
AUDIT REPORT



LAKEWOOD CARE CENTER MULTIFAMILY EQUITY SKIMMING

MILWAUKEE, WISCONSIN

2005-CH-1004

DECEMBER 22, 2004

OFFICE OF AUDIT, REGION V
CHICAGO, ILLINOIS



Issue Date December 22, 2004
Audit Report Number 2005-CH-1004

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

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

SUBJECT: Lakewood Care Center; Milwaukee, WI; Multifamily Equity Skimming of More
Than \$1 Million in Project Funds

HIGHLIGHTS

What We Audited and Why

We reviewed the books and records of the Lakewood Care Center (Project), a 196-bed skilled nursing facility in Milwaukee, WI. The review was part of our efforts to combat multifamily equity skimming. The review was also part of our nationwide reviews of nursing homes due to the increasingly high default rate and number of Federal Housing Administration (FHA) insurance claims being paid under the Section 232 program. We chose the Project due to its default status and more than \$1 million dollar write-off of bad debt reported in its fiscal year 2002 audited financial statements.

Our review objective was to determine whether the owner/management agent used Project funds in compliance with the Regulatory Agreement and the Department of Housing and Urban Development's (HUD) requirements.

What We Found

The owner of the Project, 2115 Woodstock Place, LLC (Woodstock Place), inappropriately disposed of \$1,021,056 in Project assets on December 31, 2002, without obtaining HUD approval and in violation of its Regulatory Agreement.

The Project was in a non-surplus cash position and in default of its FHA-insured loan at the time of the disposition.

Woodstock Place also inappropriately loaned \$612,500 of Project funds to Summit Health Care, Incorporated, the identity of interest operator of the Project. The Project was in a non-surplus cash position and/or in default at the time Woodstock Place made the loans.

What We Recommend

We recommend that HUD's Director of Multifamily Housing Hub, Minneapolis Field Office, ensure that Woodstock Place reimburse the Project's Reserve for Replacement and/or HUD's FHA insurance fund \$1,021,056 for the inappropriate disposition of Project assets. We also recommend that HUD's Director of Multifamily Housing Hub, in conjunction with HUD's Office of Inspector General, pursue double damages remedies if Woodstock Place does not reimburse the Project's Reserve for Replacement and/or the FHA insurance fund for the inappropriate disposition of Project assets.

We also recommend that HUD's Director of Departmental Enforcement Center impose civil money penalties and pursue administrative sanctions against Woodstock Place and its Managing Member.

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

Auditee's Response

We provided our discussion draft audit finding to Woodstock Place's Managing Member and HUD's staff during the review. We held an exit conference with the Managing Member and HUD's staff on June 7, 2004.

Woodstock Place's Managing Member did not disagree with our finding that Woodstock Place disposed of and loaned the Project's assets. However, the Managing Member did not agree with our recommendations due to either HUD's knowledge and/or approval of Woodstock Place's disposition and/or loaning of the Project's assets. We included the complete text of the Managing Member's comments in appendix B of this report.

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BACKGROUND AND OBJECTIVE

Lakewood Care Center (Project) is a 196-bed skilled nursing facility in Milwaukee, WI. The Project was insured under Section 232 of the National Housing Act and its Regulatory Agreement was executed on September 1, 1999. The Project's owner was 2115 Woodstock Place, LLC (Woodstock Place). The Managing Member of Woodstock Place was also the President of Summit Health Care, Incorporated (Summit), the identity of interest operator of the Project. The Project was in a non-surplus cash position as of September 1999 and Woodstock Place was in default of its U.S. Department of Housing and Urban Development (HUD)-insured mortgage as of June 2002. Woodstock Place sold the Project on August 28, 2003, through a Transfer of Physical Assets.

The review was part of our efforts to combat multifamily equity skimming. The review was also part of our nationwide reviews of nursing homes due to the increasingly high default rate and number of FHA insurance claims being paid under the Section 232 program. We chose the Project due to its default status and more than \$1 million dollar write-off of bad debt reported in its fiscal year 2002 audited financial statements.

Our review objective was to determine whether the owner/management agent used Project funds in compliance with the Regulatory Agreement and HUD's requirements.

RESULTS OF AUDIT

Finding: Woodstock Place Inappropriately Disposed of More than \$1 Million in Project Funds

The owner of the Project, 2115 Woodstock Place, LLC (Woodstock Place), inappropriately disposed of \$1,021,056 in Project assets on December 31, 2002, without obtaining HUD approval and in violation of its Regulatory Agreement. The Project was in a non-surplus cash position and in default at the time of the disposition. The inappropriate disposition included \$509,778 in loans and \$511,278 in delinquent lease payments. Contrary to the Regulatory Agreement, Woodstock Place loaned \$612,500 of Project funds to Summit, the identity of interest operator of the Project. Further, Woodstock Place reclassified the payment of \$147,478 in 1998 real estate taxes as a loan to Summit in its fiscal year 1999 audited financial statements. Summit repaid \$250,200 of the loans as of December 2002. However, Summit failed to make \$511,278 in lease payments to Woodstock Place from April 2001 through December 2002. The problems occurred because Woodstock Place did not follow its Regulatory Agreement and lacked effective procedures and controls to assure Project funds were used appropriately. As a result, fewer funds were available for debt service, and Project funds were not used efficiently and effectively.

Woodstock Place Inappropriately Disposed of More than \$1 Million in Project Funds

Woodstock Place inappropriately wrote-off \$1,021,056 in Project assets as bad debt on December 31, 2002. The Project was in a non-surplus cash position at the time of the disposition. Further, Woodstock Place had been in default of its mortgage since June 2002. Woodstock Place failed to obtain HUD approval for the disposition of the Project assets.

The inappropriate disposition included \$509,778 in loans and \$511,278 in delinquent lease payments. Woodstock Place's Managing Member said he was not aware the Regulatory Agreement required him to obtain HUD's approval before disposing of Project assets.

Woodstock Place Inappropriately Loaned Project Funds to Summit

Contrary to the Regulatory Agreement, Woodstock Place loaned \$612,500 of Project funds to Summit, the identity of interest operator of the Project. Woodstock Place loaned \$594,500 from October through December 1999. Woodstock Place loaned the remaining \$18,000 to Summit in October 2002. The loans occurred while the Project was in a non-surplus cash position. The October 2002 loan also occurred while the Project was in default. Woodstock Place failed to obtain HUD approval for the loans. Further, Woodstock Place reclassified the payment of \$147,478 in 1998 real estate taxes as a loan to Summit in its fiscal year 1999 audited financial statements. Summit repaid \$250,200 of the loans between November 1999 and September 2000.

Woodstock Place's Managing Member, who was also the President of Summit, said Woodstock Place's former Accountant transferred the Project funds for the 1999 loans without informing him. The Managing Member also said he first found out about the loans during the preparation of the 1999 audited financial statements. The former Accountant said she would have informed the Managing Member of any transfer of funds from the Project's account.

The Managing Member signed the check from Woodstock Place to Summit for the \$18,000 loan. The Managing Member said he was not aware that HUD approval was required for a loan of Project funds while the Project is in a non-surplus cash position.

Summit Failed To Make Lease Payments to Woodstock Place

Summit failed to make \$511,278 in lease payments to Woodstock Place from April 2001 through December 2002. Woodstock Place's Amended and Restated Lease with Summit, dated September 1, 1999, required Summit to make monthly lease payments of \$92,338. The lease payments were for the Project's mortgage payment, real estate taxes, and property insurance.

Summit paid its President, who was also Woodstock Place's Managing Member, and/or his wife more than \$1.2 million in salaries and distributions from September 1999 through August 2002. Therefore, Summit had ample funds to make the lease payments instead of paying the Managing Member and/or his wife the salaries and distributions. We believe these salaries and benefits of more than \$1.2 million were an undue enrichment to the Managing Member and/or his wife at the expense of the Project's financial position.

The Project's Reserve Was Reduced by 92 Percent

Woodstock Place had \$1,021,056 less in Project funds to make mortgage and Reserve Fund for Replacement payments due to the inappropriate disbursements. HUD was not aware Woodstock Place made the loans to Summit or that Woodstock Place disposed of the Project's assets. HUD approved Woodstock Place's use of \$526,754 from its Reserve account to bring its mortgage up to date. HUD's Director of the Milwaukee Field Office of Multifamily Housing Program Center said HUD would not have approved the use of the Project's Reserve if it had known about the loans and disposition of assets. Woodstock Place sold the Project on August 28, 2003, through a Transfer of Physical Assets. As a result, the Project's reserve at the time of the sale was \$48,811, \$49,189 below HUD's minimum requirement of \$98,000 for the Project. Further, the Project's reserve would have been \$621,931 if Project funds had been available to make the mortgage and reserve payments.

Recommendations

We recommend that HUD's Director of Multifamily Housing Hub, Minneapolis Field Office, ensure that Woodstock Place

- 1A. Reimburse the Project's Reserve for Replacement and/or HUD's FHA insurance fund \$1,021,056 for the inappropriate disposition of Project assets.

We also recommend that HUD's Director of Multifamily Housing Hub, Minneapolis Field Office, in conjunction with HUD's Office of Inspector General (OIG)

- 1B. Pursue double damages remedies if Woodstock Place does not reimburse the Project's Reserve for Replacement and/or the FHA insurance fund for the inappropriate disposition of Project assets.

We also recommend that HUD's Director of Departmental Enforcement Center

- 1C. Impose civil money penalties against Woodstock Place and its Managing Member for the inappropriate loans and disposition of Project assets cited in this report that violated the Project's Regulatory Agreement.
- 1D. Pursue administrative sanctions against Woodstock Place and its Managing Member for the inappropriate disposition of Project assets cited in this report.

SCOPE AND METHODOLOGY

We performed the review at HUD's Milwaukee Field Office and the Project from October 2003 through June 2004. To accomplish our audit objectives, we interviewed: HUD's staff; the Project's employees; Woodstock Place's Managing Member and Summit's President; employees from BDO Seidman, LLP, the independent public accountant who audited Woodstock Place; and the Executive Vice-President of Capital Funding Group, Inc., with whom Woodstock Place entered into the HUD-insured mortgage for the Project.

To determine whether the owner/management agent used Project funds in compliance with the Regulatory Agreement and HUD's requirements, we reviewed:

- The Regulatory Agreements among HUD, Woodstock Place, and/or Summit;
- HUD's project files and correspondence related to the Project;
- HUD's Real Estate Management System information related to the Project;
- Woodstock Place's Amended and Restated Operating Agreement, Articles of Organization, Mortgage and Security Agreement with Capital Funding Group, Inc., and Amended and Restated Lease with Summit;
- Woodstock Place's and Summit's financial records;
- Woodstock Place's audited financial statements for the years ending December 31, 1999, 2000, 2001, and 2002; and
- The Articles of Incorporation for Summit and other identity of interest companies.

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

The review covered the period September 1, 2001, to August 31, 2003. This period was adjusted as necessary. We performed our review in accordance with Generally Accepted Government Auditing Standards.

INTERNAL CONTROLS

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

- Effectiveness and efficiency of operations;
- Reliability of financial reporting; and
- Compliance with applicable laws and regulations

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

Relevant Internal Controls

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

- Program Operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.
- Validity and Reliability of Data – Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.
- Compliance with Laws and Regulations – Policies and procedures that management implemented to reasonably ensure that resource use is consistent with laws and regulations.
- Safeguarding Resources – Policies and procedures that management implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse.

We assessed the relevant controls identified above. However, our assessment of the controls was limited since Woodstock Place no longer owned the Project as of August 28, 2003.

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

Significant Weaknesses

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

- Program Operations – Woodstock Place did not operate the Project according to its Regulatory Agreement. Specifically, Woodstock Place disposed of assets while in a non-surplus cash position and without approval from HUD (see Finding).
- Safeguarding Resources – Woodstock Place inappropriately wrote-off \$1,021,056 of Project assets as bad debt and loaned \$612,500 of Project funds to Summit while in a non-surplus cash position and without approval from HUD (see Finding).

Appendixes

Appendix A

SCHEDULE OF INELIGIBLE COSTS

Recommendation Number	Ineligible 1/
1A	<u>\$1,021,056</u>
Total	<u>\$1,021,056</u>

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

Memorandum

To: Mr. Brent Bowen, US Dept. of HUD- office of Inspector General
CC: James Forman, Esq.
From: Thomas Zwicker, Managing member 
Date: 7/7/2004
Re: Draft Audit Findings, Woodstock Place

In your May 24, 2004 correspondence to me you requested that I respond to HUD draft audit findings. Enclosed you find my response. Please feel free to contact me by phone 262-251-3899 should you have additional questions or concerns.

Ref to OIG Evaluation

Auditee Comments

Comment 1

Comment 2

July 8, 2004

Mr. Brent Bowen
Assistant Regional Inspector General
for Audit U.S. Department of HUD-Office
Inspector General
77 West Jackson Boulevard, Suite 2646
Chicago, IL 60604

Re: 2115 Woodstock Place, LLC

Dear Mr. Bowen:

You provided a draft of the audit finding of the Office of Inspector General for Audit, HUD concerning 2115 Woodstock Place, LLC ("Woodstock Place") and requested that management review and comment on the draft audit. Additional time was requested to respond to the draft audit so that we could more fully respond and consult with our legal counsel. The request was denied. We did not have access to certain documents as a result of the 2003 loan assumption and asset purchase of Lakewood Health and Rehabilitation Center ("Lakewood Nursing Home" or "Lakewood"). When we requested to review the documents from the new owners of the nursing home, we were told that HUD was in possession of the documents. Under these restrictions, this letter sets forth management's comments regarding the draft audit to the best of our current ability.¹

We are distraught over the allegations that we did anything improper in the operation and ownership Woodstock Place. In our efforts to care for senior citizens (our "elders") and in serving the public, we did our best under the circumstances to service our patients' medical and social needs and to comply with our obligations to HUD and others. We provided to HUD yearly (1999-2002) audited financials by BDO Seidman, LLP Accountants and Consultants ("BDO Seidman"). Because HUD had these financials and knew of Lakewood's financial issues, yet never complained of any of our actions until after the asset purchase and loan assumption in 2003, and, in fact, authorized the transaction with the new buyer, we believed we were acting properly in the operation of the businesses. Under these circumstances, we believe it is unfair and improper for HUD to now seek a million dollars-plus, and other fines and sanctions for actions to which HUD had acquiesced in previous years.

¹ Because of these limitations, please note that any failure on our part to address or to respond to a finding, conclusion or recommendation in the draft audit not be deemed to be an admission against our interest, an acknowledgement of responsibility, an acknowledgement as to the truthfulness of the findings, conclusions and/or recommendations, or a waiver to assert any other position, factual and/or argument.

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I. FACTUAL BACKGROUND

As the findings of the audit report are considered, we believe it is important to look at the whole nursing home industry and the regulatory and financial climate of the industry during the period of time at issue, as well as the businesses of Woodstock Place and Lakewood Nursing Home.

A. History of Lakewood Nursing Home and Woodstock Place.

In 1976, I became involved in the nursing home industry. I obtained my nursing home administrator's license and worked for several large corporations, thereby gaining experience and expertise in the nursing home industry. In 1993, I became the administrator of Lakewood Nursing Home, a 246-bed nursing home in Milwaukee, Wisconsin. I came to Lakewood Nursing Home to improve its reputation by getting it back into compliance. I had been asked to operate Lakewood because I had been successful in turning around a 400-bed nursing home in Glendale, Wisconsin that had faced similar problems. As reported in the *Milwaukee Journal Sentinel* in 1996, "over a 15-year period, Zwicker had developed a reputation as a turnaround specialist."

When I started with Lakewood Nursing Home, it had a poor reputation among nursing homes in the state of Wisconsin and had been in and out of compliance with state and federal regulations. During my first week in managing Lakewood, the business was involved in a survey process conducted by the Bureau of Quality Compliance, Department of Health and Family Services, State of Wisconsin. As a result of the survey, a 55-page report was generated describing the deficiencies of the home. It was placed in Medicare and Medicaid decertification. Faced with this and other challenges, I, along with my wife Debbie Van Straten,² and a team of health care professionals worked to "fix Lakewood." Managers were changed and other experts were consulted. Systems were reapplied and checks and balances proved effective in returning Lakewood to a high level provider of medical treatment and care to our elders. We worked to reclaim Lakewood's reputation and cure its financial problems and non-compliance issues while focusing on providing medical and social services to our elders.

In 1995, my wife and I became the owners of Lakewood Nursing Home through a company called Summit Health Care, Inc. ("Summit"). We were the sole shareholders of Summit. We continued to own and operate Lakewood Nursing Home through Summit until the asset sale in 2003.

² I focused on the operation of Lakewood Nursing Home, and Debbie focused on marketing and promoting Lakewood. Debbie also became instrumental in attempting to generate revenue for the business. Further, Debbie helped shape the culture of Lakewood as a home focusing on the social needs of our elders in addition to their medical needs.

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B. Medical Compliance Accomplished and Finances in Order.

In 1995, the state and federal governments declared Lakewood Nursing Home to be deficiency-free. This was a significant accomplishment for us. We had worked really hard, putting in very long hours, to achieve this goal. At this time, Lakewood also received several awards and was recognized as a well-run establishment providing health care and other services to persons in need.

After my team and I took charge of Lakewood Nursing Home, its financial condition also improved. In 1996, the *Milwaukee Journal Sentinel* reported, "Lakewood had a \$600,000 loss in 1992. A year later, the first year Zwicker was on board, losses fell to \$250,000. By 1994, the home was breaking even. Lakewood was \$100,000 in the black in 1995"

C. Nursing Home Industry Changes.

During the late 1990s, the nursing home industry dramatically changed. Medicaid funding dramatically declined. In addition, the 1997 Balanced Budget Act resulted in the biggest decrease in Medicare funding and thus payments to nursing homes. Correspondences³ from U.S. Senators Russell D. Feingold (February 9, 2001) and Herb Kohl (May 22, 2000) highlighted the funding crisis. As stated by Senator Kohl,

There has been mounting concern about the ability of Medicare's financing mechanisms to adequately fund the unprecedented growth in its programs, including home health care. As you may know, for the past twenty-five years, Medicare trustees have been predicting insolvency of the program by the year 2001. Therefore, Congress reformed the Medicare program in 1997 in order to meet the critical need to bring Medicare spending under control. The agreement, which will help extend the Medicare hospital trust fund until 2007, achieved Medicare savings largely through reducing the growth in payments to hospitals, physicians, and other providers. In addition, payment policies were revised for skilled nursing facilities and home health agencies.

While these changes will save the Medicare program from bankruptcy in the short-term, we still have a great deal of work to do to ensure that seniors have access to affordable long-term care services. . . . I agree that as Congress continues to look for ways to reform our nation's health care system, we must take steps to ensure that seniors have access to a variety of long-term care options, including nursing facilities

³ The letters from the Senators were written in direct response to inquiries by us, Lakewood employees, elders at Lakewood and family members of the elders.

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We determined that to keep our care of elders at its high level, Lakewood Nursing Home would not cut direct patient care positions to address the lack of Medicaid and Medicare reimbursements. Instead, we cut administrative positions. Notwithstanding our efforts, Lakewood spiraled into debt because of the changes to the nursing home industry and the payment and reimbursement cuts from Medicaid and Medicare.

D. Acquisition of Lakewood Nursing Home's Lease Property.

In June 1998, Woodstock Place purchased the land and building leased by Lakewood Nursing Home. On June 4, 1998, Woodstock Place obtained a bridge loan for the acquisition. On September 21, 1999, Woodstock Place obtained a loan through Capital Funding that was insured through HUD. Lakewood Nursing Home continued its tenancy in the building and leased the space from Woodstock Place.

E. Inter-Company Loans.

In addition to cutting our administrative expenses and as a result of the reimbursement crisis, from June 1998 to the close of Capital Funding/HUD-insured loan, Woodstock Place loaned money to Lakewood Nursing Home for operating expenses. In turn, Lakewood repaid Woodstock Place significant amounts of the loan, plus interest.⁴

After the closure of the HUD-insured loan, Woodstock continued to loan money to Lakewood Nursing Home from October 1999 through December 1999, with one additional loan in the amount of \$18,000 in October 2002. Lakewood repaid a significant portion of these loans. We did not think our continued practice of these inter-company loans was improper.

F. Milwaukee County Nursing Home Market Changes From Fallout of Medicaid and Medicare Funding Crisis. The Funding Crisis Cripples Lakewood Nursing Home.

In 1999, the Family Care Pilot Program was introduced to Milwaukee County. It provided alternative options for care and housing. Over a 5-year period, Family Care Pilot Program, as well as other factors, contributed to a reduction in the number of occupied nursing home beds by 25%. Many nursing homes were significantly affected, but Lakewood maintained or increased its market share. As of December 31, 1999, Lakewood was noted in a 3-way tie for 7th place relating to Medicaid occupancy in Milwaukee County. In other words, Lakewood had one of the highest Medicaid occupancies in the County. This illustrated the need for care facilities such as Lakewood, but highlighted the funding crisis that had been caused by the

⁴ Prior to giving the loan, Capital Funding was aware of this activity. Because Capital Funding was aware of the loans, we believe HUD also knew or should have known about these inter-company transactions.

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decline in the Medicaid reimbursements. The financial crisis was illuminated by the fact that of the top 9 nursing homes listed with the highest Medicaid occupancy, the top 5 had closed and 1 was in the process of closing. Moreover, nursing homes with lower Medicaid occupancy than Lakewood had also closed.

On September 18, 2000, a conference was held at Lakewood Nursing Home where the Wisconsin Health Care Association shared a special report created by BDO Seidman on the financial conditions of nursing homes in Wisconsin. Key findings in the report indicated a crisis for nursing home care, in part because of the changes to the Medicaid program. For example, in fiscal year 2000, the average Medicaid loss per patient was \$10.90 a day. For a 100-bed facility, with a 70% Medicaid occupancy, this loss translated into an annual loss of \$250,000. Taking into account all sources of payment, the average margin for all Wisconsin nursing homes in 1999 was a negative 4.79%. The Medicaid reimbursements from the State of Wisconsin also decreased and were set to further decrease in the future. According to the special report:

Nursing home facilities are in a well-documented financial crisis. The reduction of Medicaid payment ceilings over the past decade, plus the reductions in fiscal year 2001, places Wisconsin Medicaid payment system among the worst in the country. The system has eroded to the point where other payers can no longer compensate for the other significant Medicaid shortfalls in payment. The problem has been compounded by excess cuts in Medicare payment, higher vacancy rates, increasing patient acuity, and unparalleled shortage of labor, and greater competition for private pay residents.

The funding crisis created a financial peril for Lakewood. In an attempt to address the situation, in 2001, Lakewood worked with the State of Wisconsin to reduce the number of beds and increase the Medicaid rate at Lakewood. We believe that this was the only relief available under state regulations. For Lakewood, this amounted to a brief, short-term relief.

G. Lakewood Meets With Representatives from HUD and the State of Wisconsin.

In addressing the financial crisis facing Lakewood Nursing Home, we were frank and honest about the frightening financial situation. Lakewood management attempted to increase revenues and cut costs but without affecting the quality of elder care. Lakewood encouraged people to contact politicians through letters and phone calls regarding the Medicaid funding crisis. In addition, in 2002, Lakewood facilitated a meeting between a representative from Medicaid and representatives from HUD to try to rectify the financial difference between the Medicaid reimbursement that Lakewood was receiving and the mortgage payment due to HUD. With the Medicaid representative on one side of the table and the HUD representative on the other, Lakewood was caught in the middle listening to both representatives from different

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agencies of the government. The Medicaid representative from the State of Wisconsin argued that they had no money to rectify the problem and the HUD representative said the business would be sold in a "fire sale" but that HUD would not reduce the value of the loan. Although the issues were openly discussed at the meeting, there was no resolution or help provided. Lakewood management had many other meetings with representatives from HUD and representatives from the State of Wisconsin. These many meetings occurred in Milwaukee, Madison, and at the Lakewood facility. At all times, HUD was aware of the financial situations of Lakewood and Woodstock Place.

As it became ever more apparent that there would be no "give" either in relief from the State with respect to Medicaid reimbursements or from HUD with respect to the value of the mortgage, we began looking at options, like finding a buyer of the business/assumer of the loan or closing Lakewood and relocating the elders. However, with so many closures of nursing homes in Milwaukee County, there were serious questions as to whether the elders would have a place to live. Although this was the primary issue, there were other matters of concern, including the displacement of 250 employees of Lakewood.

With all of these things considered, we decided the most prudent thing to do was to find a buyer for Lakewood rather than subject the businesses to a firesale or foreclosure proceeding.

H. HUD Consented to the Asset Sale and Loan Assumption with Full Knowledge of the Inter-Company Loans, including the Disposition of the Receivables.

We worked with Capital Funding (lender) and with HUD in the asset sale of Lakewood Nursing Home and Woodstock Place and the assumption of the loan. In early 2003, I spoke with a vendor who was owed money from Lakewood. I informed the vendor that we were interested in selling the business. The vendor advised us of the existence of a potential buyer. The contemplated transaction with the new buyer included the assumption of the \$8.1 Million dollar loan and a transfer of the assets, including a million dollar-plus receivable.

Capital Funding advised us that HUD would approve a transaction with the new buyer, but that before it would do so, HUD would need to approve the financials for the year ending December 31, 2002. HUD had in its possession audited financials for the previous years. HUD required that financial statements (with supplemental materials) had to be approved by HUD before a sale would be approved. BDO Seidman, on behalf of Woodstock Place, prepared the 2002 financial statements with supplemental material and the documents were provided to HUD.

Note 3 to the 2002 audited financial report specifically provided:

Note 3-Related Party Receivable

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Lakewood (see Note 1) is a related entity due to common ownership/control. All amounts due from Lakewood at December 31, 2002 have been deemed uncollectible. The Company reported bad debt expense of \$1,021,256 for the year ended December 31, 2002, relating to amounts due from Lakewood.

We believe that BDO Seidman determined that for the Woodstock Place to be in compliance with Generally Accepted Accounting Principles, the "bad debt expense" needed to be deemed uncollectible and thus written off.

Additionally, BDO Seidman reported in its: "Opinion on Compliance with Specific Requirements Applicable to Major HUD Programs" the following:

In our opinion, the Company [Woodstock Place] complied, in all material respects, with the requirements described above that are applicable to each of its major HUD-assisted programs for the year ended December 31, 2002, except for those items described in the following paragraph.

The Company has not complied with program requirements relating to its mortgage status and replacement reserve. The Company is two payments behind in its mortgage payments and has not made all of its required payments to the replacement reserve account.

Furthermore, BDO Seidman reported in the "Schedule of Findings and Questioned Costs" the following:

Item 02-1

Condition:

The Company is behind two months in its mortgage payments and has not made all of its required reserve for replacement payments.

Criteria:

Project owners must ensure that all payments due under the mortgage are made promptly.

Effect:

The owner must pay the amounts due under the mortgage as soon as possible or at a minimum, continue to make timely monthly payments and not fall further behind.

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Cause:

The lessee (a related party) is having serious financial difficulties meeting its current obligations as they come due. As a result, the lessee has defaulted on its lease agreement with the Company who in turn did not have the cash to make the mortgage payments.

Recommendation:

To the extent it can, the financial performance of the lessee must be improved. Given the current state of the long-term care environment, this could be a difficult challenge. The current owner is in negotiations to sell the building and related operations. The new owner would refinance the existing mortgage at a lower interest rate.

Comments:

The owner is currently working with HUD to keep the mortgage status as current as possible and in dealing with the potential sale of the facility.

The report specifically noted that it was for use by HUD.

HUD and Capital Funding (who was working closely with HUD) lead us to believe that while the transaction with Sugar Creek may have some marginal impact on Woodstock Place's and our reputation with HUD, it should not impact our ability to go forward in the future with another possible HUD loan. In fact, it was the thought at the time that we might actually establish a new nursing home in the future and possibly obtain HUD funding. We acted in reliance on those representations.

After receipt of the financial report, HUD approved the asset sale and loan assumption. As part and parcel of the transaction with Sugar Creek, the nursing home transferred to the new owner all receivables owed to it, including a million dollar-plus receivable owed by Medicaid, Medicare and private revenue sources.

Accordingly, HUD was fully aware of the \$8.1 Million Dollar assumption of loan and mortgage, the transfer of the receivable and the uncollectible receivable owed to Woodstock Place from Lakewood Nursing Home as it had been noted in the financials that had been sent to HUD prior to HUD's approving the sale. Thus, while BDO Seidman reported in its 2002

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financial statements that \$1,021,256 was "deemed uncollectible,"⁵ we do not agree with the draft audit's conclusion that the disposition was inappropriate. In any event, with knowledge of the receivable disposition, HUD consented to the transaction.

Had HUD withheld its consent or expressed concern over the finances, we would not have sold the \$1 Million dollar-plus receivable. Funds may then have been available to repay the loans to Woodstock Place. Accordingly, the accounts receivable to Woodstock Place may not have required to be written off as an uncollectible debt.

I. BDO Seidman Reported No Cash Surplus Issue Regarding the Loans.

The draft audit alleges that loans between Woodstock Place and Lakewood between October and December 1999 were inappropriate. BDO Seidman prepared an audit for Woodstock Place for the year ending December 31, 1999, with financial statements and with supplemental material. The report noted the following:

It reported in Note 3:

Note 3-Related Party Transactions

Lakewood (see Note 1) is a related entity due to common ownership/control. Accounts receivable, related party at December 31, 1999 consist of the following:

Lakewood	<u>\$578,978</u>
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Included in financial revenue-project operations is interest paid to the Company by Lakewood on monthly outstanding balances in 1999.

BDO Seidman reported in its "Opinion on Compliance with Specific Requirements Applicable to Major HUD Programs":

In our opinion, the Company complied, in all material respects, with the requirements described above that are applicable to each of its major HUD-assisted programs for the year ended December 31, 1999.

⁵ The draft audit refers to default on a couple of different occasions, including in reference to this disposition. We do not recall receiving notice from HUD declaring a default under the Regulatory Agreement.

Ref to OIG Evaluation

Auditee Comments

Comment 2
Comment 3
Comment 5

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BDO Seidman reported in the "Schedule of Findings and Questioned Costs":

"Not applicable. There were no findings or questioned costs."

BDO Seidman reported that there was no correction action plan needed.

HUD was sent a copy of the BDO Seidman audit for year ending December 31, 1999. Accordingly, HUD was fully aware of the related company transactions between Lakewood and Woodstock Place as referenced in the report.

For contrasting purposes, we reference the December 31, 2000 BDO Seidman audit of Woodstock Place, in which BDO Seidman reported on the "Schedule of Findings and Questioned Costs" the following:

Item 00-1

Condition:

2115 Woodstock Place, LLC reported a cash distribution of \$60,000 in 2000 while not in a surplus position.

Criteria:

An owner's distribution is only allowed from surplus cash.

Effect:

Unallowable distributions, regardless of materiality, are questioned costs.

Cause:

The cash distribution took place before the relevant calculation of surplus cash.

Recommendation:

The owner should not take any distribution of assets without first calculating that surplus cash is available for such distribution.

Comments:

Comment 2

Comment 2
Comment 6

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The owner agrees with the finding and further agrees to follow the recommendation as stated. The owner will wait for HUD's evaluation of the finding and take the necessary action based upon HUD's comments.⁶

The point of this contrast is that if BDO Seidman had determined that there was a cash surplus Regulatory Agreement issue in 1999, it would have reported it, as it had in the year 2000.

We agree that money was loaned from Woodstock Place to Lakewood Nursing Home from October 1999 through December 1999 and also in October 2002. Even if some of the loans were made at a time when Woodstock Place did not, as the draft audit argues, have a sufficient cash surplus, we do not believe we were acting improperly. Lakewood repaid a significant portion of the loans. Moreover, we believe HUD excused the balances of the loans with HUD's awareness of and acquiescence to approval of our audited financial documents and HUD's approval of the sale and loan transfer in 2003.

J. Reliance on BDO Seidman Audits.

We relied upon BDO Seidman as our consultant and accountant in performing audits of our business and reviewing our compliance with HUD regulations. The annual BDO Seidman audits were provided to HUD, thereby providing HUD with information of our business operation.

K. HUD Approved Woodstock Place's Use of Reserve Account Money.

As noted in the draft audit, the money was used from the reserve account to bring the mortgage current. HUD consented to the use of this money. We cannot comment on whether the HUD's Director of Multi-Family Program Center, Milwaukee Field Office made the reference which appears on page 5 of the draft audit. However, we disagree that the use of the money from the reserve account to bring the mortgage current was an inappropriate disbursement. HUD had the BDO Seidman audited reports for Woodstock Place. The reserve account usage predated the disposition of the receivable referenced in Section I. H. above.

L. Findings Contained in Draft Audit.

To the extent that the findings contained in the draft audit are different than the information contained above, we dispute the findings. In addition, the attributions of statements to me that are contained on page 4 of the draft audit do not give a complete and accurate account of my recollection of events.

⁶ Before HUD ever commented on this item, the \$60,000 was reimbursed to Woodstock Place.

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II. RECOMMENDATIONS

We do not concur with the recommendations of your office. In light of HUD's awareness and consent to the inter-company loans and dispositions of the receivables, we do not believe that any of the recommended items should be imposed. Furthermore, if we had been advised before we sold the assets of Lakewood and Woodstock to Sugar Creek that HUD had concerns with the receivable disposition or the inter-company loans and if HUD had not made the representations upon which we relied, the transaction with Sugar Creek would never have proceeded and the \$1 Million-plus receivable would have remained available to address Recommendation 1 of the draft audit. Further, at all times, we believe we acted in the best interests of our elders and their families and the public at large. Moreover, we are no longer involved in the ownership or operation of Lakewood Nursing Home.

Notwithstanding the above and without waiver of any rights, we do request the opportunity to sit down with the Office of Inspector General for Audit to further discuss the draft audit and/or with the United States Department of Housing and Urban Development to discuss this matter.

Sincerely,

Thomas Zwicker
Managing Member of Woodstock Place, LLC

OIG Evaluation of Auditee Comments

- Comment 1** We granted Woodstock Place an extension of 30 days to respond to the draft audit finding.
- HUD did not have possession of the Project's documentation during the 45 days Woodstock Place had to respond to the draft audit finding.
- Comment 2** HUD's receipt of annual financial statements does not constitute approval and/or knowledge of the Project's financial position and actions. Further, HUD does not approve annual financial statements.
- Comment 3** HUD was not, and would not be expected to be, aware that Woodstock Place loaned Project funds to Summit prior to obtaining its HUD-insured mortgage.
- Comment 4** Woodstock Place loaned \$612,500 of Project funds to Summit while the Project was in a non-surplus cash position. Woodstock Place's Regulatory Agreement did not allow the loaning of Project funds while the Project was in a non-surplus cash position.
- Comment 5** Woodstock Place's audited financial statements for the year ending December 31, 1999 submitted to HUD referred to Woodstock Place's loans of Project funds to Summit as related party receivables. Therefore, HUD was not aware the related party receivables were loans to Summit.
- Comment 6** Woodstock Place loaned \$594,500 of Project funds to Summit from October 1999 through December 1999. Woodstock Place loaned an additional \$18,000 to Summit in October 2002. Woodstock Place wrote-off \$1,021,056 in Project assets as bad debt on December 31, 2002. HUD approved Woodstock Place's use of \$526,754 from its Reserve account to bring its mortgage current. HUD's approvals occurred from June 2001 through August 2003. Therefore, HUD's approvals did not occur prior to Woodstock Place's inappropriate disposition of Project assets.

Appendix C

FEDERAL REQUIREMENTS

Woodstock Place's Regulatory Agreement, paragraph 6, mandated that the owner may not, without the prior written approval of the Secretary, (b) 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 (e) make or receive and retain any distribution of assets or any income of any kind of the project except surplus cash.

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

Paragraph 3 of Woodstock Place's LLC Rider to Note, Mortgage, and Regulatory Agreement requires all signatories to the Rider to be liable for a) funds or property of the Project coming into their hands that they are not entitled to retain and b) their own acts and deeds or acts and deeds of others, which they have authorized, in violation of the provisions.

HUD Handbook 4370.2, REV-1, CHG-1, "Financial Operations and Accounting Procedures for Insured Multifamily Projects," paragraph 2-10, section A, states that if the owner takes distributions when the project is in default or when the project is in a non-surplus cash position, the owner is subject to criminal and/or civil penalties.

According to 24 Code of Federal Regulations, part 24.110, HUD is permitted to take administrative sanctions against employees or recipients under HUD assistance agreements that violate HUD's requirements. The sanctions include debarment, suspension, or limited denial of participation and are authorized by 24 Code of Federal Regulations, parts 24.300, 24.400, or 24.700, respectively. HUD may impose administrative sanctions based upon the following conditions:

- Failure to honor contractual obligations or to proceed in accordance with contract specifications or HUD regulations (limited denial of participation);
- Deficiencies in ongoing construction projects (limited denial of participation);
- Violation of any law, regulation, or procedure relating to the application for financial assistance, insurance, or guarantee or to the performance of obligations incurred pursuant to a grant of financial assistance or pursuant to a conditional or final commitment to insure or guarantee (limited denial of participation);
- Violation of the terms of a public agreement or transaction so serious as to affect the integrity of an agency program such as a history of failure to perform or unsatisfactory performance of one or more public agreements or transactions (debarment);
- Any other cause so serious or compelling in nature that it affects the present responsibility of a person (debarment); or

- Material violation of a statutory or regulatory provision or program requirements applicable to a public agreement or transaction, including applications for grants, financial assistance, insurance, or guarantees, or to the performance of requirements under a grant, assistance award, or conditional or final commitment to insure or guarantee (debarment).

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

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