cost based" will now become "priced based." This would include activities, social services and recreation. In a sense, all of the active treatment components of Horizons would fall under a capitated payment and not be cost based.

(f) Given this dynamic and the uncertainty of the proposed State ICF/MR Relocation Initiative, discussion of another downsizing agreement took place. Discussions centered on reducing the licensed capacity of Horizons to 65 beds to be accomplished by extending the existing June 30, 1998 downsizing agreement through December 31, 2004. Mr. Friese agreed to consider this idea and respond to Mr. Lund.

(g) Mr. Lund and Mr. Friese talked again on November 14, 2003. It was agreed that extending the downsizing agreement would be the best course of action. Mr. Friese felt that reducing the licensed bed capacity to 65 beds by end of 2004 was too aggressive and not able to be accomplished given a lack of cooperation by various counties in relocating residents. It was agreed to reduce the licensed beds to 70 by extending the original agreement from March 1, 2004 to December 31, 2004 with the same conditions as set forth in the original agreement, including $50,000 per month for mortgage debt reduction, which was again specifically requested by Mr. Friese. This approach was again confirmed in a face-to-face meeting between Mr. Lund and Mr. Friese on November 26, 2003 at 1 West Wilson Street, Madison, at the offices of the Department of Health and Family Services and the Agreement was signed on November 26, 2003.

Mr. Heath Wolfe
September 13, 2005
Page 10

(h) On May 25, 2004 Mr. Friese updated Mr. Lund on the status of HUD discussions and attempts at mortgage modification. Mr. Friese explained problems with attempting to get a mortgage modification through HUD that would permit an interest rate reduction. Mr. Friese also described the dilemma of requesting bed reduction approval that the State agreed to in November 2003. The dilemma centered on two issues: 1) HUD's position that the reduction request should have been submitted with the mortgage modification request in December 2003. 2) There was no guarantee that HUD would approve future downsizing without first restoring funds to the replacement reserve account which was almost depleted.

Mr. Friese expressed considerable concern to Mr. Lund that without the downsizing agreement and mortgage modification, default on the HUD mortgage loan would be imminent. This concern was heightened by the implementation of the State's ICF/MR Relocation initiative and the changes in direct care reimbursement.

(i) Mr. Lund's response was one of shared frustration. He indicated there wasn't any more that he could do and felt that a crisis was inevitable. He indicated that the original downsizing agreement had expired on February 28, 2004 and that what should happen is a voiding of the extension agreement signed on November 26, 2003 and that Horizons and the State should come to an agreement on what a "settlement amount" would be "and let the chips fall where they will." Mr. Friese brought up the issue of amounts already paid by the State in March, April, and May 2004 for mortgage debt principal reduction. Mr. Lund indicated those funds would be part of the settlement payments to Petersen and to be used to meet the obligations of Petersen in any manner that Petersen deemed necessary. Summarizing this meeting:

1) The State will not pay State funds into a Replacement Reserve account.

2) Monies paid from March through May for mortgage debt principal reduction were to be part of the "settlement figure" and to be used at Petersen's discretion.

3) Prepare for default.

4) State will be prepared to negotiate with whomever HUD sells the mortgage, whenever that may occur.

(j) Mr. Lund and Mr. Friese agreed to talk again in early June.

Mr. Heath Wolfe
September 13, 2005
Page 11

(k) A follow-up conversation between Mr. Lund and Mr. Friese occurred in early June 2004. Mr. Lund indicated that the settlement would go forward and the amount of settlement would be $230.50 a day for the period July 1, 2003 to May 31, 2004 plus an additional $46,532.79 for June 2004. This equated to payments totaling $599,768.79 plus the $150,000 paid in March, April, and May 2004 for mortgage principal reduction. Thus, the total settlement was $749,768.79. Mr. Lund indicated that the final settlement payment possessed a unique and separate character different from the prior downsizing arrangements which were designed primarily to provide funds for mortgage debt reduction payments at the request of Mr. Friese. Mr. Lund and Mr. Friese agreed that the final settlement payment would not be used for mortgage debt reduction and was being advanced without preconditions.

Comment 2

(l) As Mr. Lund indicated, unlike the previous monthly payments which were specifically earmarked for debt reductions (at Petersen's insistence), the final payments, like the vast majority of similar payments made by the State, were not designated for specific purposes. Rather, the payments were designed to cushion the effect on the business of the facility caused by the reduction in the resident population. For example, a reduction in resident population may affect the level of office, maintenance or grounds keeping staff. It may affect the purchase obligations for capital equipment or current lease obligations. It may affect ancillary services, such as pharmacy, dental or physical therapy services and staffing, such as those provided by Petersen, all of which were directly impacted by the reduction in the resident population inherent in a bed reduction. Each of these are effects on the "general business" of the facility which need to be addressed in the wake of a reduction in resident population caused by the downsizing. Mr. Lund appreciated that these effects on the general business of Petersen had to be addressed, and intended the final payment, which was given without restriction, to be a fund to be used, in part, for these and other purposes.

Comment 1

3. Whether or not the funds received from the State of Wisconsin referred to in No. 2 above constitute personal property of the Project as referred to in Paragraph 6(b) of the P.P.F. Regulatory Agreement, P.P.F. owes no responsibility to HUD for Petersen's distribution to its shareholders since P.P.F. was not a party to any such conduct even though there is an identity of interest between P.P.F. and Petersen. Contrary to the apparent conclusion contained in the Draft Audit Report, P.P.F. has no responsibility for the conduct of Petersen or the shareholders of Petersen or other entities owned by such shareholders. Petersen has committed no default under the Regulatory Agreement which it entered into with HUD (the "Petersen Regulatory Agreement") other than resulting from its financial inability to make payments under the Lease. It is inappropriate for the OIG to criticize P.P.F. for

Comment 1

actions which the OIG auditors may believe were improperly taken by either Petersen or the shareholders of Petersen, despite the identity of interest which exists between P.P.F. and Petersen. This appears to be clear from the fact that when the HUD-insured loan in question was insured for mortgage insurance by the Secretary of Housing and Urban Development, two separate, distinct and independent Regulatory Agreements were entered into, one between P.P.F. and HUD, and a second substantially different one between Petersen and HUD. The Draft Audit Report cites, as authority for the OIG's apparent conclusion, Article II, Section 2.1, Paragraph E, of the Lease. It is hard to understand or discern the meaning of the covenant cited by the OIG from the Lease. The P.P.F. Regulatory Agreement contains many covenants and undertakings which, among other things, constrain the behavior of P.P.F. For instance, Section 6(a) of the P.P.F. Regulatory Agreement prohibits P.P.F., without HUD's prior written approval, from transferring title to the Project. Would Petersen be in default under the Lease if P.P.F. were to breach this covenant and convey title to the Project without HUD's prior written approval? Obviously, no. As such, each specific covenant of the P.P.F. Regulatory Agreement needs to be studied to determine whether any of Petersen's conduct violated the P.P.F. Regulatory Agreement as opposed to the Petersen Regulatory Agreement. The manner in which the OIG is apparently interpreting the Lease provision appears to take the questionable legal position that Project funds coming into Petersen's possession should, by some legal fiction or feat of magic, be treated as if the same funds had come into P.P.F.'s possession. We disagree with this strained and unfair legal conclusion. If, in fact, this conclusion is what was intended, the Petersen Regulatory Agreement should have said so. Furthermore, if and to the extent that Petersen breached the Lease (as the Draft Audit Report indicates) the remedies for such breach are limited to those remedies available under Wisconsin law, including the eviction of Petersen from the premises. See Section 12.2 of the Lease. It is inappropriate to impose duties and obligations upon P.P.F. by virtue of an alleged breach of the Lease by Petersen.

4. P.P.F. questions the conclusion that Petersen inappropriately disbursed $133,971 for expenses which were not reasonable and necessary operating expenses of the Project. Analyzing each of the items making up this amount in the order presented in the Draft Audit Report, P.P.F. offers the following:

(A) P.P.F. incorporates in response to these items, the discussion contained in No. 3 above.

(B) **Prepaid Legal Services**

Comment 3

The Draft Audit Report includes a finding that Petersen inappropriately disbursed $80,385 in prepaid legal services. This money for prepaid legal services represents a pool of money that was advanced for the purpose of

Comment 3

paying legal expenses related to the Project. In addition, this money has been and continues to be available to the Project.

Reinhart requires that clients provide money in advance as a retainer with the firm to engage the firm's services. This is a common practice among law firms. The retainer is held by Reinhart in a trust account on behalf of Petersen, and these monies are and always have been available to Petersen. Without advancing a retainer of this sort, Petersen would not be in a position to hire legal counsel to provide advice and represent its interests with respect to the Project.

As discussed below, all of the legal services provided to Petersen were for the benefit of the Project and not the owner of the Project. Similarly, as with the other legal services, these Petersen assets held in trust by Reinhart will only be used for services provided to benefit the Project. As such, the prepaid legal services should not be characterized as an improper disbursement from Petersen. These monies continue to be available to the Project and can be returned at any time.

(C) **Non-Project Legal Services**

The Draft Audit Report includes a finding that Petersen inappropriately disbursed $47,890 for legal services "not related to the project's operations." HUD Directive Number 4370.2, Section 6340 defines legal expenses as "legal fees or services incurred on behalf of the project" but does not further describe what types of legal fees are incurred "on behalf of a project."

Comment 4

(a) Two cases have attempted to clarify the circumstances under which a legal expense is a reasonable operating expense incurred on behalf of a project. In United States v. Thompson, 408 F.2d 1075 (8th Cir. 1969), the court stated that operating expenses must primarily benefit the project rather than the owner. A subsequent court case, United States v. Maurice B. Frank, 587 F.2d 924 (8th Cir. 1978), examined the reasonable operating expense in the context of attorney's fees. The Frank court stated that it is accepted that attorney's fees are operating expenses only if they are incurred to benefit the project. Whether a legal action benefits the project, however, has been infrequently considered.

(b) Another layer of complexity found with respect to the Project makes it different from the typical arrangement for which the HUD regulations and Directives were originally written, and which was not contemplated by either the Thompson or Frank courts. Petersen operates health care facilities, which are strictly regulated

Ref to OIG Evaluation | **Auditee Comments**

Mr. Heath Wolfe
September 13, 2005
Page 14

by both the State of Wisconsin and the federal government and subject to a host of regulations and requirements far beyond those found in a standard landlord-tenant relationship. In contrast with the typical apartment complex constructed with the benefits of HUD-insured financing, the operating revenue of the Project involves a complex matrix of reimbursement streams, causing an equally complex series of legal issues in the ongoing operation of the Project. Negotiations between Petersen and the state over bed reductions or a negotiation with HUD and Cambridge over interest rate reductions were both done in furtherance of the Project's continued viability, especially given the current reimbursement climate, as discussed in more detail above. These complexities go beyond the "legal fees for eviction procedures" which the HUD Directive contemplated when it was drafted.

Comment 4

The threshold question seems to be whether legal expenses incurred on behalf of Petersen and termed inappropriate in the Draft Audit Report were actually incurred to benefit the Project rather than the owner of the Project, and thus should be viewed as appropriate.

(c) As we understand it, the OIG auditors used a categorization system in order to determine whether billing entries for legal services were related to the Project's ongoing operations. This course of action might be perfectly reasonable in the standard HUD-insured apartment project. Unfortunately, with respect to the Project, the categorization system fails to adequately take into account the complexities described above. We will attempt to explain the various situations in which Petersen's legal counsel provided services, and the reasons why the legal work performed in each of these situations was undertaken to benefit the Project itself and not the owner of the Project. It should be noted that in all of these cases, it was necessary to examine the permissibility of any action taken with respect to the various Regulatory Agreements between Petersen, P.P.F., and HUD.

1) <u>Negotiations to Restructure the Mortgage Loan with Cambridge</u>. The legal services rendered to Petersen to restructure the loan were essential for the ongoing operations of the Project. Petersen was required under its agreement with P.P.F. to pay P.P.F. a monthly rental equal to what P.P.F. had to pay to Cambridge for debt service as well as various other payments (escrow amounts, etc.) Due to unfavorable changes in the Medicaid reimbursement system and some policy changes at the state level resulting

Ref to OIG Evaluation	Auditee Comments

Mr. Heath Wolfe
September 13, 2005
Page 15

Comment 4

in a reduction of the number of beds in one of the facilities (discussed below), Petersen faced increasing difficulty in making the required lease payments. Restructuring the debt would have lowered the monthly payments from P.P.F. to Cambridge, thereby lowering the lease payments required from Petersen to P.P.F., thus protecting the long-term viability of the Project. These expenses are clearly for the benefit of the Project, and not the owner.

2) Downsizing Agreements with the State of Wisconsin. The State of Wisconsin's policy has changed in recent years regarding inpatient facilities for the mentally retarded ("ICF/MR"). One of the facilities in the Project, Horizons Unlimited, is one such ICF/MR. Counsel was retained to negotiate the downsizing of Horizons Unlimited in a manner which attempted to protect the Project's ongoing viability given the decrease in revenues that would stem from this downsizing. Included in this work was research and review of HUD documents to determine whether a downsizing without HUD's approval would result in a default under the HUD-insured loan as well as any additional consequences. Again, this work was done in order to provide Petersen with information sufficient to make a decision as to the ongoing operation of the Project.

3) Negotiations with Ministry Health Care and Other Potential Investors. Petersen entered into negotiations with Ministry Health Care, the owner of the hospital system serving the area, to gauge their interest in investing in, partnering with, or possibly acquiring the Project and the possible assumption of the HUD-insured debt. This was done once it became clear that a restructuring of the HUD-insured debt would not occur in time to allow Petersen to continue to meet its obligations to P.P.F. under the lease. Additional resources were needed to ensure the continued viability of the Project, and this legal work was done in furtherance of this goal, and not to benefit the owner of the Project. Similar work was done in an attempt to target other possible investors.

4) Negotiations with Bethesda Lutheran. Petersen entered into negotiations with Bethesda Lutheran, at the direction of the State of Wisconsin, for Bethesda to act as the "manager" for purposes of relocating all of the residents of Horizons Unlimited and its closing by December 31, 2005.

Ref to OIG Evaluation **Auditee Comments**

Mr. Heath Wolfe
September 13, 2005
Page 16

This clearly was done in connection with a regulatory directive from the State of Wisconsin and in no way benefited the owner.

5) Legal Research and Other Work Regarding a Section 232 HUD-Insured Loan in Default. When it became clear to Petersen that, despite everyone's best efforts, the loan was likely to go into default due to unfavorable reimbursement levels and other financial pressures placed upon health care facilities in Wisconsin such as those involved in the Project, Petersen's advisors conducted research in order to determine the best course of action for the Project. This work included research on HUD guidance as to the proper payment for services related to the ongoing operation of the Project while the loan was in default and case law on the same subject given the limited HUD guidance. This legal work was done to provide on-going planning advice for the Project, consistent with the Wisconsin regulatory requirements for the operation of skilled nursing facilities.

Comment 4

Comment 4

(d) In reviewing the legal work done on behalf of Petersen, the OIG auditors did not consider the above, instead using the following five categories. If the auditors determined that billing entries fell within category 1 and 5, they were disallowed as not related to reasonable operating expenses, and thus if paid for out of Project funds these legal services were deemed to have been improperly disbursed.

The categories are as follows:

1. Restructuring/Sale.

2. Discussions/meetings with various State officials regarding downsizing, reimbursement rates, other possible State assistance.

3. Review of the management agreement with Bethesda for the Horizons Unlimited closing.

4. Financial planning and ongoing facility operations.

5. Analysis of HUD regulations and policy/guidance on a number of issues, including: loan default, loan assignment, loan sale, foreclosure, bed license reductions and HUD allowable expenses.

Mr. Heath Wolfe
September 13, 2005
Page 17

Comment 4

(e) The main concern in the way that the legal fees were categorized in the Draft Audit Report is with respect to the arbitrary categories that were developed as well as the arbitrary nature in which billing entries were categorized. For example, an entry on February 19, 2004 with a description reading "Legal research regarding options involving restructuring debt and operations; office conference regarding same; meeting with Mr. Friese regarding status and analysis of alternatives" was disallowed as a category 5 entry. This entry describes work done to identify long-term options available to the Project as it planned for the continued financial viability of the Project. This goes to the very essence of an expense "related to the ongoing operations of the Project" – it was directly related to the survival of the Project. This entry serves only as an example of the difficulties in trying to place billing entries in arbitrary categories.

(f) In further reviewing the categorization of billing entries, it becomes clear that in most cases, when a billing entry included the term "HUD" it was categorized as a 5 regardless of whether the rest of the billing entry indicated a relationship to the ongoing operations of the Project. As described above, all actions taken by Petersen in negotiations with the State of Wisconsin, Cambridge, and potential investors had to be done in compliance with P.P.F.'s obligations to HUD. Billing entries containing HUD-related research were done with an eye to identifying options available to Petersen in developing a long-term plan to keep the Project afloat.

Comment 4

(g) On multiple occasions, the auditors placed substantially similar billing entries into different categories. For example, a billing entry on July 15, 2004 with a description "Office conference in preparation for HUD meeting; attend HUD meeting with Mr. Friese and Attorney Blain; review post-meeting strategy and discuss same with Mr. Friese." was found to be an allowable expense. However, on July 13, 2004, an entry with the description "Conference with Mr. Friese and others regarding July 15 HUD meeting; office conference regarding preparation for the meeting; legal research regarding HUD regulatory matters" was included in category 5 and not allowed. Thus, the auditor allowed for legal services in relation to a meeting with HUD on July 15 but disallowed legal services regarding the exact same issue two days earlier. This type of ambiguity in categorization is indicative of the inconsistencies found throughout the auditors' review of the legal services performed on behalf of Petersen. Given the complexities of this entire situation, these inconsistencies are not

Ref to OIG Evaluation **Auditee Comments**

Mr. Heath Wolfe
September 13, 2005
Page 18

unexpected, and as such we submit that the $47,890 in disallowed legal fees is incorrect based upon the analysis above.

(D) **Miscellaneous Additional Expenses**

Comment 5

The funds expended for scholarships, Christmas presents to doctors, charitable campaign cash prizes and a charitable donation were, in fact, reasonable and necessary operating expenses of the Project. All of the expenditures in question reflect reoccurring expenditures which were made in order to augment the operation of the Project for a number of years in engendering good-will among physicians and other members of the community. None of the expenditures in question inured to the personal benefit of P.P.F., Petersen or its principals. Furthermore,

- Scholarships were given to employees or children of employees who were choosing health care as a profession in hopes of returning to the Project as a skilled employee. One scholarship was a contribution to a memorial fund established for the children of a previous Human Resource Director who died unexpectantly at age 37.
- The charitable donation of $100.00 was for the Alzheimer Association. Considering that the Project serves a significant number of people with Alzheimer disease, this is an obvious project related expense. The local Alzheimer's Association assists the facilities in providing information and comfort to families affected by this disease.
- The $2,000 spent in candy as Christmas presents to about 50 physicians for two Christmas's is meager compensation to professionals who are continually "on call" to assist the Project in meeting the needs of the people served.

Comment 6

5. With respect to the allegations contained in the Draft Audit Report labeled "HUD Assumed the Owner's Mortgage," P.P.F. disputes the allegation that Petersen failed to make $2,043,401 in lease payments to P.P.F. from July 2003 through December 2004. The Lease requires Petersen to pay rent to P.P.F. in amounts sufficient so that P.P.F. can make all of its payments on the HUD-insured loan. Over the years, several events occurred which adjusted the amount of P.P.F.'s monthly payment obligation, including modifications of the HUD-insured loan resulting in lower monthly payments. Such adjustments occurred each month from July 2003 through May 2004 when HUD permitted funds to be withdrawn from both the Replacement Reserve and the Sinking Fund Reserve in order to assist P.P.F. in meeting its monthly obligations. Such withdrawals were permitted by HUD in recognition of the precarious economic condition of the Project

Ref to OIG Evaluation | **Auditee Comments**

Mr. Heath Wolfe
September 13, 2005
Page 19

Comment 6

Comment 7

created by reimbursement reductions mandated by the State of Wisconsin and had the effect of causing P.P.F. to forgive the obligation of Petersen to make corresponding monthly lease payments to P.P.F. In lieu of such payments, HUD mandated that such withdrawals from such reserve accounts "…must be repaid…when the project's cash flow allows for such payment..." Furthermore, P.P.F. strenuously objects to the OIG auditors' conclusion contained in this section that implies that HUD would not have authorized the utilization of the Project's reserve funds to assist in meeting monthly payment obligations had HUD been aware the expenditures being criticized by the OIG in the Draft Audit Report. As indicated above, many, if not all, of the criticized actions are based upon strained and questionable legal interpretations, and, as used in this context constitute nothing more than "Monday morning quarterbacking."

CONCLUSION

P.P.F. and Petersen take their duties and responsibilities very seriously. P.P.F. and Petersen worked diligently from the time that the HUD-insured loan originated to make sure that the Project was solvent and that services to people would continue. If, based upon inexperience, lack of knowledge or incorrect professional advice, P.P.F. or Petersen took actions which are inappropriate, every effort will be made to rectify and remedy the situation.

P.P.F. ENTERPRISES

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OIG Evaluation of Auditee Comments

Comment 1 The owner is ultimately responsible for the project. The owner entered into a lease with the operator that states the operator agrees to be bound by all terms and conditions of the owner's regulatory agreement with HUD. Therefore, it is the owner's responsibility to ensure the operator properly used funds required to be used for project expenses. HUD was not a party to the lease between the owner and operator.

Comment 2 The State of Wisconsin provided the funds to the operator through Medicaid payments for expenses associated with the closing of Horizons Unlimited. The owner entered into a lease with the operator that states the operator agrees to be bound by all terms and conditions of the owner's regulatory agreement with HUD. Therefore, the funds were required to be used for project expenses.

Comment 3 The project was in a non-surplus-cash position and/or in default of its HUD-insured mortgage at the time of the disbursements. Further, the operator inappropriately disbursed funds required to be used for project expenses for non-project legal services. Therefore, prepaid legal services totaling $80,385 were not necessary and reasonable expenses of the project.

Comment 4 We do not dispute that the cited cases, Thompson v. United States, 408 F.2d 1075 (8th Cir. 1969) and United States v. Frank, 587 F.2d 924 (8th Cir. 1978), stand for the basic proposition that permissible operating expenses under the regulatory agreement are expenses that primarily benefit the project as opposed to its owners. However, in the context of the instant audit, the basic proposition does not resolve the relevant issues. Rather, it is necessary to evaluate what types of legal expenses benefit the project as opposed to its owner.

Generally, legal expenses may be reasonable and necessary to the operation of the project within the meaning of the regulatory agreement if they are expended to collect rent, evict tenants, or defend lawsuits growing out of the operation of the project. See United States v. Mansion House Center North Redevelopment Co., 419 F. Supp. 85 (E.D. Mo. 1976). On the other hand, legal expenses to alter the financing of a project—through bankruptcy—or otherwise, defend against foreclosure, etc. are not considered to benefit a project or be necessary to its operation; rather, this sort of re-financing expense is considered to be for the benefit of the ownership entity and is not allowable under the Regulatory Agreement. See, e.g., United States v. Harvey, 68 F. Supp. 2d (S.D. Ind. 1998); United States v. Berk & Berk, 767 F. Supp. 593 (D. N.J. 1991); In re EES Lambert Assoc., 63 Bankr. 174 (N.D. Ill. 1986).

Comment 5 The disbursements for scholarships, Christmas presents to doctors, charitable campaign cash prizes, and charitable donations were not necessary and reasonable for the operation of the project.

Comment 6 HUD's approval of the use of the project's reserve fund for replacement and sinking fund accounts to make mortgage payments did not reduce the operator's obligation to make lease payments sufficient for the owner to pay the project's mortgage payment.

Comment 7 We did not imply that HUD would not have approved the use of the project's reserve fund for replacement and sinking fund accounts to make mortgage payments if HUD would have known about the inappropriate disbursements. We made statements of fact regarding the project and reported that HUD was not aware of the inappropriate disbursements.

Appendix C

FEDERAL REQUIREMENTS

The operator’s lease with the owner, article II, section 2.1, paragraph E, states the operator agrees to be bound by all terms and conditions of the owner’s regulatory agreement with HUD.

The owner’s regulatory agreement, paragraph 6, mandates that the owner shall not, without prior written approval of the secretary of HUD, assign, transfer, dispose of, or encumber any personal property of the project, including rents, or pay out any funds except for surplus cash, except for reasonable operating expenses and necessary repairs, and make or receive and retain any distribution of assets or any income of any kind of the project except surplus cash.

Paragraph 13(g) of the regulatory agreement defines distribution as any withdrawal or taking of cash or any assets of the project, excluding payment for reasonable expenses incident to the operation and maintenance of the project.

HUD Handbook 4370.2, REV-1, CHG-1, page 2-6, requires that all disbursements be used to make mortgage payments and required deposits, pay reasonable expenses necessary for the operations and maintenance of the project, and pay distributions of surplus cash. Page 2-10 states that if the owner takes distributions when the project is in default or when the project is in a non-surplus-cash position, the owner is subject to criminal and/or civil penalties. Page 4-33 of the Handbook permits legal expenses necessary and reasonable to the operation of the project. However, page 4-40 states legal expenses applicable to the corporation or mortgagor entity may be charged against project operations only with the prior written approval of HUD.
According to 24 CFR [*Code of Federal Regulations*] 24.100, HUD is permitted to take administrative sanctions against employees of recipients under HUD assistance agreements that violate HUD’s requirements. The sanctions include debarment, suspension, or limited denial of participation and are authorized by 24.800, 24.700, or 24.1105, respectively. HUD may impose administrative sanctions based upon the following conditions:

- Failure to honor contractual obligations or to proceed in accordance with contract specifications or HUD regulations (limited denial of participation);

- Violation of any law, regulation, or procedure relating to the application for financial assistance, insurance, or guarantee, or to the performance of obligations incurred pursuant to a grant of financial assistance or pursuant to a conditional or final commitment to insure or guarantee (limited denial of participation);

- Violation of the terms of a public agreement or transaction so serious as to affect the integrity of an agency program, such as a history of failure to perform or unsatisfactory performance of one or more public agreements or transactions (debarment); or

- Any other cause so serious or compelling in nature that it affects the present responsibility of a person (debarment).

Title 12, *United States Code*, section 1715z-4a, “Double Damages Remedy for Unauthorized Use of Multifamily Housing Project Assets and Income,” allows the U.S. attorney general to recover double the value of any project assets or income that was used in violation of the regulatory agreement or any applicable regulation, plus all cost relating to the action, including but not limited to reasonable attorney and auditing fees.

Title 12, *United States Code*, section 1735f-15, "Civil Money Penalties Against Multifamily Mortgagors," allows the secretary of HUD to impose a civil money penalty of up to $25,000 per violation against a mortgagor with five or more living units and a HUD-insured mortgage. A penalty may be imposed for any knowing and material violation of the regulatory agreement by the mortgagor, such as paying out any funds for expenses that were not reasonable and necessary project operating expenses or making distributions to owners while the project is in a non-surplus-cash position.