Middlesex Health Care Center, Middletown, CT

Section 232 Program

Office of Audit, Region 1
Boston, MA

Audit Report Number: 2018-BO-1004
June 29, 2018

To:	Timothy Gruenes Director, Asset Management and Lender Relations, HP
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From:	Ann Marie Henry Regional Inspector General for Audit, Boston Region, 1AGA
Subject:	The Middlesex Health Care Center, Middletown, CT, Was Not Always Operated According to Its Regulatory Agreement and HUD Requirements

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our audit of the Middlesex Health Care Center.

HUD Handbook 2000.06, REV-4, sets specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the audit.

The Inspector General Act, Title 5 United States Code, section 8M, requires that OIG post its publicly available reports on the OIG website. Accordingly, this report will be posted at http://www.hudoig.gov.

If you have any questions or comments about this report, please do not hesitate to call me at 617-994-8345.

Audit Report Number: 2018-BO-1004
Date: June 29, 2018

The Middlesex Health Care Center, Middletown, CT, Was Not Always Operated According to Its Regulatory Agreement and HUD Requirements

Highlights

What We Audited and Why

We audited the Federal Housing Administration-insured nursing home, Middlesex Health Care Center in Middletown, CT, because we identified profitability and solvency issues during ongoing work with the Section 232 program. Additionally, the U.S. Department of Housing and Urban Development (HUD) identified the project as potentially troubled as of November 2017. Our audit objective was to determine whether the project was operated according to its regulatory agreement and HUD requirements.

What We Found

Although the owner, Athena Middlesex LLC, generally complied with the regulatory requirements tested, it did not operate according to its regulatory agreement and HUD requirements when it transferred or distributed funds from the project to affiliated healthcare facilities, and while the project was not in a surplus-cash position. The owner's regulatory agreement, sections 6(b) and 6(e), state that owners shall not 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, and that owners shall not make or receive and retain any distribution of assets or any income of any kind of the project except from surplus cash. This condition occurred because the owner treated the project the same as its other affiliated healthcare facilities that were covered under a master lease, which allowed available funds to be transferred between each facility. However, the master lease did not include the project. As a result, more than $1.1 million in project transfers or distributions made did not comply with the regulatory agreement and were not available to the project for necessary and reasonable expenses.

What We Recommend

We recommend that HUD's Director of Asset Management and Lender Relations require the owner to (1) repay the project the more than $1.1 million in ineligible distributions made to affiliated healthcare facilities and (2) implement controls to ensure that project distributions are made from surplus cash and comply with the regulatory agreement and HUD requirements.

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Background and Objective

Section 232 of the National Housing Act authorizes the Federal Housing Administration (FHA) to insure mortgages made by private lenders to finance nursing homes and other eligible facilities. The Office of Residential Care Facilities, under the U.S. Department of Housing and Urban Development (HUD), Office of Healthcare Programs, manages the Section 232 program. Federal regulations at 24 CFR (Code of Federal Regulations) 200.105(a) require HUD to regulate FHA-insured borrowers by means of a regulatory agreement, providing terms, conditions, and standards established by HUD.

The Middlesex Health Care Center in Middletown, CT, is a 150-bed for-profit nursing home facility that is owned by Athena Middlesex LLC and managed by Athena Health Care Systems. The project's owner and the management agent, as well as the 44 other healthcare facilities managed by the management agent, are all affiliated and share a majority stakeholder. The owner is licensed by the Connecticut Department of Public Health and participates in the Medicare and Medicaid programs. The mortgage was refinanced in 2011 under section 223(a)(7) of the National Housing Act of 1937 with a principal balance of more than $8 million. As of November 1, 2017, the mortgage was current and had an unpaid principal balance of more than $7.2 million.

The project had profitability concerns during our audit period. It reported a net loss of more than $1.2 million in fiscal year 2015 and a net income of $686,376 in fiscal year 2016. However, to meet its debt service requirement, affiliated healthcare facilities advanced the project more than $1.8 million over the 2-year period. Although the project reported net income in 2016, more than $1.4 million in advances had been forgiven by an affiliated healthcare facility, and the management agent had stopped charging a management fee. If the healthcare facility had not forgiven the advances and the management agent had charged a management fee, the project would have reported a net loss of around $1 million in 2016.

Our audit objective was to determine whether the project was operated according to its regulatory agreement and HUD requirements.

Results of Audit

Finding 1: The Project Was Not Always Operated According to Its Regulatory Agreement and HUD Requirements

Although the owner generally complied with the regulatory requirements tested, it did not operate according to its regulatory agreement and HUD requirements when it transferred or distributed funds from the project to affiliated healthcare facilities, and while the project was not in a surplus-cash position. This condition occurred because the owner treated the project the same as its other affiliated healthcare facilities that were covered under a master lease which allowed available funds to be transferred between each facility. However, the master lease did not include the project. As a result, more than $1.1 million in project transfers or distributions made did not comply with the regulatory agreement and were not available to the project to distribute for necessary and reasonable expenses.

The Project Owner Generally Complied With the Regulatory Requirements Tested

We reviewed $725,119 of more than $29.5 million in project disbursements during fiscal years 2015 and 2016 and determined that the costs were generally eligible, necessary, and supported. The mortgage was current, and the project and its systems appeared to be in good, serviceable condition. However, we found one area of noncompliance in which the owner did not operate the project in accordance with its regulatory agreement and HUD requirements.

The Owner Transferred or Distributed Funds From the Project While It Was Not in a Surplus-Cash Position

The owner transferred or distributed more than $1.1 million from the project to affiliated healthcare facilities while the project was not in a surplus-cash position. The owner's regulatory agreement, sections 6(b) and 6(e), state that owners shall not 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, and that owners shall not make or receive and retain any distribution of assets or any income of any kind of the project except from surplus cash. Management agent officials explained that funds were transferred weekly as needed between the project and other affiliated healthcare facilities to cover costs. The funds were transferred dependent on each healthcare facility's negative or positive cash flow. The funds were transferred from the project as if it were covered under a master lease.[1] Although some of the other healthcare facilities were covered under a master lease, the project was not. As a result, more than $1.1 million in project transfers or distributions

[1] Section 13.1 of HUD Handbook 4232.1 states that a master lease requires a facility operator to allow available funds from one facility to be used for any other facility in the master lease portfolio that is unable to generate adequate cash flow. The project was not part of the master lease that was executed between the other affiliated healthcare facilities.

made did not comply with the regulatory agreement and were not available to the project to distribute for necessary and reasonable expenses.

A similar finding was identified in the project's draft financial statements for the year ending December 31, 2017, prepared by an independent public auditor. The finding identified that the project paid legal fees of $108,284 on behalf of affiliated healthcare facilities, which violated the regulatory agreement because the project was prohibited from making loans or advances without having available or sufficient surplus cash. As a result of the finding, the affiliated healthcare facilities agreed to repay the legal fees paid by the project, and the management agent agreed to implement a control policy whereby all distributions are made only from available and sufficient surplus cash.

Conclusion

The project was not always operated in accordance with its regulatory agreement and HUD requirements. The deficiency occurred because the owner treated the project the same as its other affiliated healthcare facilities that were covered under a master lease which allowed available funds to be transferred between each facility. However, the master lease did not include the project, and as a result, more than $1.1 million in project transfers or distributions made did not comply with the regulatory agreement and were not available to the project to distribute for necessary and reasonable expenses.

Recommendations

We recommend that HUD's Director of Asset Management and Lender Relations require the owner to

1A. Repay the project the $1,168,000 in ineligible distributions made to affiliated healthcare facilities during fiscal years 2015 and 2016.

1B. Implement controls to ensure that project distributions are made from surplus cash and comply with the regulatory agreement and HUD requirements.

Scope and Methodology

We performed our audit work from December 2017 through April 2018 at the project located at 100 Randolph Road, Middletown, CT, and at the management agent located at 135 South Road, Farmington, CT. Our audit generally covered the period January 1, 2015, through December 31, 2016, and was adjusted when necessary to meet our objective. To accomplish our objective, we performed the following:

- Reviewed the Code of Federal Regulations, HUD handbooks, and the project's policies and procedures.
- Reviewed key documents for the project, including the regulatory agreement, the management agent agreement, and the mortgage.
- Interviewed key personnel to determine financial and operational controls.
- Reviewed independent public auditor reports for the project.
- Reviewed HUD and U.S. Department of Health and Human Services monitoring reports to determine areas on which to focus our review.
- Reviewed the mortgage statement to determine whether the mortgage was current.
- Reviewed bank statements to identify unusual transactions.
- Reviewed the reserve for replacement account to determine whether deposits were made and expenditures were authorized by HUD.
- Reviewed owner distributions and determined whether the project was in a surplus-cash position.
- Reviewed any loans made with project funds.
- Identified related entities and reviewed contracts and invoices for cost reasonableness.
- Reviewed 100 percent of the more than $1.1 million in project distributions made to the affiliated healthcare facilities to determine whether the distributions were eligible and supported.
- Selected a sample of 20 disbursements totaling $725,119 from a universe of 3,207 disbursements totaling more than $29.5 million to determine whether the costs were eligible, necessary, and supported. The sample was chosen based on large dollar disbursements and disbursements that appeared unusual to the project. A sample was chosen rather than reviewing 100 percent of the universe because the universe was too large. We did not perform a statistical sample, so our results were not projected.

To achieve our objective, we relied in part on the project's computer-processed data. We used the data to select samples to determine whether disbursements were eligible, necessary, and supported. For our disbursement tests, we traced automated data to source documents. Although we did not perform a detailed assessment of the reliability of the data, we performed a minimal level of testing and found the data to be adequate for our purposes.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective(s). We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Internal Controls

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

- effectiveness and efficiency of operations,
- reliability of financial reporting, and
- compliance with applicable laws and regulations.

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

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

- Program operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.
- Compliance with laws and regulations – Policies and procedures that management has implemented to reasonably ensure that the use of resources is consistent with laws and regulations.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Significant Deficiency

Based on our review, we believe that the following item is a significant deficiency:

- The owner did not establish and implement adequate controls to ensure compliance with regulatory requirements for project distributions (finding 1).

Appendixes

Appendix A

Schedule of Questioned Costs

Recommendation number	Ineligible 1/
1A.	$1,168,000
Totals	**1,168,000**

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.

Appendix B

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation	Auditee Comments

Middlesex Health Care Center

June 1, 2018

Ann Marie Henry
Regional Inspector General for Audit
Region 1 Boston
U.S. Department of Housing and Urban Development
Office of Inspector General
10 Causeway Drive, Room 370
Boston, MA 02222-1092

Dear Ms. Henry:

Comment 1

In response to the HUD OIG summary finding regarding Athena Middlesex LLC ("Middlesex"), Middlesex disagrees with the audit finding that it violated its HUD regulatory agreement and disagrees that certain disbursements were termed as distributions subject to surplus cash restrictions.

Comment 2

Middlesex agrees with the HUD OIG's assessment that Middlesex is not an affiliated entity covered under a master lease. As noted in the report, such master lease would allow covered facilities to transfer funds between them. Middlesex, however, was a party to a HUD approved line of credit amendment dated February 2015. Middlesex argues that the majority of the activity in the intercompany accounts reflects internal cash re-allocations to the line of credit borrowings between Middlesex and the 13 other facilities (" Athena 14"). All of the terms and conditions of the lines of credit including the addition of Middlesex to the Athena 14 were approved by HUD.

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Managed by Athena Health Care Systems

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation	Auditee Comments
Comment 2 Comment 3	As explained during the audit and exit interview, cash flow for each facility is assessed at least weekly at each of the Athena 14. Excesses are then transferred to one of the other Athena 14 as necessary to cover any shortfalls. Instead of one facility paying down the line and another borrowing, these transactions were recorded in an intercompany account at each of the Athena 14. In Middlesex's case they have received over $2.2 million through 12/31/16 in cumulative funds from the other Athena 14 to fund cash shortfall issues at Middlesex. Most of the $2.2 million could have been eligible for distributions to the owners at those other facilities but due to our commitment to HUD and our facilities the decision was made to forgo distribution and support Middlesex.
Comment 2	Although Middlesex has received over $2.2 million from other Athena 14 facilities, the issue is when Middlesex in a particular week had excess cash flow and that excess was needed at another Athena 14 facility. Middlesex argues that it could have paid those excess funds toward the HUD approved credit line. This would now create availability in the line which would now be available to another Athena 14 facility to borrow it. The whole purpose of a multifacility line of credit. What the Athena 14 did instead of paying and borrowing on the line was to simplify the process. Athena 14 facilities simply transferred the cash internally through its operating accounts to avoid all the banking transactions and delays involved with transferring through the line of credit. This reduces the cost and time involved for these transactions to meet the cash flow needs which are usually immediate (cover payroll, rent, supplies, etc}. This has the exact same effect as paying and borrowing on the credit line but simply eliminated the extra steps.
Comment 4 Comment 2	In addition to the above, the audit lists all intercompany transactions paid to other facilities during the audit period totaling $1,168,000. However, the audit findings do not include the $1,841,000 that was contributed in during that same period. The audit also suggests that surplus cash was transferred to facilities outside the Athena 14 by Middlesex during the audit period. That amount was $250,000. However, the amounts contributed to Middlesex by these facilities totaled $451,000 during that same period. Contributions exceeded distributions by $201,000.
Comment 4	To further assist Middlesex with cash flow, Athena Health Care Associates, Inc. ("Athena"}, the project manager, amended its management contract to remove the amount of the management fee beginning June 1, 2016 to further assist Middlesex with cash flow. This amendment is not a HUD requirement however

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation	Auditee Comments
	Athena felt it was necessary for Middlesex at the time. To date, the cash flow savings to Middlesex for the management fee is approximately $1.2 million.
Comment 4 Comment 2	In summary, Middlesex disagrees with the finding that it violated its regulatory agreement for the reasons noted above. In fact, Middlesex was supported through its line of credit and the removal of management fees to the extent of over $3.4 million. Such support is not a requirement of Middlesex's regulatory agreement. In addition, although the audit process may not take this into account Middlesex's intent should be considered. The intent of the transfers was not in any way to move "surplus plus" cash funds from Middlesex to other facilities. The intent was simply our attempt to move monies as allowed through the line of credit. We may have simplified that approach by moving the monies directly instead of through the line but the ending result either way would have been the same.
Comment 3	We believe that our decision to support Middlesex during this time was our commitment to HUD and Middlesex. As we have noted during the audit and exit conference, Middlesex is financially turning around to become successful once again.

Hopefully the additional information provided above will support our stance with HUD on this matter.

Sincerely,

Lawrence G. Santilli
Manager

cc: Michael E. Mosier
Chief Financial Officer

OIG Evaluation of Auditee Comments

Comment 1 Project officials disagreed with the finding that they violated the HUD regulatory agreement and they disagreed that certain disbursements were termed as distributions subject to surplus-cash restrictions.

We disagree that certain disbursements should not be termed as distributions subject to surplus-cash restrictions. As stated in the audit report, more than $1.1 million was distributed to affiliated healthcare facilities while the project was not in a surplus-cash positon. Section 13(g) of the project's regulatory agreement defines a distribution as any withdrawal or taking of cash or any assets of the project, including the segregation of cash or assets for subsequent withdrawal within the limitations of paragraph 6(e) hereof, and excluding payment for reasonable expenses incident to the operation and maintenance of the project. Section 6(e) states that owners shall not without the prior written approval of the Secretary, make or receive and retain any distribution of assets or any income of any kind of the project except surplus cash. Since the questioned distributions were not for reasonable expenses of the project, and the project was not in a surplus-cash position, the distributions violated the regulatory agreement and were ineligible.

Comment 2 Project officials agreed that the project was not covered under a master lease. They stated that the project was, however, a party to a HUD approved line of credit amendment, dated February 2015, along with 13 other affiliated healthcare facilities (Athena 14). Project officials stated that cash flow for each of the 14 facilities was assessed at least weekly and excesses from one facility were transferred to another facility as necessary to cover any shortfalls. They stated that instead of one facility paying down the line of credit and another one borrowing from the line of credit, the transactions were recorded in an intercompany account at each of the facilities. They argued that they could have paid any excess funds toward the HUD approved line of credit thereby creating availability in the line for use by one of the affiliated healthcare facilities. They stated this has the same effect as paying and borrowing on the line of credit, but simply eliminated the extra steps. Project officials also acknowledged $250,000 was transferred by the project to facilities outside of the Athena 14. However, they stated that the amounts contributed to the project by these facilities totaled $451,000 during the same period and that contributions exceeded distributions by $201,000.

We agree that the project was added to the HUD approved line of credit in February 2015. However, project officials chose not to use the HUD approved line of credit. Instead they chose to distribute funds from the project while it was not in a surplus-cash position in violation of the regulatory agreement. We audited the transactions that occurred and not the transactions that could have occurred if the line of credit was used. As stated in the audit report, this occurred because the owner treated the project the same as its other affiliated healthcare facilities that were covered under a master lease which allowed available funds to be transferred between each facility. During the exit conference, project officials acknowledged that they treated the project as if it were part of the master lease and discussed working with HUD to add the project to the master lease in the future. We offer no comment regarding the contributions made by other facilities to the project because we did not audit any of those facilities.

Comment 3 Project officials stated that the project received over $2.2 million through December 31, 2016 in cumulative funds from the other affiliated healthcare facilities to fund cash shortfall issues at the project. They stated that most of the $2.2 million could have been eligible for distributions to the owners at those other facilities but due to their commitment to HUD and their facilities, the decision was made to forgo distribution and support the project. They also stated that, as noted during the exit conference, that the project is financially turning around to become successful once again.

We acknowledge the commitment shown by project officials. We offer no comment on whether or not the $2.2 million received by the project could have been eligible for distributions to the owners at the other affiliated healthcare facilities because we did audit any of those facilities.

Comment 4 Project officials stated that the audit finding discussed the more than $1.1 million paid by the project to other affiliated healthcare facilities, but it did not include the more than $1.8 million that was contributed to the project from affiliated healthcare facilities. They also stated that the management agent amended the management agreement to stop paying a management fee as of June 2016. Project officials believe the intent regarding the distributions should be considered. They stated that the intent of the distributions was not to move surplus cash from the project to affiliated healthcare facilities, but instead to simplify the approach of moving the money.

In the background section of the report we acknowledged that affiliated healthcare facilities advanced the project more than $1.8 million and that more than $1.4 million was forgiven. We also acknowledged that the management agent stopped charging a management fee. That information or the intent of the distributions does not change the fact that distributions were made from the project while the project was not in a surplus-cash position. We stand by our conclusion that the distributions violated the regulatory agreement and were ineligible.