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TO: J. Tom Miller
Director, Oklahoma City Multifamily Program Center, 6IHM

FROM: D. Michael Beard
Regional Inspector General for Audit, 6AGA

SUBJECT: Mustang Nursing Center
Project Number 117-22003
Section 232 Nursing Home Audit
Mustang, Oklahoma

INTRODUCTION

We completed a limited audit of the Mustang Nursing Center (Center) while owned by the Mustang Nursing Center, Inc. The Center officials defaulted on a mortgage HUD insured under Section 232 pursuant to 223(f). The objective of the audit was to determine whether the Center's owners and management agent complied with regulatory requirements when disbursing project funds. The audit covered a 34-month period: from February 26, 1998, the date officials signed the HUD Regulatory Agreement, to December 31, 2000, the day after the Center ceased operations.

To accomplish the objectives, we reviewed HUD's regulations regarding Section 232 Programs, the Regulatory Agreement, and the owner's and management agent's certification with the management agreement attached. We interviewed HUD multifamily staff and project owners. We also reviewed management agent records: the general ledger, cash disbursements journal, 1998 audited financial statements, cancelled checks, and invoices. For the 34-month period, the population of disbursements totaled $3,926,285 (2,594 checks and 1 electronic transfer). Using ACL computer software to analyze the general and cash disbursements journals, we reviewed all amounts over $150 for payments to the owners, related entities, and unusual vendors. We reviewed a total of 168 payments totaling $635,670. Since we did not review payments under $150, we cannot project the results of our test to the total population of disbursements. We conducted the audit during the period June 23, 2003, and February 24, 2004. We conducted our audit in accordance with generally accepted government auditing standards.

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 Jerry Thompson, Assistant Regional Inspector General, at (817) 978-9309.

SUMMARY

The audit disclosed that officials had violated the Regulatory Agreement with HUD. They used project-operating funds to pay owners' debt, repay an owner's loans, pay car lease payments for an owner, and pay for the architectural design of another living center. In addition, they overpaid and made unsupported payments to the management agent. As a result, the Center misspent $171,554.

We are recommending HUD take action necessary to collect the diverted amounts from the owners.

We briefed Center officials on December 3, 2003. HUD officials attended. Center officials commented by letter dated December 15, 2003. Officials asserted they did not know that what they were doing was wrong. They expected HUD to intervene when they were not following HUD requirements.

We provided a copy of the final draft report to the owners on March 1, 2004, and requested an exit conference and their final comments. On March 29, 2004, they advised us through an attorney that they did not wish to have an exit conference with us or provide any additional comments regarding our finding.

BACKGROUND

Congress established HUD's Section 232 Nursing Home Program in 1969 to accomplish three purposes.

(1) Conserve and increase the supply of nursing homes, intermediate care facilities, board and care homes;
(2) Provide credit enhancement through insurance of mortgages for new or substantially rehabilitated projects; and
(3) Purchase or refinance existing Section 232 insured projects with or without repair.

Under the program, HUD insures mortgages made by private lending institutions. These mortgages are used to finance nursing homes, assisted living, and rest homes for the elderly. HUD's Office of Multifamily Housing Development administers the program.

Mustang Nursing Center, Inc. purchased the Center on February 26, 1998. HUD insured the mortgage loan under Section 232 pursuant to 223(f) of the National Housing Act. The Oklahoma State Department of Health licensed and regulated care at the Center.

In February 1998, three persons formed Mustang Nursing Center, Inc., an Oklahoma S-Corporation (for-profit), to acquire and operate the 80-bed nursing home located in Mustang, Oklahoma. Initial ownership was comprised of Messrs. James O. Brown, 45 percent ownership; Alex W. Dout, 35 percent ownership; and Jack R. Collins, 20 percent ownership. Jim Brown & Associates, Inc. of Bartlesville, Oklahoma, an identity-of-interest management agent, operated the Center. Jim Brown and Associates, Inc. is owned and operated by Messrs. Brown, Dout, and Jeff Young. Mr. Young was the Comptroller.

Messrs. Brown and Dout have considerable experience in the nursing home and residential care business. Mr. Brown served as president of the Center. The State of Oklahoma licensed him as a nursing home administrator in 1976. He has over 25 years experience in the nursing home and residential care business. In 1998, he had interest in eight other nursing homes in Oklahoma. Mr. Dout, Senior Vice President in charge of Center operations, is also a licensed nursing home administrator with knowledge in field operations, purchasing, and all phases of Medicare billing and services.

The third owner, Mr. Collins, was an investor. In 1998, Mr. Brown added two investors when he sold two-thirds of his 45 percent interest to Messrs. Cordell Rumsey, 15 percent ownership; and Jonathan Grant Rhodes, 15 percent ownership.

Mustang Nursing Center, Inc. purchased the property for the contract sales price of $2,240,000 from Mustang Nursing Home, LLC.[1] HUD insured the mortgage of $2,257,200 based on a FHA appraised value of $2,730,000. Mr. Brown, President, Mustang Nursing Center, Inc., signed both the settlement statement and Regulatory Agreement with HUD on the date of purchase. The Regulatory Agreement is form HUD-92466 applicable to owner-managed Section 232 nursing homes. Mr. Brown signed the Project Owner's and Management Agent Certification for both owner and management agent.

According to the HUD-1 Settlement Statement, financing of the sale totaled over $2.7 million. The buyer's HUD insured mortgage was $2,257,200. The buyer signed a second mortgage note of $199,250 payable to the seller and paid over $273,000 in cash.

The Center had three managers[2] during the 34-month period of operations, as shown below:

Manager	Period
Jim Brown & Associates, Inc.	February 1998 through October 1999
Mr. Tom Graves	October 1999 through April 2000
Mr. Robert Yarbrough	May 2000 through December 2000

None of the three had success in operating the facility.

The Center officials defaulted on the mortgage note and the mortgagee assigned it to HUD. According to records from the Oklahoma State Department of Health, significant declining occupancy began around September 1999, although the owners had kept the property in good condition. HUD became aware of the troubled status of the project in May 2000. HUD worked with the owners to find an experienced third-party who was willing to assume the debt and operation of the facility. When HUD could not find any qualified parties, the ownership gave up trying to make the operation successful. The Center officials defaulted on the mortgage note in November 2000. The principal balance was over $2.2 million. The owners abandoned the facility on December 30, 2000. During January 2001, the mortgagee assigned the mortgage to HUD and the owners filed for bankruptcy protection. HUD paid the mortgagee over $2.2 million to settle its claim from the default.

Although the property was in good condition HUD received almost nothing for it. On September 28, 2001, HUD sold the property to Mustang Public Schools for ten dollars ($10.00).

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1 The settlement statement lists four persons as the seller: Mr. Larry J. Sparks, Mr. Edmund E. Stites, Mr. James H. Martin, and Ms. Marcedith Martin.

2 HUD had not approved Messrs. Graves and Yarbrough as managers.

FINDING

Center Officials Misspent $171,554

The Center officials used project funds to make unauthorized payments to and for the owners. Specifically, Center officials used:

(1) $62,109 to make payments on a note they made to the seller when they purchased the property;
(2) $55,246 to repay owners for working capital loans;
(3) $18,748 to repay an owner for closing and organization costs;
(4) $17,212 to overpay the management fee of the identity-of-interest management agent;
(5) $11,089 to lease a car for use by an owner; and
(6) $5,500 to pay for the design of another development.

Further, Center officials could not provide adequate documentation to support $1,650 in other payments to the identity-of-interest management agent. Center officials disregarded HUD requirements although the report of an independent audit of the financial statements for 1998 contained findings that brought the violations of HUD requirements to their attention. They told us they ignored the report. Therefore, they continued to make these unauthorized payments through June 20, 2000. As a result, the Center officials violated HUD requirements and misspent $171,554. The mortgagee assigned the mortgage to HUD, the owner filed for bankruptcy, and HUD took possession of the property on March 2, 2001.

The Regulatory Agreement and HUD handbooks govern the use of project funds and the management certification shows the owner and management agent acknowledged the requirements.

1. The Regulatory Agreement between the owners and HUD states, "owners shall not without the prior written approval of the Secretary: … Assign, transfer, dispose of, or encumber any personal property of the project including rents, or pay out any funds except from surplus cash, except for reasonable operating expenses and necessary repairs." It also requires, among other things, Center officials to maintain their books, records, documents, and their papers in reasonable condition for proper audit.

2. In the Project Owner's & Management Agent's Certification (Certification), the owner and management agent (agent) certified they would comply with HUD requirements and contract obligations. The management agreement between the owner and agent is attached to the Certification. It shows the fees agreed on between the owner and agent and approved by HUD.

3. HUD Handbook 4370.2 REV-1, Financial Operations and Accounting Procedures for Insured Multifamily Projects, directs that advances made by owners for reasonable and necessary operating expenses may be paid from surplus cash at the end of the annual or semiannual period. Such a payment is a repayment of advances and is not considered an owner distribution. Such a payment when a property is in a non-surplus cash position, may subject the owner to civil and criminal penalties.

4. HUD Handbook 4600.1 REV-1, Section 232 Mortgage Insurance for Residential Care Facilities directs makers of secondary financing notes to use HUD's promissory note form without alteration or amendment. The secondary financing may be unsecured or secured. Either way, HUD limits the maker to only make payments from surplus cash and not operating funds.

On February 26, 1998, the president of Mustang Nursing Center, Inc. signed the Regulatory Agreement between HUD and the owner. Before that, he signed the Certification as owner and agent thereby certifying that the owner and agent would comply with all HUD regulatory requirements.

Title 12, United States Code, Section 1715z-4a provides a double damages remedy for the unauthorized use of multifamily housing project assets and income. The HUD Secretary may request the Attorney General to bring an action in a United States district court to recover any assets or income used by any person in violation of a regulatory agreement that applies to a multifamily project whose mortgage is insured or held by the Secretary. The Attorney General may recover double the value of the assets and income of the project that the court determines to have been used in violation of the regulatory agreement or any applicable regulation, plus all costs relating to the action, including but not limited to reasonable attorney and auditing fees. The Secretary may apply the recovery, or any portion of the recovery, to the project or to the Department for administrative costs related to enforcement of the requirements.

Center made payments totaling $62,109 on a secondary financing loan without having surplus cash.

Contrary to HUD requirements, the Center officials made 28 monthly payments totaling $62,109 on the owners' unsecured secondary financing note payable to the seller of the property. They made the payments when the property had no surplus cash and without HUD approval. Payments started on March 16, 1998, and ended on June 20, 2000. The payments were to reduce the owners' debt to the seller and not for the operations of the property.

Center officials contend that HUD approved the second mortgage since HUD staff had not objected to it at the property sale closing. On February 1, 1998, the Center officials executed the note payable to Mustang Nursing Home, LLC, (seller of the property). Line item 204 of the settlement statement for the property sale lists the loan as a "Second

Mortgage to Seller." The seller accepted the note instead of $199,250 in cash from the Center.

Although HUD Handbook 4600.1 REV-1, Section 232 Mortgage Insurance for Residential Care Facilities permits secondary financing, the project may only make payments from surplus cash.

Center made payments totaling $55,246 on loans from owners without having surplus cash.

Without surplus cash and HUD's approval, officials used $55,246 in Center funds to make payments on loans the owners of Mustang Nursing Center, Inc., made between them. On December 17, 1997, Mr. Jack Collins loaned $200,000 to Messrs. James O. Brown, Cordell Rumsey, Alex Dout, and Grant Rhodes. For this loan, monthly payments from property funds started on March 12, 1998. The payments continued through June 20, 2000, and totaled $46,667. On May 11, 1999, Mr. James O. Brown loaned Messrs. Grant Rhodes and Alex Dout $124,454. The monthly payments from property funds on this loan started on May 14, 1999, and continued through April 14, 2000, and totaled $8,579.

The notes secured owners' cash loans to operate the Center. The first note states the purpose of the note is capital for the Mustang Nursing Center, Inc. The second note does not state a purpose. Mr. Brown stated the loan documented his accumulated personal cash loans to May 11, 1999, that the Center had not repaid. Since the Center had not accumulated surplus cash that could be distributed to the owners, the payments from Center funds violated requirements.

Center made payments totaling $18,748 to reimburse an owner for costs of purchasing the property and for organizing the corporate ownership.

The Center made two payments to Mr. Jim Brown totaling $18,748.28 to reimburse him for some closing costs when buying the property and for costs of organizing the ownership entity. Mr. Dout told us the payments were for these purposes. The Center made the first payment of $13,748.28 on March 19, 1998. It made the second one for $5,000 on April 3, 1998. Notes on available documentation described each payment as a "Payment on loan." Center officials supported the two payments with a list of eight payments made by Mr. Brown for closing and organization costs. Mr. Brown made the first payment on August 7, 1997, and the last one on March 10, 1998. HUD requirements prohibit the Center from paying owner costs from property funds.

Center made overpayments totaling $17,212 to the identity-of-interest management agent.

The Center overpaid the identity-of-interest management agent. The Center's management agent was Jim Brown & Associates, Inc., (Brown)[3]. HUD approved Brown. The management agreement between the Center and Brown specified a fee of $0.20 per resident per day for long-term care residents,[4] which HUD approved. Instead of $0.20, the Center paid a $0.50 rate throughout 1998, except for October when the Center paid a fixed fee of $1,180. In 1999, the Center paid a fixed fee of $1,500 a month through June and a fee of $1,600 thereafter and through October 1999. The high fees resulted in overpayments totaling $17,212 to Brown.

Center made 20 car lease payments totaling $11,089 for its management agent.

From March 18, 1998, through December 8, 1999, the Center misspent $11,089 on a car lease. The Center made 20 payments. Jim Brown & Associates, Inc., (Brown), the management agent, leased the car in Mr. Brown's name. And, another owner used it to travel between Brown's office in Bartlesville, Oklahoma, and the Mustang Nursing Center, in Mustang, Oklahoma. The car lease was not an operating expense of the Center but it was a management agent or owner's expense.

Center made an architectural designs payment of $5,500 for another property.

On December 6, 1999, an official used a Center check (number 2793) to pay Boynton-Williams & Associates $5,500. The payment was for architectural designs to build Clear Springs Senior Living. Officials planned for this facility to be an assisted living center next to the Mustang Nursing Center. Since the service was not for operating the Center and the Center had no surplus cash, the payment was a misuse of project funds.[5]

Center made six unsupported payments totaling $1,650 to the management agent.

The Center made six unsupported payments totaling $1,650 to Jim Brown & Associates, Inc., the management agent. Notes on available documentation described the payments as payments of accruals and "MUS." Center officials could not explain the two items.

Officials did not have documentation to support the above payments. According to the Regulatory Agreement,[6] Center officials agreed to maintain documents in a reasonable condition for proper audit.

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3 Messrs. James O. Brown and Alex Dout are the owners of Jim Brown & Associates, Inc. as well as the owners of Mustang Nursing Center, Inc.

4 At the time, the Center only housed long-term care residents.

5 HUD did not approve this expenditure.

6 Section 9(c) of the regulatory agreement addresses documentation.

Center officials operated the nursing home without regard to HUD requirements.

Despite signing a Regulatory Agreement and a management certification, officials stated they were unaware of the rules and regulations governing the use of Center funds. They said they had not intended to misuse funds.

However, the Center officials continued to misspend project funds after its independent public auditor (auditor) reported questionable expenditures and the need to support payments. From auditing the Center's 1998 Financial Statements, the auditor disclosed five conditions. In October 1999, the independent auditor reported its findings to the Center's accountant. Reported items included payments made to or on behalf of the owners without HUD authorization. The payments were for repayment of owner advances, interest on owner advances, and a car lease for which the Center was not liable. In addition, the auditor reported the need to maintain expense documentation. Yet after October 1999, the Center continued to make unauthorized payments to or on behalf of the owners. It made the last one on June 20, 2000.

Officials told us they considered their independent audit report an unimportant formality. Therefore, they ignored it. They thought HUD would let them know about any wrongdoing.

The auditor sent the report to the Center for owner and management agent certifications of accuracy. However, Center officials failed to certify the financial statements and supplemental data and send the report to HUD.

AUDITEE COMMENTS

The Auditee chose not to provide additional comments on our draft audit report.

OIG EVALUATION OF AUDITEE COMMENTS

None.

RECOMMENDATIONS

We recommend HUD require payments and sanction the owners of Mustang Nursing Center, Inc. and Jim Brown & Associates, Inc., jointly and severally, as follows:

1A. Require $169,904 to be repaid to HUD for the ineligible expenditures.

1B. Require $1,650 to be repaid to HUD for unsupported expenditures, if the owners cannot furnish adequate documentation supporting the six items as reasonable and necessary operating expenses.

1C. If the owners are not responsive to the demands, initiate and/or support the initiation of a civil action under Title 12, United States Code, Section 1715z-4a, against the principals of the owner and management agent.

1D. Take administrative sanctions against the principals of the owner and management agent involved in running the Center.

Appendix A

SCHEDULE OF QUESTIONED COSTS

Recommendation Number	Type of Questioned Cost	
	Ineligible [1]	Unsupported [2]
1A	$169,904	
1B		$1,650

[1] Ineligible costs are costs charged to a HUD-insured program or activity that the auditor believes are not allowable by law, contract or Federal, State or local policies or regulations.

[2] Unsupported costs are costs charged to a HUD-insured program or activity and eligibility cannot be determined at the time of audit. The costs are not supported by adequate documentation or there is a need for a legal or administrative determination on the eligibility of the costs.