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TO: Encarnacion Loukatos, Director, Pennsylvania Multifamily HUB, 3AHMLA

Daniel G. Temme

FROM: Daniel G. Temme, Regional Inspector General for Audit, Mid-Atlantic, 3AGA

SUBJECT: Carbondale Nursing Home
(Project #034-43089)
Carbondale, Pennsylvania

INTRODUCTION

In response to an audit request by the Philadelphia Multifamily HUB Office, we completed an audit of Carbondale Nursing Home (Project), a Section 232 Multifamily Insured Project owned by CNH, Incorporated (Owner). The purpose of our audit was to assess the Owner's compliance with the terms and conditions of the Regulatory Agreement, and all other applicable HUD requirements.

To accomplish our objective, we: interviewed responsible staff from the Owner, current Management Agent, Mortgagee, and HUD; examined files maintained by HUD, the Mortgagee, and the Owner; obtained the Independent Public Accountant (IPA) reports for 1998 and 1999 and reviewed the related work papers; and, reviewed all surveys and inspections conducted by Pennsylvania's Department of Health and Medicare.

Our audit work was conducted from April 2003 to October 2003 and covered the Owner's operations from April 1998 through December 2002. We performed the audit in accordance with generally accepted government auditing standards.

This report contains one finding and three recommendations. 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 J. Phillip Griffin, Assistant Regional Inspector General for Audit, at (215) 656-3401, extension 3490.

SUMMARY

We found the Owner did not comply with the Regulatory Agreement and other HUD requirements in operating the Project. In total, the Owner made \$1,261,301 of ineligible and unsupported payments from Project funds. Specifically, the Owner: received ineligible salary payments of \$374,790; collected ineligible distributions/repayment of advances of \$170,155; paid ineligible expenses for another company of \$485,997; disbursed ineligible extension fees of \$132,728; and paid unsupported loan payments of \$97,631. Several staff persons at the Project, including the Controller and Administrator, stated the Owner was not aware of the HUD requirements prohibiting these expenditures. If the Owner had complied with HUD requirements and used Project funds for only necessary operating expenses of the Project, the Owner could have used these funds to pay the mortgage costs (principal and interest) for over two years and possibly avoided bankruptcy and default on the HUD-insured loan.

BACKGROUND

In 1996, Ms. Joyce M. Kaufman, President and sole shareholder of CNH, Incorporated (Owner), applied for a HUD-insured mortgage to construct a new nursing home in Carbondale, Pennsylvania, to replace an already existing Carbondale Nursing Home. HUD approved a mortgage for \$5.4 million on March 11, 1997 between Beacon Hill Mortgage (Mortgagee) and the Owner.

In March 1998, the construction of the Project was considered substantially complete and HUD permitted the Project to be occupied. During March and April of 1998, residents of the older existing Carbondale Nursing Home (owned by Carbondale Nursing Home, Incorporated – President, Ms. Joyce M. Kaufman) were transferred to the Project.

Soon after the Project was occupied, a problem with the floor was identified. The floor problem resulted from the removal of a vapor barrier from the original construction specifications. As a result, HUD refused to allow the disbursement of the final loan draw and the Owner was not allowed to go to final closing until the problem was corrected. As a result, the Owner never went to final closing and the total final loan was \$5,108,826.

The Project has been mainly self-managed from 1998 through 2001, except for a six-month period at the end of 1998/beginning of 1999. Toward the end of 2001, the Owner could not meet the financial demands of the nursing home and in February 2002, the Project filed bankruptcy.

As a result of the bankruptcy filing in 2002, the Mortgagee insisted that an outside Management Agent be brought in to manage the Project. The Bankruptcy Court

approved Amcare Management Services as the Management Agent. Amcare Management Services assigned its contract to Merion Healthcare Incorporated on April 30, 2002 and Merion Healthcare Incorporated has since been the Management Agent.

In order to minimize its losses, HUD sold the Mortgage Note, along with others, in September 2003.

FINDING 1

INELIGIBLE AND UNSUPPORTED COSTS WERE PAID FROM PROJECT FUNDS

The Owner did not comply with the Regulatory Agreement and other HUD requirements resulting in questionable payments from Project funds totaling \$1,261,301. Specifically, the Owner: received ineligible salary payments of \$374,790; collected ineligible distributions/repayment of advances of \$170,155; paid ineligible expenses for another company of \$485,997; disbursed ineligible extension fees of \$132,728; and paid unsupported loan payments of \$97,631. Several staff persons at the Project, including the Controller and Administrator, stated that the Owner was not aware of the HUD regulations that prohibited these actions. As a result, over \$1.2 million in ineligible and unsupported payments were made from Project funds.

The Regulatory Agreement¹ between the owner and HUD requires the owner to properly maintain the books and records of the Project, physically keep the Project in good order, and submit annual financial statements within 60 days of fiscal year end. Further, the Regulatory Agreement states:

- Owners shall not pay out any funds, except from surplus cash, except for reasonable operating expenses and necessary repairs [Paragraph 6. (b)].
- Owners shall not make any distribution of income except from surplus cash [Paragraph 6. (e)].

Surplus cash is defined by the Regulatory Agreement as the cash remaining after all necessary and reasonable expenses of the Project have been paid or funds have been set aside for such payment and all reserve requirements have been met [Paragraph 13. (f)].

Details of the ineligible and unsupported payments from Project funds follow.

Salary Payments to the Owner

From the period of April 1998 through December 2002, the Owner was paid a salary, contrary to HUD requirements. Project records showed that the Owner worked 20-hour

¹ Signed by the owner on March 11, 1997.

weeks for an average of \$80,000 per year. As a result, the Owner received a total of \$374,790 in salary and bonus payments.

Project staff, who are also related to the Owner, stated that they did not think these payments were excessive because the Owner put in significant hours that were not documented in the books. However, regardless of whether the Owner worked 20 hours a week or more, the Owner cannot receive a salary because these payments are considered distributions. HUD Handbook 4370.1, Reviewing Annual and Monthly Financial Reports, Paragraph 2-25 contains the following regarding distributions to Owners:

“A distribution is any withdrawal or taking of cash or any assets of the project other than for the payment of reasonable expenses necessary to the operation and maintenance of the project. The term distribution includes, for example, supervisory fees paid to general partners and any salaries or other fees paid to the sponsor or owner, unless those salaries or fees have been approved by HUD as essential to the operation of a project....”

On August 29, 2002, HUD sent a letter to the Owner explaining that the Owner’s salary is a violation of the Regulatory Agreement and the salary paid appears to be an unauthorized distribution of funds. Also, HUD asked for the repayment of these funds. However, the Owner continued to receive a salary until December 2002 and did not reimburse the Project for the salary payments.

Distribution/Repayment of Advances to Owner

Our review also identified \$170,155 of direct payments to the Owner during our audit period. Representatives of the Project told us that these payments were for the repayment of advances from the Owner. In addition, they told us the Owner was not aware that HUD prohibited these payments.

These payments are prohibited by paragraph 6 (e.) of the Regulatory Agreement, which was signed by the Owner. In addition, paragraphs 2-10 and 2-11 of HUD Handbook 4370.2, Financial Operations and Accounting Procedures for Insured Multifamily Projects, provide further guidance on these prohibited payments.

The Owner received \$170,155 from May 1998 through January 2002, with \$94,121, or more than half, taken within 3 months of filing bankruptcy. The payments from Project funds are as follows:

CHECK NUMBER	CHECK OR WIRE DATE	AMOUNT OF CHECK/WIRE
6909	05/20/98	\$ 5,000.00
7074	06/23/98	\$ 763.06
7281	08/10/98	\$ 14,552.00
7811	12/21/98	\$ 500.00
7829	12/24/98	\$ 1,000.00
1097	06/03/99	\$ 5,000.00
1179	07/07/99	\$ 33.92
1663	12/17/99	\$ 367.14
1116	02/10/00	\$ 3,000.00
2005	10/24/00	\$ 10,000.00
Wire	12/18/00	\$ 25,000.00
2525	03/26/01	\$ 5,000.00
2560	04/05/01	\$ 5,000.00
2653	05/01/01	\$ 617.74
2662	05/03/01	\$ 200.00
1133	11/29/01	\$ 54,032.30
1134	11/29/01	\$ 20,089.00
1364	01/22/02	\$ 20,000.00
TOTAL		\$170,155.16

Since the accounting records were so poorly maintained, we could not confirm these payments as offsets of the Owner's advances. An outside Certified Public Accountant working for the Owner could only provide us with a schedule of payments that were supposed to be evidence that money was advanced by the Owner.

Nonetheless, whether the payments were direct distributions and/or repayment of advances, the payments are still prohibited because there was no surplus cash available since the inception of the Project.

Payments on the Behalf of an Affiliate

The Owner allowed ineligible expenditures totaling \$485,997 to be paid for loan and other expenses of an Affiliate. In addition, the Owner could not provide support for another \$97,631 for other loan payments. Again, representatives of the Project told us the Owner was not aware of the HUD requirements that prohibit these payments.

Ineligible Payments

We identified numerous payments to two local banks that were not disclosed to HUD. These payments were for 13 loans (12 loans from one bank and one loan from the other). Payments for seven short-term loans were determined to benefit the HUD-insured Project. Since we could track the loan funds being used for eligible Project purposes, we classified these seven loans as eligible. However, any additional cost for these loans, including interest expense and late fees were classified as ineligible because the Owner failed to obtain, as required, HUD's prior approval. The loan expense above the loan proceeds that benefited the Project for these seven loans totaled \$3,753.

Several other payments, though, were for four loans taken out for the old nursing home. We determined \$355,154 was paid for two loans that were issued in 1992. We also identified \$2,693 in payments that appeared to include personal loan debt for the Owner. Although we did not receive the loan agreement for the fourth loan and thus could not determine the exact issue date, we did determine that the loan existed before the construction of the new HUD-insured Project because we found payments in early 1996. In addition, this loan's invoices listed the old nursing home's Owner and the old nursing home's location as the debtor. Due to the early existence of payments and the debtor information listed on the invoices, we also classified this loan for the old nursing home and disallowed these loan payments. The payments for this fourth loan totaled \$19,248.

Besides undisclosed loan payments, we also identified \$105,149 in other expenses paid for the old nursing home during our review of account payables. These expenses included, among others, maintenance costs for elevator repairs, insurance expenses, utility payments, corporate taxes, and delinquent taxes.

Unsupported Payments

The two remaining loans were classified as unsupported because we could not find evidence that the loans were used for Project purposes. Although we received the loan agreement for one loan and it appeared to be for the new HUD-insured Project, we could not locate a deposit in any Project account. The other loan is considered unsupported because we were never provided the loan agreement and thus, do not know its purpose. All payments for the two loans totaled \$97,631.

Overall, the Project made ineligible payments of \$485,997 on the behalf of the old nursing home or loans not approved by HUD and could not support another \$97,631 in loan payments.

Ineligible Extension Fee Payments

Although prohibited by mortgage documents certified by the Owner, the Owner paid extension fees to the Mortgagee out of Project funds. The Owner, we were advised, did not know that this was prohibited. Consequently, \$132,728 was used for these payments that could have been used for much needed operating expenses.

In order to receive an approved mortgage from HUD and the Mortgagee, the Mortgagor was required to sign a number of documents at the initial endorsement. These documents included the Mortgagee's Certificate, Third Party Obligee Certification, and the Cognovit Promissory Note, which all prohibit the payment of extension fees from Project funds.

The Mortgagee's Certificate explains that the Owner will be personally liable for the payment of extension fees if the mortgage does not go to final closing. In addition this document explains how these fees will be calculated.

As detailed in the Background section of this report, this mortgage never went to final closing and the Owner was personally liable for these expenses. The Third Party Obligee Certification signed by both the Mortgagee and the Mortgagor (Owner), restates that extension fees will not be paid from Project funds (similar to the Rider or Addendum to Mortgagee's Certificate) as follows:

"The undersigned does not now have and will not later assert, any claim against the mortgagor, mortgaged property, mortgage proceeds, any reserve or deposit made with the undersigned or another required by HUD in connection with the mortgage transaction, or against the rents or other income from the mortgaged property for payment of any part of such discount."

Under the Cognovit Promissory Note, the Owner agrees to pay the extension fees to the Mortgagee. The Note shows how the fees will be calculated and further contains language which also prohibits the payments of extension fees as detailed below:

"It is a condition of this note that the payee or any subsequent holder hereof may not assert any claim arising from this note against the following assets of the maker:

The interest of the maker in property located at Hart Place and Dundaff Street, Carbondale, PA and covered by a mortgage insured by HUD under Project No. 043-43089 [sic] or deposit made with the Mortgagee or another required by HUD in connection with the mortgage transaction or the rents or other income from the property."

In May 2000, the Director of the Philadelphia Multifamily HUB sent a letter to the Owner explaining that the extension fees could not be paid from Project funds. This was almost two years after \$132,728 had already been paid from Project funds. The payment of the extension fees stopped in June 2000.

In total, the Owner paid \$1,163,670 in Project funds for ineligible purposes and another \$97,631 for items not properly supported. The Owner allowed these funds to be disbursed for personal purposes, including salary, distributions/repayment of advances, debts for an Affiliate company of the Owner and the personal liability of extension fees. If the Owner had complied with HUD requirements and used Project funds for only

necessary operating expenses of the Project, the Owner could have used these funds to pay the mortgage costs (principal and interest) for over two years.

AUDITEE COMMENTS

We discussed the results of our audit with Project representatives during the audit. On February 4, 2004, we provided the Owner a copy of our draft report and we discussed the finding and recommendations with Project representatives in a meeting on March 3, 2004. At that meeting, it was agreed the auditee would meet us on March 17, 2004, for an Exit Conference and provide comments if deemed necessary. On March 16, 2004, we received notice from a representative of the auditee the meeting the next day was not necessary at the time. We feel the auditee was afforded ample opportunity to comment on the report and, as of the issuance date of this report, the auditee had not provided any written comments to the report.

RECOMMENDATIONS

We recommend you:

- 1A. Require the Owner to immediately repay the ineligible cost totaling \$1,163,670 to HUD.
- 1B. Instruct the Owner to provide documentation to support the eligibility of the unsupported cost totaling \$97,631 and require the Owner to reimburse HUD any amounts not supported or determined to be ineligible based on your review of the support provided.
- 1C. Based on the information in this report, take appropriate administrative action against the Owner.

FOLLOW-UP ON PRIOR AUDITS

This was the first audit the Office of Inspector General completed on the Carbondale Nursing Home.

SCHEDULE OF QUESTIONED COSTS

<u>Recommendation Number</u>	<u>Ineligible^{1/}</u>	<u>Unsupported^{2/}</u>
1A	<u>\$1,163,670</u>	<u>\$97,631</u>
Total	<u>\$1,163,670</u>	<u>\$97,631</u>

^{1/} Ineligible costs are those that are questioned because of an alleged violation of a provision of a law, regulation, contract, grant, cooperative agreement or other agreement or document governing the use of funds, or are otherwise prohibited.

^{2/} Unsupported costs are those whose eligibility or reasonableness cannot be clearly determined during the audit since they were not supported by adequate documentation or due to other circumstances. Under Federal cost principles, a cost must be adequately supported to be eligible.