
AUDIT REPORT



FARMINGTON HEALTH CARE CENTER
FARMINGTON, CONNECTICUT

2003-BO-1001

MARCH 7, 2003

OFFICE OF AUDIT, NEW ENGLAND
BOSTON, MASSACHUSETTS



Issue Date	March 7, 2003
Audit Case Number	2003-BO-1001

TO: Suzanne C. Baran, Director, Multifamily Program Center, Hartford Field Office,
1EHMLAT

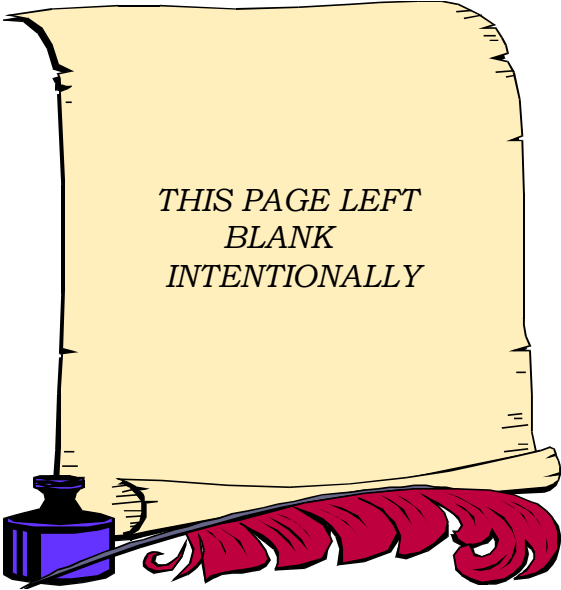
FROM: Barry L. Savill, Regional Inspector General, Office of Audit, 1AGA

SUBJECT: Farmington Health Care Center
FHA Loan Number 017-22015
Farmington, Connecticut

As requested by your office, we performed an audit of the Farmington Health Care Center. Our report contains two findings (combined into one) with recommendations requiring action by your office---1) Major Moveable Equipment and Other Non-Critical Repairs Encumbered Without HUD Approval, and; 2) Lack of Installation of an Emergency Generator.

In accordance with HUD Handbook 2000.06 REV-3, within 60 days please provide us, for each recommendation without a management decision, 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 report issuance for any recommendation without a management decision. Also, please furnish us copies of any correspondence or directives issued because of the audit.

Should you or your staff have any questions, please contact Michael Motulski, Assistant Regional Inspector General for Audit, in our office at (617) 994-8380.



Executive Summary

We have completed an audit of the Farmington Health Care Center (FHCC) located in Farmington, Connecticut. The primary purpose of our audit was to assess the project's performance relating to: a) utilizing project funds appropriately; b) maintaining the property in a satisfactory physical condition; and c) other general management practices.

Audit Results

The Operator/Lessee inappropriately executed a capital lease purchase agreement with a leasing company for major moveable equipment and other non-critical repairs without HUD consent. The Mortgagor/Lessor included this equipment and repairs in the costs to refinance the project and HUD used these costs in the determination of the maximum mortgage insurance amount. However, the Operator/Lessee subsequently leased the equipment and repairs. Furthermore, title to the equipment and other repairs belongs to the leasing company. Consequently, the loan was over-insured by \$341,682 and HUD has lost security in the equipment and repairs. Therefore, the lease is in violation of HUD regulations.

Furthermore, an installation of an emergency generator, as required under the Escrow Agreement, remains uncompleted. Repairs under the agreement were to be completed within twelve months of the final loan endorsement, unless HUD grants an extension.

Recommendations

We recommend ensuring that the installation of the emergency generator is completed in a timely manner using non-project funds, the Repair Escrow funds, or a combination thereof. We also recommend freezing an appropriate amount of Repair Escrow funds and/or Reserve for Replacements funds to protect HUD's security interest in the facility in the event of a default on the lease. If Reserve for Replacements funds are frozen, consideration could be given to requiring an increase in the monthly deposits to the account to ensure that sufficient funds are available in event that emergency repairs are required, without detracting from the "frozen" funds.

Furthermore, upon payoff of the lease and execution of the purchase option, we recommend requiring the Operator/Lessee to assign the title of equipment and repairs to the Mortgagor/Lessor, using an approved mechanism, to ensure that title remains with the real estate.

Findings and
Recommendations
Discussed

We discussed the findings in this report with the project's Mortgagor, Operator, applicable Management Agent staff, and HUD program management during the course of the audit. We held an exit conference on November 19, 2002. On December 4, 2003, we provided the Mortgagor/Lessor and Operator/Lessee each a copy of the draft audit report for formal comments. We received the Mortgagor's/Lessor's and the Operator's/Lessee's written responses on January 14, 2003. Appropriate revisions were made where deemed necessary. We included a summary of pertinent comments in the Findings section of this report. The complete responses are included in Appendix B.

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Abbreviations

AFS	Audited financial statements
CFR	Code of Federal Regulations
FHA	Federal Housing Administration
FHCC	Farmington Health Care Center
FYE	Fiscal Year Ending
HFO	Hartford Field Office
HUD	U.S. Department of Housing and Urban Development
IOI	Identity-of-Interest
OIG	Office of Inspector General
RA	Regulatory Agreement
REAC	Real Estate Assessment Center
REMS	Real Estate Management System

Introduction

Farmington Health Care Center (FHCC) is a residential care facility located in Farmington, Connecticut, and is licensed for 140 Chronic and Convalescent Nursing Home beds. The mortgage was refinanced and insured under Section 232 pursuant to 223(f) of the National Housing Act (FHA number 017-22015). The original amount of the insured mortgage was \$6,341,200. The final loan endorsement date (the loan closing date) was October 4, 2000.

The Housing Act of 1959 established Section 232 of the National Housing Act, Section 232 Mortgage Insurance for Residential Care Facilities (12 U.S.C. 1715w). The Housing and Urban Development Act of 1968 authorized the inclusion of major non-realty equipment in mortgage insurance. The Housing and Community Development Act of 1987 extended Section 223(f) eligibility to the refinancing or purchase of Section 232 facilities. Part 232 of Title 24 of the Code of Federal Regulations (CFR) contains the program's regulatory guidelines.

The Mortgagor of FHCC is Farmington Realty Co., a Connecticut General Partnership, and is located in Brooklyn, New York. The Mortgagor leases the project including all buildings, land, equipment, etc. to an operator of the facility. The Operator/Lessee only has the right to use the building, land, and equipment as stipulated in the HUD approved lease agreement dated October 4, 2000, as amended. The Operator/Lessee is Farmington Health Center, LLC, a Connecticut single member limited liability company having its principle place of business in Farmington, Connecticut. The current Management Agent is Haven Healthcare Management, having its principle place of business in Cromwell, Connecticut. Haven Healthcare Management is an Identity-of-Interest (IOI) company of the Operator/Lessee, whereby it is an affiliate through common ownership. The Owner/Lessor does not have an IOI relationship with the Operator/Lessee or the Management Agent.

Audit Objectives

The overall audit objective was to assess the project's performance relating to: a) appropriate use of project funds; b) maintaining the property in a satisfactory physical condition; and c) other general management practices.

Audit Scope and Methodology

To accomplish the audit objectives, we:

- Reviewed Federal requirements including: the Code of Federal Regulations (CFR); HUD Handbooks; HUD Housing Notices and Directives; and the Regulatory Agreements between HUD and the mortgagor, and between HUD and the operator.
- Reviewed the project's files maintained by the HUD Hartford Field Office (HFO) and HUD's automated systems, such as the Real Estate Management System (REMS).

- Reviewed the FHCC's organizational and administrative structure.
- Reviewed management agreements, facility and capital lease agreements, and HUD Repair Escrow Agreements.
- Reviewed Independent Public Accountant (IPA) reports prepared for the operator and the certified financial statements submitted to REAC on behalf of the owner for fiscal years ending 2000 and 2001.
- Interviewed applicable management agent personnel to obtain information relating to FHCC's operations and management controls; its procedures for accounting, administration, procurement, maintenance, cash receipts, cash disbursements, and fixed assets to determine if the FHCC's procedures were adequate.
- Tested samples of management controls relevant to the audit through inquiries, observations, inspection of documents and records, or review of other reports, and evaluated the effects of any exceptions found.
- Reviewed the project's books and records and assessed:
 - a) the reliability of information contained in the books and records;
 - b) the appropriateness of disbursements;
 - and c) the reasonableness of costs incurred.
- Visited the project and surveyed the physical condition.

The audit was conducted between March 2002 and August 2002, and covered the period from October 4, 2000, through December 31, 2001. When appropriate, the audit was extended to include other periods.

We conducted our audit in accordance with generally accepted government auditing standards.

Major Moveable Equipment And Other Non-Critical Repairs Encumbered Without HUD Approval

The Operator/Lessee (Farmington Health Center, LLC) of Farmington Health Care Center (FHCC) inappropriately executed a capital lease purchase agreement with a leasing company for major moveable equipment and other non-critical repairs in January 2001, without HUD consent. The Mortgagor/Lessor included this equipment and repairs in the costs to refinance the project and HUD used these costs in the determination of the maximum mortgage insurance amount. However, the Operator/Lessee subsequently leased the equipment and repairs. Furthermore, title to the equipment and other repairs belongs to the leasing company. Consequently, the loan was over-insured by \$341,682 and HUD has lost security in the equipment and repairs. Therefore, the lease is in violation of HUD regulations.

Additionally, installation of an emergency generator, as required under the Escrow Agreement between the Mortgagor/Lessor and HUD, remains uncompleted. The costs for the installation were also used in the determination of the maximum mortgage insurance amount. Repairs under the agreement were to be completed within twelve months of the final loan endorsement (October 4, 2000). The emergency generator is needed to ensure the safety of the patients who rely on electronic equipment for daily functioning, such as oxygen apparatus, electric beds, etc.

We attribute the cause of the conditions to the Operator's/Lessee's insufficient knowledge of HUD program regulations and the lack of Mortgagor/Lessor oversight over project operations.

Repair Escrow
Established

As part of the loan process, the Mortgagor/Lessor presented a schedule of the costs to refinance the existing loan as well as additional capital expenditures for the project to obtain an insured mortgage (form HUD-2205-A). Since the equipment and repairs were not installed/completed at the time the loan closed (October 4, 2000), an escrow account was established to cover the equipment/repair costs using mortgage proceeds.

Capital Lease
Inappropriately Executed
By Operator

The Mortgagor/Lessor drew down on the escrow account and provided the proceeds to the Operator/Lessee through the Operator's/Lessee's affiliated management company. Instead of directly purchasing the equipment/repairs, the Operator/Lessee executed a five-year capital lease purchase agreement (January 2001). According to the terms and conditions of the capital lease agreement, title to equipment/repairs belongs to the leasing company.

HUD Regulatory Agreement Violated

The Mortgagor/Lessor is in violation of the Regulatory Agreement with HUD because the Mortgagor/Lessor permitted the encumbrance of mortgaged property, without written HUD consent. According to Paragraph 6b of the RA between HUD and the Mortgagor/Lessor (form HUD-92466), a project owner shall not, “*assign, transfer, dispose of, or encumber any personal property of the project or permit the conveyance, transfer or encumbrance of such property...without the prior written approval of the Secretary.*” The Mortgagor/Lessor permitted the encumbrance by submitting three requests to the mortgagee for the approval of advance of Repair Escrow funds for the leased items that were not purchased.

No written approval from HUD was obtained by the Operator/Lessee or the Mortgagor/Lessor for the encumbrance of equipment/repairs.

Violation of the Repair Escrow Agreement

The intention of the Repair Escrow was to purchase the equipment and to pay for the repairs. According to the Escrow Agreement, disbursements from the escrow could be authorized by HUD or designee to meet any established cost for which the escrow deposit was intended, and be completed within twelve months after endorsement. Funds were requested by the Mortgagor/Lessor (based on the supporting documentation provided by the Operator/Lessee) to cover advances made for the items under the Repair Escrow Agreement (form HUD-92464, “Request for Approval of Advance of Escrow Funds”). However, these funds, drawn down through three separate requests, were not for actual advances, because the majority of items listed in the Escrow Agreement were actually acquired through the capital lease agreement, in which monthly lease payments are made.

Mortgage Over-Insured And HUD Lost Security

The maximum mortgage limit as determined by HUD was limited to the cost to refinance the existing indebtedness, which included the actual repair costs and major moveable equipment. Because the leased repairs and equipment do not represent costs that support the mortgage, the mortgage is over-insured by \$341,682 as follows:

Item	Amount
Major Moveable Equipment	\$ 261,307
Non-Critical Repairs	80,375
Total	\$ 341,682

Furthermore, all equipment/repairs were included in the HUD mortgage security and covered by the security agreement, which creates a security interest made to the mortgagee. Because the items were encumbered and title belongs to the leasing company, HUD has lost security in the project.

Lack Of Program
Knowledge And
Mortgagor Oversight

The Operator/Lessee and Management Agent (IOI companies) do not have adequate knowledge of the program requirements for projects insured under Section 232 pursuant to 223(f). Based on the results of our audit, Management Agent officials agreed that HUD consent should have been obtained before the execution of the capital lease.

Furthermore, the Mortgagor/Lessor does not have sufficient oversight over the operations of the project. The Mortgagor/Lessor is not actively involved or does not otherwise participate in project affairs.

Emergency Generator
Needs To Be Installed

An installation of an emergency generator, as required under the Repair Escrow Agreement as a non-critical repair, remains uncompleted, as of February 19, 2003. As with the other non-critical repairs under the agreement, it was to be completed within twelve months of the final loan endorsement (October 4, 2000). The installation of the emergency generator is the last item to be completed under the Escrow Agreement with an estimated cost of \$100,000.

The emergency generator is needed to ensure the safety of the residents who rely on electronic equipment for daily functioning, such as oxygen apparatus, electric beds, etc. In the event of a serious power outage or interruption at the project, the safety of the residents may be in jeopardy without it. This was an important HUD concern during the Firm Commitment processing and is still a concern today for HUD and the project administrator.

Auditee Comments

The Mortgagor's/Lessor's unedited comments are included as Appendix B of this report.

The Mortgagor/Lessor disagreed with the comment that they are in violation of their RA with HUD. The lessor stated that:

"Farmington Realty did not 'permit' the encumbrance because it was not aware that the encumbrance existed and therefore Farmington Realty did not violate the Regulatory Agreement with HUD."

The Mortgagor/Lessor also does not believe they could have known that the Operator/Lessee encumbered the mortgage property. The Mortgagor/Lessor stated that:

"Although we believe that greater diligence of the Lessee's operations by the Lessor would likely have led us to realize that the new generator had not been installed as required, we do not believe that the level and type of diligence of the Lessee's operations that we need to maintain in order to preserve our property and to fulfill our obligations to HUD would have uncovered the Lessee's further encumbering of the mortgaged property."

The Mortgagor/Lessor also argues that part of the escrow "must" be returned to them. The Mortgagor/Lessor states:

"...the Escrow Cushion is not part of the mortgage loan proceeds, it is the Lessor's money...and per the Escrow Agreement, must be returned to Lessor after the completion of the repairs unless the cost of the repairs exceeds the escrowed amounts."

The Operator/Lessee argues that they fully intended to use the escrowed funds to purchase the encumbered property. The Operator/Lessee stated that:

"In the initial budget projections, the facility intended to finance both renovations and equipment with the HUD funds. Due to construction overruns, it became apparent that the \$850,000 was insufficient to complete the project."

The Mortgagor/Lessor and Operator/Lessee also argue that our recommendation to pay down the mortgage would "adversely effect" the financial health of the project. Furthermore, they believe that all funds were ultimately used to enhance "HUD's collateral position."

Based on the arguments above, the Operator/Lessee proposes two alternatives to our recommendations, and the Mortgagor/Lessor concurs:

- 1) That HUD should consider additional capital improvements added to the property instead of requiring that the mortgage be paid down by \$341,682; or
- 2) To allow the Mortgagor/Lessor to assume the lease from the Operator/Lessee.

Furthermore, the Operator/Lessee advised that they contracted with a firm and ordered two emergency generators to be installed. The cost for the generators and the installation is \$136,573.58.

OIG Evaluations of Auditee Comments

We disagree with the first two Mortgagor/Lessor statements above. The capital lease and the encumbrance of mortgaged property is clearly described in Note 4 of the Operator's/Lessee's FYE September 30, 2001, AFS. According to Article 24, Section 24.6, "Financial Statements," of the Amended and Restated Lease Agreement between the Mortgagor/Lessor and the Operator/Lessee, the Operator/Lessee is required to provide the Mortgagor/Lessor all their financial statements within 120 days after the FYE. In addition, we found no documentation and we were not made aware of any documentation, that the Mortgagor/Lessor questioned the capital lease, as described in the AFS. Furthermore, the signature of the managing partner for the Mortgagor/Lessor was found on each of the HUD forms HUD-92464, "Request for Approval of Advance of Escrow Funds." Therefore, we conclude the Mortgagor/Lessor should have been aware of the encumbrance and as a result, even if by ignorance, permitted the encumbrance and is in violation of the RA with HUD.

We also disagree with the Mortgagor's/Lessor's statement regarding the "Escrow Cushion." The Mortgagor/Lessor violated the Repair Escrow Agreement by claiming that the items in the agreement would be owned by the Mortgagor/Lessor entity and not leased by the Operator/Lessee. Furthermore, the Escrow Agreement states that:

"The balance remaining in the escrow deposit will be subject to immediate application to the mortgage debt in part or total in the event that certification of the disbursements is not completed and received within the

time prescribed...and the HUD approved costs do not support the mortgage.”

Therefore, we conclude that the Mortgagor/Lessor cannot justify a return of the “Escrow Cushion.”

We also disagree with the Operator’s/Lessee’s first statement. Our review found that in the initial application to HUD, "Firm Commitment for Project Mortgage Insurance," Exhibit 17, the Lessee clearly indicated that they intended to execute the capital lease. However, HUD ultimately informed the Operator/Lessee that an escrow account must be established to purchase the equipment and pay for the repairs after closing.

Furthermore, our recommendations contained in our Draft Audit Report should not “adversely effect” the financial health of the project. Our recommendations specifically precluded the Mortgagor/Lessor from using project funds to pay down the mortgage. We acknowledge that “HUD’s collateral position” in the facility may have increased. However, the added renovations paid with Repair Escrow funds were not approved by HUD nor were they determined to be critical to support the facility’s core business. Additional Repair Escrow funds could have been requested by the Mortgagor/Lessor for the added renovations before closing. Therefore, we are not in a position to “substitute” these improvements for those specifically required by the Mortgagor’s/Lessor’s contractual agreements with HUD. We also conclude that program regulations were violated and potential cases exist for false claims and statements to HUD.

Our initial recommendation was to have the Mortgagor/Lessor prepay the mortgage by \$341,682, the over insured amount. However, it was determined that the mortgage does not contain a prepayment option. The auditees initially proposed to negotiate a favorable pay-off of the capital lease and transfer title to the Mortgagor/Lessor. However, based on the auditees’ final response and subsequent meetings it appears that favorable buyout terms could not be negotiated. In addition, the auditees stated that a lump sum buyout would adversely affect the reimbursement of Medicare/Medicaid funds. Therefore, in order to protect HUD’s security interest in the property an alternative would be to “freeze” an appropriate amount of assets in the Repair Escrow account. The assets could remain frozen until the

remaining \$321,875 in lease payments are made and title to the assets is transferred to the Mortgagor/Lessor. If sufficient funds are not available in the Repair Escrow account, consideration could be given to “freeze” additional funds in the Reserve for Replacements fund to protect HUD’s security interest. The funds could then be used pay off the capital lease and obtain title to the assets should the Operator/Lessee fail to make the required payments.

Consideration could also be given to requiring an increase in the monthly deposits to the Reserve for Replacements fund. This course of action would ensure that sufficient funds are available in event that emergency repairs are required without detracting from the “frozen” funds. Furthermore, this would not adversely affect the project since these funds remain with the project.

Finally, we acknowledge the intended purchase and installation of the emergency generators. We will recommend the Operator/Lessee move forward with this course of action. Although we would prefer that this be paid for out of non-project funds, the auditee has indicated that the financial resources are not available. Therefore, an alternative action would be to allow the use of the Repair Escrow funds, since it is an appropriate use for which the escrow was established.

Upon evaluating the auditees' comments above and the additional discussions held with HUD management officials, we made changes to the Draft Audit Report recommendations, which are reflected below.

Recommendations

We recommend that you:

- 1A. Ensure that the installation of the emergency generator is completed in a timely manner, as specified by your office, using non-project funds, the Repair Escrow funds, or a combination thereof.
- 1B. Freeze an appropriate amount of Repair Escrow funds and/or Reserve for Replacements funds to protect HUD’s security interest in the facility in the event of a default on the lease. If Reserve for Replacements funds are frozen, consider requiring an increase in the

monthly deposits to the account to ensure that sufficient funds are available in event that emergency repairs are required without detracting from the “frozen” funds.

- 1C. Upon payoff of the lease and execution of the purchase option, require the Operator/Lessee to assign the title of equipment and repairs to the Mortgagor/Lessor, using a mechanism approved by your office, to ensure that title remains with the real estate.

Management Controls

In planning and performing our audit, we obtained an understanding of the management controls used by the Farmington Health Care Center (FHCC) that were relevant to our audit objectives. We reviewed the FHCC's management control systems to determine our auditing procedures and not to provide assurance on management controls.

Management controls consist of a plan, organization, methods, and/or procedures adopted by management to ensure that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data is obtained, maintained, and fairly disclosed in reports.

Relevant Management Controls

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

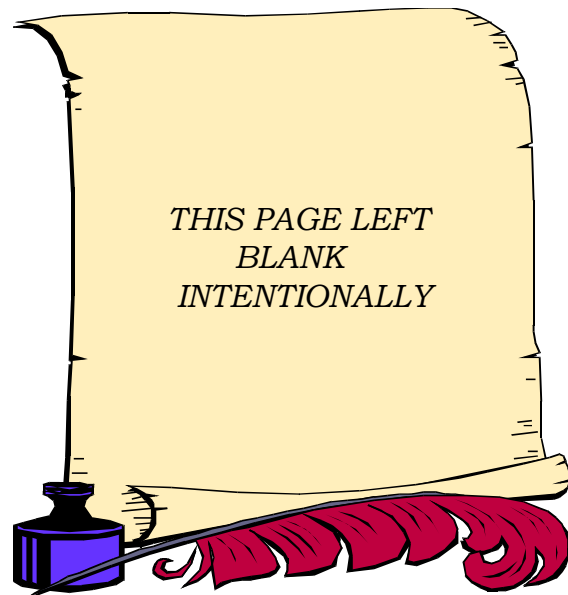
- Management controls over project expenditures.
- Management controls over project financial reporting requirements.
- Management controls over maintaining the project in satisfactory physical condition.
- Assuring the safeguarding of project assets.
- Assuring compliance with applicable laws and regulations.

We assessed the relevant controls identified above.

Significant Weakness

A significant weakness exists if management controls do not give reasonable assurance that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data is obtained, maintained, and fairly disclosed in financial statements and reports.

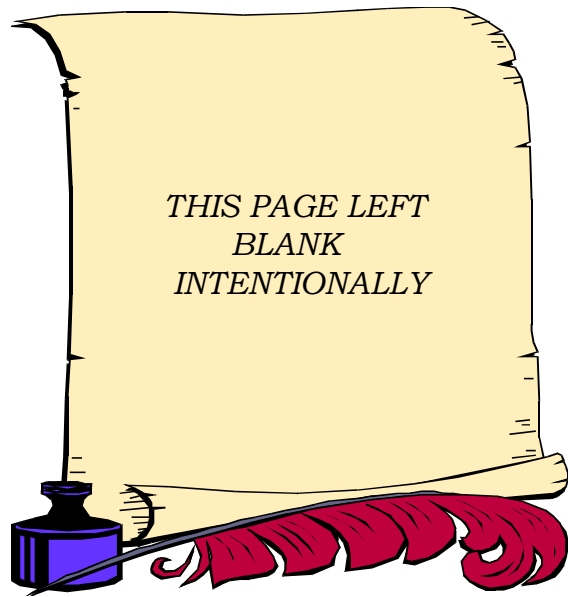
Our review identified a significant weakness in assuring compliance with applicable laws and regulations. The auditee lacked the necessary controls to ensure that major moveable equipment and other non-critical repairs, which are part of the mortgaged property, were not encumbered without HUD consent. The specific weakness is discussed in the Finding section of this report.



Schedule of Questioned Costs

Finding	Ineligible Cost <u>1/</u>
1. Costs do not support the cost to refinance	\$341,682

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 policies or regulations.



Auditee Comments

Farmington Realty Co.
c/o Martin Friedman & Co.
2600 Nostrand Avenue
Brooklyn, N.Y. 11210

(718) 338-6900

January 14, 2003

Mr. Barry Savill
Regional Inspector General
Office of Audit
U.S. Department of Housing and Urban Development
New England Office of District Inspector General for Audit, IAGA
Thomas P. O'Neill, Jr. Federal Office Building
Room 370
10 Causeway Street
Boston, Massachusetts 02222

RE: Response (the "Lessor Response") by Farmington Realty Co. to the Letter Dated December 4, 2002 to Jerome Lieberman, Managing Partner, Farmington Realty Co. ("Farmington Realty") from Barry L. Savill, Regional Inspector General, Office of Audit, U.S. Department of Housing and Urban Development ("HUD") and the OIG Draft Audit Report (the "Draft Report") Attached Thereto

Dear Mr. Savill:

This is the Lessor Response of Farmington Realty to the Draft Report. We appreciate the delay that HUD allowed us from December 24, 2002 until today to file this Lessor Response.

General Response

We are attaching to this Lessor Response a letter (the "Lessee Explanation") to me from Mr. Raymond Termini of Farmington Health Center LLC (the "Lessee") that provides the Lessee's explanation for the deficiencies noted in the Draft Report that resulted from the acts or omissions of the Lessee.

Mr. Barry Savill
January 14, 2003

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As more specifically set out below, we (i) generally echo the Lessee's responses (set out in the Lessee Explanation) to the HUD recommendations (the "HUD Recommendations") set out in the Draft Report, and (ii) propose a plan for addressing the deficiencies noted in Farmington Realty's "oversight over the operations of the project."

We state for the record that the Lessee's acts and omissions that brought about the HUD Recommendations were done without the knowledge or consent of the Lessor and are contrary to Lessee's obligations to us under our lease with the Lessee. Thus, contrary to the statement on page 4 of the Audit Report that Farmington Realty is in violation of the Regulatory Agreement with HUD because Farmington Realty "permitted" the encumbrance of the mortgaged property without HUD consent, Farmington Realty did not "permit" the encumbrance because it was not aware that the encumbrance existed and therefore Farmington Realty did not violate the Regulatory Agreement with HUD.

We also note the following statement on page 5 of the Audit Report:

Furthermore Mortgagor/Lessor does not have sufficient oversight over the operations of the project. The Mortgagor/Lessor is not actively involved or does not otherwise participate in project affairs.

We acknowledge the implication of the above statement. Although we believe that greater diligence of the Lessee's operations by the Lessor would likely have led us to realize that the new generator had not been installed as required, we do not believe that the level and type of diligence of the Lessee's operations that we need to maintain in order to preserve our property and to fulfill our obligations to HUD would have uncovered the Lessee's further encumbering of the mortgaged property. Nevertheless, we would like to meet with the appropriate officials from HUD so that we fully understand HUD's expectations of us regarding our oversight of the Lessee so that we can implement an appropriate oversight regimen over Lessee.

Background

Lessor owns the real and personal property that is used by the Lessee to operate a 140 bed nursing home. Until July 1, 1999, Lessor leased that real and personal property to Farmington Manor, Inc., a company owned by the Lessor's partners. Since that date, Lessor has leased that real and personal property to Lessee, a company that is completely unrelated to Lessor. As a general matter, Lessee has taken care to improve the operations, physical condition and financial condition of the nursing home, and that has given us quite a bit of comfort that our property is being properly cared for (we note that in this regard, our interests and those of HUD are aligned). Nothing in the Draft Report disturbs that comfort.

Mr. Barry Savill
January 14, 2003

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The HUD Recommendations

The Draft Report essentially has three recommendations:

1. Recommendations 1B and 1C require the prompt completion of the installation of the emergency generator. Based on the Lessee Explanation, we expect that installation will be completed by February 28, 2003. In response to Recommendation 1C, Lessor is prepared to take the steps necessary to ensure that the emergency generator is promptly installed.
2. Recommendation 1D recommends that any funds remaining in the escrow deposit account after completion of the installation of the emergency generator should be subject to immediate application to the mortgage debt. Farmington Realty disagrees with this recommendation. Contained within the escrow deposit account is the amount of \$198,050 (the "Escrow Cushion"). The Escrow Cushion is fifty percent in excess of the estimate of the amounts needed to complete the repairs for which the escrow account was established and for which mortgage loan proceeds were allocated. The Escrow Cushion was added to the escrow by Lessor as security against the possibility that the cost of repairs for which the escrow account was established would exceed the amount of the repair escrow account. Thus, the Escrow Cushion is not part of the mortgage loan proceeds, it is the Lessor's money (Note - half of which was advanced by Lessee) and per the Escrow Agreement, must be returned to Lessor after the completion of the repairs unless the cost of the repairs exceeds the escrowed amounts. Even if HUD ultimately adopts Recommendation 1A, unless the cost of repairs for which the escrow account was established exceeds the amount of the repair escrow account, HUD must refund the Escrow Cushion to Lessor.
3. Recommendation 1A recommends that the mortgage be paid down by \$341,682. Lessor agrees with the arguments against Recommendation 1A that are set out in the Lessee Explanation. Lessor has no stake in whether HUD adopts the Lessee's arguments against Recommendation 1A -- if HUD requires that the mortgage be paid down, Lessor will look to Lessee to provide Lessor those funds. That said, the arguments made by Lessee in the Lessee Explanation against Recommendation 1A make sense. While, from a purely technical point of view, HUD's security has been reduced by \$341,682, according to the Lessee explanation Lessor has added almost twice that amount in additional value which enhances HUD's security. In addition, Lessor is prepared to take an assignment of the equipment lease from Lessee so that the equipment lease will technically become an asset of Lessor. Finally, as pointed out by Lessee,

Mr. Barry Savill
January 14, 2003

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Lessor and HUD's true security is in the viability of Lessee as a going concern. HUD should not strain Lessee's working capital by requiring a pay down of the mortgage or a current buy-out of the equipment lease, where such a pay down or buy-out will not enhance HUD's technical security in any meaningful manner but instead may diminish the true security that HUD has - the viability of Lessee as a going concern.

Sincerely,
Farmington Realty Co.

Jerome Lieberman
Managing Partner

cc: Suzanne Baran
Tim Bannon
Michael Motulski
Janine Ross
Raymond Termini
Tom Dodge
Martin Friedman
Akiba Stern

JAN-14-2003 14:35

P.02/04



January 13, 2003

Jerome Lieberman
C/O Martin Friedman
Farmington Realty Company
2600 Nortrand Avenue
Brooklyn, New York 11210

RE: HUD Audit of Farmington Healthcare Center

Dear Mr. Lieberman:

Please accept this letter in response to the HUD Audit Report that was performed on Farmington Healthcare Center also known as Farmington Health Center, LLC with the expectation that you will submit this letter to HUD on our behalf for their reconsideration.

As you are aware, the Report contained two findings: 1) Major moveable equipment and other non-critical repairs encumbered without HUD approval and 2) Lack of installation of an emergency generator.

In response to the comments that major movable equipment and other non-critical repairs were encumbered without HUD's approval:

In the initial budget projections, the facility intended to finance both renovations and equipment with the HUD funds. Due to construction cost overruns, it became apparent that the \$850,000 was insufficient to complete the project. To offset the shortfall, the facility secured a capital lease to finance the capital equipment needed. As the HUD collateral and capital reserves far exceed the value of the equipment leased, in our accounting departments interpretation of the HUD guidelines, this lease would not be an issue.

We propose reconsideration of recommendation 1-A which states:

"The Mortgagor/Lessor be required to pay down the mortgage by \$341,682 to reflect the actual costs to refinance the project as required by Section 232 regulations pursuant to 223(f). Specifically, we recommend that funds be left in the deposit account to cover the costs for the installation of a new emergency generator and subject the remaining balance to immediate application to the mortgage debt. Furthermore, for the remaining costs that do not support the mortgage, we recommend that the Owner be required to immediately prepay the mortgage from non-project funds."

HAVEN HEALTHCARE MANAGEMENT
421 MAIN STREET, CROMWELL, CT 06416

HAVEN ELDERCARE, LLC

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Pursuant to our lease with Farmington Realty, nursing home operations would have to fund Farmington Realty's pay down of the mortgage if mandated by HUD. The equipment was leased in an effort to strengthen the operations of the facility and to free up funds to utilize on post closing necessary improvements. It is critical that all vested parties i.e. HUD, Reilly Mortgage and Farmington Realty fully understand that all funds have been utilized to enhance the facility and subsequently has increased the unencumbered collateral strengthening HUD's collateral position.

We respectfully request for HUD not to mandate the accelerated pay-down. As a practical matter, both Farmington Realty and HUD rely on our ability to run a fiscally viable nursing home. Imposing the strain of funding the \$341,682 will result in an adverse effect on the fiscal viability of the operation, which we believe is in conflict with the best interest of this project.

We feel that there are two more suitable alternatives to solve this issue.

- a. Please consider the ~\$650,000 of fixed assets added to the building exceed the lease equipment's value of \$350,000, and by the terms of our lease with Farmington Realty Co., have become the property of Farmington Realty Co., and already enhance HUD's collateral. Although the enhancement of HUD's collateral occurred automatically through the mechanism of the lease, we are prepared to execute and file with the Farmington land records a document that transfers the ownership of the aforementioned assets to Farmington Realty Co. and to pay for an independent appraisal to determine the value of the assets;

or

As discussed in our meeting on November 19, 2002 with Suzanne Baron, Director, Multifamily Program Center, 1EHMLAT, Christine O'Rourke, Assistant District Inspector General for Audit, and Timothy Bannon, Auditor, HUD/OIG, we would allow Farmington Realty to assume the lease to ensure that the title of the equipment financed remains with the real estate in the event of a default.

At the meeting, there were also discussions that Farmington Health Center, LLC pay off the equipment lease and transfer title of the equipment to Farmington Realty Co. This is not an option because it was determined that the equipment lease has 35 months to run. If the lease is terminated, Farmington Health Center would be required to pay the remainder of payments in full, which would total \$321,875.00. The payment will result in a windfall for the leasing company and would adversely affect the fiscal viability and strength of the project. In addition, paying off the lease will eliminate a reimbursable expense and negatively effect future reimbursement by \$321,875.

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1) Lack of installation of an emergency generator:

In regard to their recommendation 1B and 1C, which states:

"The Mortgagor/Lessor be required to expedite the installation of the new generator and complete the installation by a date specified by your office. If the Mortgagor/Lessor does not complete the installation of the emergency generator by the date specified for completion, (including any approved extensions), require the mortgagee to complete the repairs using the escrowed funds."

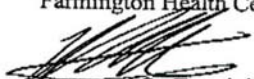
Farmington Health Center, LLC has contracted with J. R. Higgins Electric and purchased two emergency generators that will be delivered and installed no later than February 28, 2003.

Lastly, recommendation 1D:

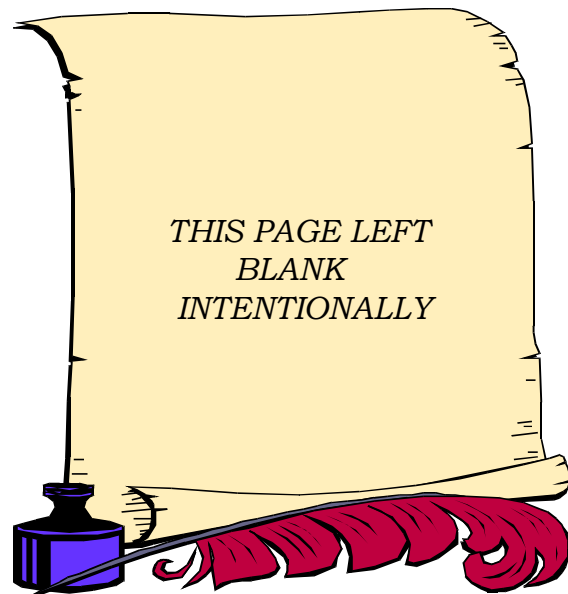
"Any funds remaining in the escrow deposit account after completion of the installation of the emergency generator should be subject to immediate application to the mortgage debt." We propose that the funds be deposited in the capital reserve account for future repairs.

I request that you carefully consider this proposal. In light of recent deep cuts in both the Medicare and Medicaid programs, this is not the time to impose further financial strains on the operations of this skilled nursing facility.

Sincerely,
Farmington Health Center, LLC


Raymond S. Termini
President/CEO

cc: Janine Ross, Director of Financial Operations
Akiba Stern, Esq.
Tom Dodge, Bedford Lending



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