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Issue Date: November 4, 2004
Audit Case Number: 2005-LA-1801

MEMORANDUM FOR: Janet L. Browder, Director, HUD's Office of Multifamily Housing, 9AHMLA

Joan S. Hobbs

FROM: Joan S. Hobbs, Regional Inspector General for Audit, 9DGA

SUBJECT: The Carmichael Rehabilitation Center
Federal Housing Administration Project Number 136-43061
Carmichael, California

INTRODUCTION

We have completed an audit of the Carmichael Rehabilitation Center, a Section 232 Nursing Home. Our review was initiated as part of a nationwide review of the Department of Housing and Urban Development's (HUD) Section 232 program. The objective of this review was to determine if the owner of the Carmichael Convalescent Center complied with the terms of the Regulatory Agreement with HUD. We found that the owner did not follow HUD requirements and mismanaged the project's operations by defaulting on the project's mortgage and through ineligible disbursements of the project funds. The audit was performed in accordance with generally accepted government auditing standards.

Audit work was performed between December 2003 and July 2004, and generally covered the period of January 1997 through September 2002, which was expanded as necessary. In conducting the audit, we reviewed records provided by the owner and interviewed appropriate members of the owner's staff and management. We also interviewed a partner from the project's financial audit firm, and reviewed their audit working papers. In addition, we reviewed HUD monitoring files, spoke to HUD officials, and reviewed the applicable HUD requirements.

As required by HUD Handbook 2000.6 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. 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 me at (213) 534-2470, or Clyde Granderson, Assistant Regional Inspector General for Audit, at (415) 489-6692.

SUMMARY

We identified violations of the Carmichael Rehabilitation Center's Regulatory Agreement and other HUD requirements. This included the owner, Sun Healthcare, incorporating the project in its petition for bankruptcy and subsequently defaulting on the project's mortgage. In addition, during the time period leading up to and during the default, the owner disbursed $3,769,290 in project funds through ineligible cash distributions and expenses. These activities resulted in increased risk to HUD, the assignment of the mortgage note to HUD, and HUD's resulting loss of $323,925 on the sale of the note.

BACKGROUND

Section 232 of the National Housing Act authorized a mortgage insurance program for residential care facilities (12 U.S.C. 1715w). HUD insured a $4.9 million mortgage under the Federal Housing Administration Section 232 program, to establish the Carmichael Rehabilitation Center in November 1992. The project has a 126-bed capacity and is located in the city of Carmichael, California. The Project Funding Corporation was the holder of the mortgage note.

The owner of Carmichael is Sun Healthcare Group, a for-profit nationwide healthcare provider founded in 1993, with corporate offices in Irvine, California, and Albuquerque, New Mexico. Sun is a publicly traded corporation subject to Security and Exchange Commission requirements. Sun's operations included inpatient services, rehabilitation therapy services, and home health; with the majority of its income coming from Medicare and Medicaid programs. In 1999, Sun operated over 300 projects through its Sunbridge subdivision, which had 40 regional offices throughout the nation.

Sun obtained the Carmichael facility in 1996 when it acquired the previous owner, Regency Health Services. Regency had ownership interest in the facility since 1988, before HUD insured the mortgage note. Sun renamed the facility the Sunbridge Care and Rehabilitation Center for Carmichael. Sun also operated seven other projects with Federal Housing Administration insured loans, located in California, Maryland, New Hampshire, New Mexico, and Tennessee. As of June 2004, Sun still operated Carmichael and five of these projects.

Between 1997 and 2001, the Independent Public Accounting firm of Lesley, Thomas, Schwarz, and Postma, Inc. prepared Carmichael's annual financial audit reports. These reports were signed by owner representatives and submitted to HUD. HUD did not require a financial audit report for fiscal year 2002.

FINDING

OWNER MISMANAGED THE PROJECT'S OPERATIONS

Sun Healthcare did not follow the project's Regulatory Agreement and other HUD requirements in managing operations of the Carmichael Rehabilitation Center. This included Sun incorporating the project into its petition for bankruptcy and defaulting on the project's mortgage. In addition, Sun Healthcare inappropriately disbursed $3,769,290 of the project's cash between January 1997 and September 2002 (see Appendix B). The latter included ineligible distributions to the owner totaling $2,965,619, and use of project funds to pay ineligible ownership costs of $803,671. The inappropriate distributions continued while the project was subject to the owner's bankruptcy, in default, and HUD held the note. In addition, when the project's financial audit reports identified a portion of the inappropriate distributions, the owner submitted misleading information to HUD to make it appear the problems had been corrected. This occurred because Sun Healthcare lacked internal controls to ensure it complied with HUD's requirements. We believe these actions increased the risk to HUD's mortgage insurance fund by reducing the cash available for the project's normal operations. In addition, the default directly resulted in HUD incurring a loss of $323,925 on the disposition of the Carmichael facility.

HUD Requirements

The Regulatory Agreement between HUD and the Carmichael Rehabilitation Center was approved on November 20, 1992. The agreement required the owner to promptly make all payments due under the note, and the owner was also not allowed to include the facility in any petition for bankruptcy. In addition, the owner could not make, receive, or retain any distributions of the project's assets or income, except surplus cash after the end of annual or semiannual periods. The Agreement stated no distributions could be made when there was a default under the mortgage. All the project's rents and receipts were supposed to be deposited in the name of the project, and such funds could be withdrawn only for project expenses or allowed surplus cash distributions. Finally, the owner could not have the facility incur any liability or obligation not in connection with the project's operations.

HUD Handbook 4370.2, Revision 1, Financial Operations and Accounting Procedures, dated January 23, 1996, stipulates under Chapter 2 that distributions can only be paid from surplus cash, but cannot be paid when the project is in default. The surplus cash generated at the end of one fiscal period is not available for distribution until the next fiscal period. 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.

12 U.S.C. Sec. 1715z-4a states that HUD may recover any assets or income used by any person in violation of a regulatory agreement applicable to a multifamily project insured by HUD. This prohibits owners and their agents from using project resources for anything other than the project's operating expenses, which are the necessary and reasonable expenses arising from the everyday operation and maintenance of the project. HUD may recover double the value of any assets and income of the project that have been used in violation of the regulatory agreement, plus all related costs such as reasonable attorney and auditing fees.

HUD Notice 01-3 regarding the Section 232 program, issued April 2001, stipulates any owner or operator of a healthcare facility that has filed for bankruptcy within the last five years, is not eligible to participate in any manner in a facility with a Section 232 insured mortgage.

Petition for Bankruptcy and Default

Although strictly prohibited by the Regulatory Agreement, Sun incorporated the project into its petition for bankruptcy and defaulted on the project's mortgage. This activity directly resulted in HUD incurring a loss on the disposition of the Carmichael facility.

Sun Healthcare filed for Chapter 11 bankruptcy protection on October 14, 1999, including all its subdivisions, affiliates, and projects (including the Carmichael Rehabilitation Center). Shortly thereafter, Sun began defaulting on the project's mortgage when it failed to make the December 1999 payment. No subsequent payments were forthcoming, so the lender, the Project Funding Corporation, optioned to assign the note to HUD in May 2000. Since the project was included in Sun's bankruptcy, it then fell under the jurisdiction of the bankruptcy court. Sun could not bring the mortgage current until its creditors approved its plan of reorganization, which didn't occur until February 2002. Thus, no mortgage payments were made until March 11, 2002, when Sun Healthcare finally brought the mortgage current with a payment to HUD of $1,129,470. This amount included all delinquent mortgage interest and principal.

In July 2002, HUD sold Carmichael's note at auction without Federal Housing Administration insurance. At that time, the note's adjusted balance was $4,559,895. However, the adjusted balance received from GE Capital's winning bid was only $4,235,970. As a result, HUD incurred a loss of $323,925 when the note sale closed in September 2002.

Ineligible Distributions to the Owner

The Regulatory Agreement strictly limited the distribution amounts the owner could withdraw from the project. However, Sun did not follow these requirements and collected excessive distributions totaling $2,965,619. This resulted from the owner's practice of transferring and commingling all the project's cash with its own funds in violation of HUD requirements.

Sun Healthcare's application of an inappropriate cash management system led to excessive distributions of the project's cash. Project receipts were initially deposited to a project operating bank account, which also held deposits of various other Sun projects. However, Sun then routinely and consistently transferred all the cash to its own bank accounts on the same day as the deposit, which Sun called a "cash sweep." The sweeps commingled the cash with the owner's other financial activity, enabling the owner to utilize it for non-project purposes and thus resulting in distributions. According to the Regulatory Agreement, Sun was only allowed to collect a distribution up to the surplus cash amount calculated on the prior year's financial audit report, and Sun could make no distributions to itself while the project was in default. Nevertheless, the net amounts collected by Sun through these transfers exceeded the available surplus cash between 1997 and 2001. Since Sun did not immediately return the cash to the project, it resulted in ineligible distributions.

Ineligible Distributions to Owner

Fiscal Year	Distribution Amount	Surplus Cash Available (1)	Ineligible Distribution
1997	$ 797,122	$ 543,665	$ 253,457
1998	$ 372,466	$ 288,661	$ 83,805
1999	$ 787,122	$ 271,858	$ 515,264
2000	$ 648,690	None (2)	$ 648,690
2001	$ 1,464,403	None (2)	$ 1,464,403
Total	$ 4,069,803	$ 1,104,184	**$ 2,965,619**

(1) Based on prior year's financial audit report calculation.

(2) No distributions of surplus cash available while project in default.

HUD Handbook 4370.1, Reviewing Annual and Monthly Financial Statements, Chapter 2-21, Section J, allows a management agent to deposit project funds in the same bank account as other projects, with HUD's prior written approval, as long as an agent can identify all receipts and liabilities of individual projects.

Although the handbook did amend the Regulatory Agreement to allow a management agent to commingle multiple housing projects in a single account, it did not amend the Regulatory Agreement to allow project funds to be commingled with those of the owner. Since Sun self-managed the facility there was no independent management agent to ensure the proper administration of the funds separate from the owner's, or prevent its utilization for the owner's other purposes. In addition, Sun did not obtain HUD approval to commingle funds with other projects or in the owner's multiple bank accounts, so it was precluded from conducting this activity.

Distributions In Excess of Surplus Cash Identified on Financial Audit Reports

Although the project's financial audit reports did not identify all the inappropriate distributions (above), they did identify approximately $1.5 million of distributions in excess of surplus cash, including $458,097 on the 2000 report and $1,056,740 on the 2001 report. The audit reports recommended that Sun Healthcare return the funds to the project's operating account, and for Sun to amend its procedures to assure distributions do not exceed the allowable surplus cash. Sun Healthcare's Vice-President and Corporate Controller attested that these funds had been returned to the project's operating account in the project's 2001 financial statements submitted to HUD. However, we found that Sun did not fully comply with these recommendations.

Although Sun claimed the funds were returned to the operating account, this was not completely accurate. To resolve the 2000 recommendation, Sun made a deposit of $458,097 to the project's operating account on March 7, 2002. However, the funds were immediately swept back to Sun's own bank accounts on the same day. As a result, the problem was not appropriately corrected. We also noted that no cash was returned to the project's operating account to resolve the 2001 recommendation. In addition, the cash management practices were never amended to prevent this activity, at least up through September 2002.

Ineligible Ownership Expenses

Sun Healthcare inappropriately charged the project $803,671 for expenses associated with its ownership of the facility without obtaining HUD's permission. This included income tax liabilities charged prior to and during the default, and goodwill expenses charged to the facility prior to the mortgage default. These were Sun's ownership expenses, as defined by HUD handbooks, and should not have been charged to the project without HUD's prior approval.

HUD Handbook Criteria

HUD Handbook 4370.2, Financial Operations and Accounting Procedures for Insured Multifamily Projects, Chapter 4-4, Section G, distinguishes mortgagor/corporate expenses from expenses necessary and reasonable for the operation of the project. Mortgagor/corporate expenses include federal and state income taxes. The handbook states owners may only charge these expenses against the project's operations with the prior written approval of HUD.

Handbook 4370.4, Basic Accounting Desk Reference for HUD Loan Servicers, Chapter 4-3, states corporate expenses may represent diversions of project funds for unauthorized purposes. The handbook also lists federal and state taxes as corporate expenses.

Inappropriate Application of Income Taxes

Between 1997 and 2001, Sun permanently reduced the cash amounts it owed the project by charging income taxes totaling $686,541 (see Appendix B). According to HUD requirements, income taxes are an expense of the owner, which should not have been charged to the project without HUD's prior written approval. Sun never obtained HUD's permission to charge these costs to the project. However, this liability was still applied to Carmichael through annual adjustments treating the ownership expense as a project liability, which affected the asset balances included on the financial audit reports submitted to HUD. Although the income taxes were shown on the project's income statements, included as part of the financial audit reports, Sun did not provide any information to HUD concerning the inappropriate adjustments.

Ineligible Goodwill Expense

The owner charged ineligible expenses to the project totaling $117,130 (see Appendix B), which Sun identified as goodwill[1] expense. The owner initially charged the goodwill expense to the project in 1998 through a series of monthly inter-company accounting entries totaling $150,108. The owner later reduced this amount by $108,032, leaving a net goodwill expense amount of $42,076. In 1999, Sun charged another $75,054 to the project. These goodwill expenses are corporate expenses of Sun Healthcare, and are not reasonable and necessary for the operation of the project. These expenses reduced the cash balance Sun owed to the project. As a result, the expense was, in effect, an additional inappropriate distribution to the owner in violation of the Regulatory Agreement.

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[1] Goodwill represents the amount an organization paid to acquire another entity over its estimated fair value. Sun Healthcare recorded goodwill in its corporate books when it acquired Regency, the prior owner of the Carmichael facility.

AUDITEE COMMENTS AND OIG EVALUATION

We provided our draft report to the auditee for its comments on September 2, 2004. We also discussed the draft report during an exit conference discussion with Sun Healthcare officials on September 3, 2004. The auditee provided its comments on September 20, 2004. Sun Healthcare issued its comments through the Carmichael Rehabilitation Center. We included the auditee's final written comments in Appendix C to the report, including all attachments.

In general, the auditee did not agree with our conclusions over the bankruptcy and default, excessive distributions, and ineligible expenses. All comments were considered but no material changes were made to our report.

Bankruptcy and Mortgage Default

Comments Synopsis:

The auditee stated that bankruptcy codes barred the application and effects of the Regulatory Agreement and subsequent administrative action. The auditee also blamed the loss on HUD's decision to sell the note. Sun believed HUD could have waited and sold the note at some subsequent date when it would not have incurred a loss.

OIG Evaluation:

We do not agree with the auditee's position that HUD was the cause for the loss on the sale of the mortgage. Sun Healthcare included the project in a bankruptcy petition and stopped making mortgage payments in violation of the Regulatory Agreement, resulting in the note being assigned to HUD. There was also no evidence to show that putting off the note sale until some unidentified future date would have further reduced HUD's losses. In addition, the bankruptcy codes cited by the auditee do not clearly bar HUD from pursuing appropriate action against the auditee.

Cash Management

Comments Synopsis:

The auditee did not believe it was in violation of HUD requirements, insisting that the provisions of Handbook 4370.2 were met. The auditee argued this handbook did not require a management agent to be independent, nor require prior approval from HUD to utilize a centralized account. As a result, cash sweeps should not be considered distributions.

OIG Evaluation:

Although HUD Handbook 4370.2 does not specifically mention whether HUD approval is required, Handbook 4370.1, Chapter 2, states the commingling of funds between projects is only permissible with the advance approval of HUD. In addition, both handbooks required the cash to be maintained in a single centralized bank account, allowing only a single separate subsidiary payroll bank account.

Sun Healthcare's practice of sweeping cash did not follow HUD's conditions for the utilization of a centralized account. Sun did not maintain the project's cash balance in one centralized bank account, but instead swept it from the project bank account to its own accounts. Sun then further transferred these funds to various other corporate bank accounts and its revolving line of credit, commingling the cash with various other corporate funds. This made the project's separate cash balance in these bank accounts unidentifiable, and provided Sun the means to utilize it for non-project purposes. If a management agent maintained the project's cash in a single joint account in accordance with HUD requirements, it would not have been available for the owner's benefit. As a result, the cash sweeps resulted in distributions to the owner.

Financial Audit Findings on Excessive Distributions

Comments Synopsis:

The auditee stated the project had access to the cash at all times prior to fiscal year 2000, so there were no distributions. Sun claimed it treated the 2000 and 2001 activity as excessive distributions because the bankruptcy limited the availability of the funds held by Sun to the project.

The auditee did not believe the statute (12 U.S.C. Sec. 1715z-4a) was applicable because all excessive distributions were repaid in 2002, leaving no remaining ineligible amounts. Sun maintained the temporary March 2002 deposit of $458,097 resolved the 2000 financial audit finding by making the cash available to the project. Sun therefore recomputed the 2000 negative surplus cash balance to include the deposit, which also reduced the excessive distributions it reported to HUD for 2001. In addition, Sun believed the payment of $1,129,470 on March 11, 2002 to bring the mortgage current sufficiently resolved all remaining distributions.

OIG Evaluation:

The auditee's positions over distributions and the availability of funds were not plausible. If Sun believed the cash was restricted in 2000 and 2001 then it should have identified all prior years excessive transfers as excessive distributions, since they were still held by Sun, and returned these funds to the project. In addition, there was no information to show that the bankruptcy court precluded Sun from resolving the distribution problem. Sun could have left receipts in the project's operating account, immediately transferred previously swept cash back to that account, or even held the project funds in an escrow account in the name of the project.

The 2002 deposit of $458,097 to the project's operating account did not resolve the 2000 financial audit finding, since it was immediately swept back to the owner's accounts. In addition, Sun should

not have retroactively applied this deposit to the negative surplus cash reported on the 2000 financial audit, just so it could understate the 2001 finding amount.

The owner did bring the mortgage current in March 2002 to prevent a HUD foreclosure. However, this payment did not change the fact that Sun had already violated the regulatory agreement in 2001 by distributing funds in excess of surplus cash. In addition, the payment did not address the total balance of excessive distributions (see Appendix B).

1999 Surplus Cash

Comments Synopsis:

The auditee stated it should have been allowed to collect the project's 1999 surplus cash in calendar year 2000, despite the mortgage default. The auditee asserted HUD was obligated to apply the project's Reserve for Replacement funds to temporarily cover the mortgage payments, making the surplus cash available to Sun.

OIG Evaluation:

We do not agree with the auditee's assertions over the application of the project's Reserve for Replacements funds. The purpose of the reserve was for the replacement of the project's capital items. HUD was not required to allow these funds to cover the owner's nonpayment of the mortgage, which would have only temporarily delayed the default and subsequent assignment. It would not have been reasonable for HUD to allow an owner to deplete the project's reserves, just so the owner could collect surplus cash.

Ineligible Ownership Income Taxes

Comments Synopsis:

The auditee stated that even though it did not obtain prior HUD approval, it should still be allowed to charge the project for the income taxes. The auditee referred to HUD handbook requirements, which state that HUD may approve such expenses. Sun also stated the income taxes were Carmichael Rehabilitation Center, Inc.'s responsibility, not Sun Healthcare's.

OIG Evaluation:

The auditee never obtained HUD's prior written permission to charge the income taxes to the project. As a result, the auditee was in violation of HUD handbook requirements. Just because HUD had the option of granting such permission, does not mean the auditee was automatically entitled to charge the project.

Ineligible Ownership Goodwill

Comments Synopsis:

Sun acknowledged goodwill amortization was a corporate expense, but claimed the charges to the project were in accordance with standard company and industry practices and generally accepted accounting principles. The auditee also wanted credit for management fees it could have charged the project.

OIG Evaluation:

Whether or not Sun's internal policies called for these expenses to be allocated to the facility level does not change the fact that they were ineligible ownership expenses in violation of the Regulatory Agreement and other HUD requirements. The goodwill was not a project asset so the associated amortization expense was not a reasonable and necessary project expense.

Sun's request to now retroactively charge a management fee to offset ineligible expenses is not reasonable.

RECOMMENDATIONS

We recommend the Director of Multifamily Housing:

1A. Pursue recovery from Sun Healthcare of the $323,925 loss incurred on the sale of the mortgage note.

1B. Take appropriate administrative action and pursue recovery of the net ineligible distributions amount of $3,769,290 from Sun Healthcare, as permitted by statute (12 U.S.C. Sec. 1715z-4a).

MANAGEMENT CONTROLS

In planning and performing our audit, we considered the management controls relevant to the Carmichael Rehabilitation Center and Sun Healthcare activity to determine our audit procedures, not to provide assurance on the controls. Management controls include the plan of organization, methods, and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

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

- Controls and procedures over cash management of project funds
- Controls and procedures over project disbursements and expenses

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

Based on our review, we believe there was a significant weakness in Sun Healthcare's lack of policies and procedures to ensure it followed HUD Handbook and Regulatory Agreement requirements over cash management and disbursement of project funds.

Appendix A

SCHEDULE OF QUESTIONED COSTS

Finding Number	Type of Questioned Cost		Funds to be Put to
	Ineligible 1/	Unsupported 2/	Better Use 3/
1A	$323,925		
1B	$3,769,290		

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditors believed are not allowable by law, contract or Federal, State or local policies or regulations.

2/ Unsupported costs are costs charged to a HUD-financed or HUD-insured program or activity, and eligibility cannot be determined at the time of the 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. Unsupported costs require a future decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of Departmental policies and procedures.

3/ Funds to be put to better use are costs that will not be expended in the future if our recommendations are not implemented; for example, costs not incurred, de-obligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made and other savings.

Appendix B

Ineligible Diversions of Carmichael's Funds

Inappropriate Activity	1997	1998	1999	2000	2001	Total
Ineligible Distributions	$253,457	$ 83,805	$515,264	$648,690 (1)	$1,464,403 (2)	$2,965,619
Ownership Goodwill Expense		$ 42,076	$ 75,054			$ 117,130
Ownership Income Taxes	$231,000	$128,510	$251,031	$ 29,300	$ 46,700	$ 686,541
Total Ineligible Diversions	$484,457	$254,391	$841,349	$ 677,990	$ 1,511,103	**$3,769,290**

Period project in default on mortgage, December 1999 through March 2002.

(1) - Financial audit report for fiscal year 2000 only identified $458,097 of the ineligible distributions.

(2) - Financial audit report for fiscal year 2001 only identified $1,056,740 of the ineligible distributions.

Appendix C

AUDITEE COMMENTS

CARMICHAEL REHABILITATION CENTER
101 Sun Avenue NE
Albuquerque, NM 87109

September 20, 2004

Joan S. Hobbs
Regional Inspector General for Audit
Office of Inspector General
U.S. DEPARTMENT OF HUD
611 West Sixth Street, Suite 1160
Los Angeles, CA 90017-3101

RE: Carmichael Rehabilitation Center
Carmichael, CA
(formerly FHA No.136-43061)

Dear Ms. Hobbs:

Based upon your letter of September 2, 2004, we are hereby responding to the findings and recommendations found in the draft OIG Audit Memorandum Report attached to your letter and referring to the above-named project.

For the reasons noted below, we believe that the findings and recommendations noted in such draft report are not supportable or reasonable in light of the facts and circumstances noted herein.

Finding - Petition for Bankruptcy and Default

Although we acknowledge that the Regulatory Agreement for Multifamily Housing Projects ("HUD Regulatory Agreement") executed in connection with this project did require payments to be made under the Mortgage Note when due (Par. 1) and that the Owner shall not have filed a petition for bankruptcy (Par. 8) we believe that the provisions of the United States Bankruptcy Code, 11 U.S.C. et seq. (the "Code") specifically bar the application of the regulatory, punitive and/or discriminatory effect of the provisions of those provisions of the HUD Regulatory Agreement and the assertions and recommendations of your letter and its findings, and specifically note that the Code sets out and provides, in part, that: (1) the trustee may use or may provide for the use of property, notwithstanding any provision in a contract, a lease, or applicable law that is conditioned on the insolvency or financial condition of the debtor or on the commencement of a case under this title concerning the debtor (11 U.S.C. Sec. 363 (l));

(2) notwithstanding a provision in an executory contract or in applicable law, an executory contract of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract that is conditioned on (A) the insolvency or financial condition of the debtor at any time before the closing of the case; (B) the commencement of a case under this title (11 U.S.C. Sec. 365 (e)(i)); and (C) a governmental unit may not deny, revoke, suspend, or refuse to renew a license, permit, charter, franchise, or other similar grant to, condition such a grant to, discriminate with respect to such a grant against, a person that is or has been a debtor under this title or a bankrupt or a debtor under the Bankruptcy Act (11 U.S.C. Sec. 525)

Notwithstanding the cited application of the provisions of the Code, we believe the decision made to file a petition under Chapter 11 in Bankruptcy Court for the Owner of this project was ultimately in the best interests of HUD and the project. By affirmatively filing a petition under Chapter 11, we were better able to present and have adopted a plan which would ultimately allow this project to be current in its outstanding mortgage indebtedness as well as being able to cover its operating expenses. This is in contrast to a situation where a creditor could file an involuntary petition for bankruptcy under Chapter 7, which could have resulted in the liquidation of the project.

Moreover, the failure to make payments under the Mortgage Note was based directly on the orders of the Bankruptcy Court, and as shown herein, adequate funds existed in the various project accounts to otherwise cover the Note payments.

Finally, it should be clearly pointed out that, as noted in the draft OIG Audit Report, we arranged to bring all amounts that had been past due current as of March 11, 2002. Mortgage payments continued to be made on a timely basis thereafter until the Department took the affirmative step of selling the Mortgage Note through auction. Thus, any loss that was incurred by HUD was a direct consequence of the Department's decision to sell the Note after the loan had been brought current and was again being paid on a timely basis, rather than the Owner's decision to file a Chapter 11 petition in Bankruptcy Court.

Finding - Ineligible Distributions to the Owner

In the draft letter of the OIG Audit Report you state that excessive distributions totaled $2,965,619. This amount represents the changes in the "due from Sun Healthcare" account less the amounts detailed on the "surplus cash calculations".

The draft OIG Audit Report further states that the excessive distributions primarily occurred due to the owner's practice of commingling all the project's cash with it own funds in violation of HUD requirements

We do not believe the project's cash management system was in violation of HUD Handbook 4370.2 Revision – 1, Change – 1 "*Financial Operations and Accounting Procedures for Insured Multifamily Projects*", issued January 23, 1996 which states.

Chapter 2-6 Regular Operating Account

A. The regular Operating account is a general operating account for the project which is used for depositing rental receipts and other receivables not specifically designated for the Security Deposits Account. The accounts also are used to pay operating expenses of general administration including mortgage payments, management fees, utilities and maintenance. The Regulatory Agreement states that the funds must be maintained in a separate account. However, this paragraph suspends the operations and effect of this Regulatory Agreement provision by authorizing the management agent to hold funds in a centralized account, up to or exceeding $100,000, in institutions under the control of, and whose deposits are insured by, the Federal Deposit Insurance Corporation, National Credit Union Association, or other U.S. government insurance corporations under the following conditions:

1. Managing agents must determine that the financial institution has a rating consistent at all times with current minimally acceptable ratings as established and published by Government National Mortgage Association (GNMA).

2. The managing agent must monitor the institution's ratings no less than on a quarterly basis, and change institutions when necessary. The managing agent must document the ratings of the institutions where the funds are deposited and maintain the documentation in the administrative record for three years, including the current year.

3. In the event that the managing agent fails to follow these procedures and the bank fails, the owner/managing agent

4. will be expected to make up losses sustained by the various project accounts held by the failed bank.

5. Deposits to and disbursements from the centralized account must clearly be traceable to each project. The actual cash position of each and every project in the centralized account must be easily identifiable at all times without exception.

6. The managing agent must allow a project owner to require, at any time, that the particular owner's funds be kept isolated and separate from the funds of other projects held by the agent; that is, at all times an owner is to

have the prerogative of not participating in the centralized account arrangement or of withdrawing from such an arrangement.

NOTE: The above language is not deemed a modification of the Regulatory Agreement. Therefore, HUD reserves the right to invoke this Regulatory Agreement provision and make it operational in the future through notice or handbook change, if it is determined that such a policy is necessary or desirable.

Please note we believe the project's cash management system met the five conditions detailed in Chapter 2 - 6 as follows:

Condition 1

The centralized bank accounts that held the project's cash were with the following financial institutions

Years 1997 - 1999	Wells Fargo, N.A.	Nationsbank of Texas, N.A.
Years 1999 - 2002	Wells Fargo, N.A.	First Union National Bank

These institutions met the minimum acceptable ratings as established and published by the Government National Mortgage Association (GNMA). Please see Condition 2 below.

Condition 2

Financial Institution	Year	Financial Institution Rating	GNMA Acceptable Ratings
Wells Fargo Bank, NA.	1997	P-1	P-3 or better
Nationsbank of Texas, N.A.	1997	P-1	P-3 or better
Wells Fargo Bank, NA.	1998	P-1	P-3 or better
Nationsbank of Texas, N.A.	1998	P-1	P-3 or better
Wells Fargo Bank, NA.	1999	P-1	P-3 or better
Nationsbank of Texas, N.A.	1999	P-1	P-3 or better
First Union National Bank	1999	P-1	P-3 or better
Wells Fargo Bank, NA.	2000	P-1	P-3 or better
First Union National Bank	2000	P-1	P-3 or better
Wells Fargo Bank, NA.	2001	P-1	P-3 or better

First Union National Bank	2001	P-1	P-3 or better
Wells Fargo Bank, NA.	2002	P-1	P-3 or better
First Union National Bank	2002	P-1	P-3 or better

The owner continually monitored each of the financial institutions to ensure that their financial ratings met or exceeded the GNMA acceptable ratings.

Condition 3

Non-applicable – the financial institutions utilized did not fail.

Condition 4

Deposits and disbursements from the centralized account were clearly traceable to the project. The actual cash position of the project in the centralized account could easily be identified at all times. The accounting system utilized and procedures implemented allowed identification of the project's cash position on a daily basis.

Condition 5

The owner always had the prerogative of not participating in the centralized account arrangement or of withdrawing from such an arrangement.

Based on these conditions the project and Sun met the applicable HUD requirements to utilize a central cash account. The amounts "due from Sun" represented the project's cash position that was being held in the centralized cash account. Since the cash was not held under the project's Federal identification number it could not be classified as cash on the project's financial statements. The changes in the account "due from Sun" were the changes in the project's cash position in the centralized cash account and not distributions to Sun as you have interpreted. Furthermore, the changes were never accounted for as distributions. If they were distributions, they would have been required to be accounted for as dividends as required by the Internal Revenue Code Section 316(a).

The HUD Handbook clearly allows the use of a centralized cash account. You have stated that "In Sun's case, it self managed the facility, so there was no independent management agent". We agree with this statement, but we do not agree that this is a violation. The HUD Handbook does not make a distinction that the centralized cash account can only be utilized by an independent management agent. If this is a requirement, it has not been included in the conditions detailed in the HUD Handbook which covers the use of a centralized cash account.

In addition you stated... "Sun did not obtain HUD approval to commingle funds with other projects or the owner's bank account, so it was precluded from conducting this

activity". HUD Handbook 4370.2, which establishes the conditions for utilizing a centralized bank account, does not require prior HUD approval. Therefore, this should not be a violation.

According to the Regulatory Agreement "Distribution is defined as… any withdrawal or taking of cash or any assets of the project including the segregation of assets for subsequent withdrawal…". As we have explained the utilization of the centralized cash account by the project should not be considered as a distribution based on the definition of "distribution" in the Regulatory Agreement. The project's cash position was specifically identified and the project had access to this cash at all times except for the period it was under Federal Bankruptcy Jurisdiction. Therefore, the changes in the "due from Sun" account should not be treated as excessive distributions during the years ended December 31, 1997, 1998 and 1999. Although, the Project did not make the December 1999 mortgage payment in a timely manner the mortgage note did not become in default until January 1, 2000, the due date of the next installment, according to the terms of the mortgage note.

During the 2000 and 2001 years, the project was under Federal Bankruptcy Jurisdiction and was prohibited by the Federal Bankruptcy Court from making payments on the mortgage note.

Due to this restriction on the cash position of the project mandated by the Federal Bankruptcy Court, the increase in the amount "due from Sun" attributable to the centralized cash account was considered as a "distribution" for HUD reporting purposes. The increase in the amounts attributable to the centralized cash account during the years ended December 31, 2000 and 2001 have been reported as excessive distributions for HUD purposes.

The 2000 year excessive distribution was reduced by the available surplus cash at December 31, 1999. Although, the project was in default on the mortgage note there was sufficient funds in the reserve for replacement account to pay at least four month's mortgage payments. Therefore, the project should not have been in default on the mortgage for the first part of the 2000 year. According to the Regulatory Agreement, the Secretary of Housing and Urban Development was authorized to instruct the mortgagee to withdraw funds from the reserve fund for replacements in order to prevent or cure the default. However, the Secretary of Housing and Urban Development did not comply with this requirement which was part of the Regulatory Agreement. If the Secretary of Housing and Urban Development had complied with the Regulatory Agreement, the project would not have defaulted on the mortgage until May 2000 and therefore would have been allowed a distribution of the available surplus cash at December 31, 1999.

The amount of excessive distribution reported on the 2000 findings was calculated as follows:

Increase in amount due from centralized account	$648,690
Available surplus cash at December 31, 1999	(190,593)
Excessive distributions for the year ended December 31, 2000	$458,097

The 2001 year excessive distribution was reduced by the repayment of the 2000 excessive distribution on March 7, 2002. Although this amount was immediately swept back into the centralized cash account it was available cash to the project and should be considered as a reduction of the excessive distribution for the year ended December 31, 2001. Again, the amounts allocated to the project and held in the centralized cash account represent the project's actual cash position. There was more than adequate cash in the centralized cash account available to fund the projects cash position.

The 2001 year excessive distribution was calculated as follows:

Increase in amount due from centralized account	$1,464,403
Surplus cash at December 31, 2000	50,434
Less: cash release from restriction on March 7, 2002	(458,097)
Excessive distributions for the year ended December 31, 2001	$1,056,740

The draft OIG Audit Report states that "...no cash was returned to the project's operating account to resolve the 2001 recommendation". However, you did not consider the principal and interest pay down made by Sun from the centralized cash account on March 11, 2002. This amount of $1,129,470 brought the mortgage current and was accounted for as a reduction of the project's actual cash position in the centralized cash account. This amount was in excess of the distribution and recommend correction that was reported on the December 31, 2001 finding.

Summary as to Ineligible Distributions to Owner

We believe the project was allowed to utilize a centralized cash account and operated it within the conditions of HUD requirements as detailed in HUD Handbook 4370.2 Revision – 1, Change - 1. The amounts originally reported as excessive distributions on the 2001 and 2000 financial statements were the correct amounts. The excessive distributions were repaid in 2002.

Finding - Ineligible Ownership Expenses

Inappropriate Application of Income Taxes

The draft OIG Audit Report states, "According to HUD requirements, income taxes are an expense of the owner, which should not have been charged to the project." HUD Handbook 4370.2 references income taxes as follows:

Chapter 4-4 Manual of Accounts:

7000 Corporate or Mortgage Expenses

These accounts record expenses applicable to the mortgagor entities distinguished from expenses necessary and reasonable to the operation of the project. In addition, these accounts record expenses for community shared facilities. Owners and agents may charge expenses included in the 7000 Series against project operations only with the prior written approval of HUD.

We agree that the project did not request prior written approval from HUD to charge the income tax expense to the project; however, the HUD Handbook suggests that these expenses may be charged to the project operations. The project was organized as a C chapter corporation for income tax reporting under the Internal Revenue Code ("IRC"). As such, the project is required to pay taxes on applicable income as defined by the IRC. If the project did not pay these taxes it would be subject to penalties, interest and potential liens imposed by the Internal Revenue Service. These income taxes are a "necessary and reasonable" expense and should be allowed to be charged to the project. Furthermore, Sun did not benefit from these charges to the project. These income tax charges are a responsibility of the entity not the owner. There is a complete distinction here. Under the Internal Revenue Code, Sun was not responsible for these income taxes, Carmichael Rehabilitation Center, Inc. was.

It is unreasonable for HUD to expect the owner to absorb these charges without reimbursement from the project. The reason these charges were incurred is because the project was profitable and generated taxable income. Therefore, the project should bear the responsibility and liability for these charges not the owner.

Ineligible Goodwill Expense

The draft Audit Report states, "the owner charge ineligible expenses totaling $117,130 (see Appendix B), which Sun identified as goodwill expense." To clarify the amount charged represents goodwill amortization expense and is charged in accordance with our company practice of allocating goodwill amortization to the facility level. Though we acknowledge that the charges are corporate expenses of Sun Healthcare, our recording of these costs is consistent with industry practice and generally accepted accounting principles. Further, our accounting treatment of the goodwill amortization costs is consistently applied to all of our facilities and we did not single out the Carmichael project.

As the draft OIG Audit Report repeatedly emphasizes the alleged ineligible expenses, it should also be noted that Sun Healthcare never charged the project a management fee for all of the services that the corporate office performed on behalf of the project. These costs include preparing Medicaid cost reimbursement reports and representing the project

on all reimbursement issues, such as audits and appeals. The corporate office also performed multiple accounting processes on behalf of the project such as accounts payable, payroll and general ledger accounting. Further, the corporate office managed and provided extensive information system support to the project. Sun Healthcare would have been entitled to have charged the project a reasonable management fee of approximately five percent to compensate the Sun Healthcare for the costs incurred to provide the project with these services. The amount of such management fee would exceed the ineligible goodwill amortization expenses identified in the draft audit report.

Summary as to Ineligible Ownership Expenses

We believe the income tax charges are "necessary and reasonable" to the operation of the project. It is highly unreasonable to not allow these charges as they have been imposed by the Internal Revenue Code on the entity, not the owner. Furthermore, failure to incur these charges could subject the property to additional charges and potential liens which is against the Regulatory Agreement.

Additionally, we believe that the OIG Audit Report should reflect that Sun Healthcare was entitled to a management fee for the services that they provided the project; and, if taken during the time period in question, such fee would have more than offset the ineligible goodwill amortization expenses.

Recommendations

1a. Pursue recovery from Sun Healthcare of the $323,925 loss incurred on the sale of the mortgage note.

Response – As noted above, it is clear that any loss attributable from the Note sale is more properly the result of the decision to proceed with such sale, even though the loan had been brought current, and was a fully performing loan at the time of the sale.

As has been noted above, the HUD Regulatory Agreement's provisions regarding bankruptcy are in direct conflict with and violation of the Code and further, notwithstanding that conflict, the effect of seeking and obtaining approval of a comprehensive Chapter 11 plan was to ensure this project's viability into the future; and, has been noted, the project's income and expenses at the time of the Note sale make it clear that the Department could have easily allowed for the continued payments on the then existing indebtedness, thereby ultimately satisfying such indebtedness over time. Or at a minimum, the removal of the project from the Note auction at the time in question would have placed the project's financial viability in such a position that the Department may have been able to more than satisfy any existing indebtedness in a future Note sale. We do not believe the Department could establish in any future recovery action that the loss incurred at the time of the Note sale was attributable to the Owner; thus, it appears

that any such recommendation to attempt to collect such "losses" form the Owner is without merit.

1b. Take appropriate administrative action and pursue recovery of the net ineligible distributions amount of $3,769,290 from Sun Healthcare, as permitted by statute (12 U.S.C. Sec. 1715z-4a).

Response -

We believe the responses and facts cited above clearly show that "ineligible" distributions did not occur, or to the extent that excessive distributions were paid, they were been repaid in 2002. Thus, at the present time, we believe that there are no "ineligible distributions" that must be repaid.

Further, the draft Audit Report cites 12 U.S.C. Sec. 1715z-4a as the basis for any recovery of "net ineligible distributions". Such statute provides in part that

> "The Secretary of Housing and Urban Development (referred to in this section as the "Secretary") may request the Attorney General to bring an action ... to recover any assets or income used by any person in violation of (A) a regulatory agreement that applies to a multifamily housing project ..."

Such statute goes on to state that:

> "For purposes of this section, a use of assets or income in violation of the regulatory agreement ... shall include any use for which the documentation in the books and accounts does not establish that the use was made for a reasonable operating expense or necessary repair of the project and has not been maintained in accordance with the requirements of the Secretary and in reasonable condition for proper audit."

As noted in the above section related to the ineligible distribution finding, we believe that the method of accounting used for this project did not have the effect of using assets except as proved by the above statutory limitations or as otherwise allowed for in the HUD Regulatory Agreement. Even to the extent that it could be argued that excessive distributions were made, the above response reflects that any such excess were already repaid in 2002.

Thus, it appears clear that there are no sums that are due or "ineligible" at this time, for which there is a basis to effectuate recovery under the above statute.

For all of these reasons, we would respectfully request that both the audit findings and recommendations be modified, so as to reflect the clarification of facts and circumstances contained herein. And, based on such incorporation of facts and circumstances noted

Joan S. Hobbs
September 20, 2004
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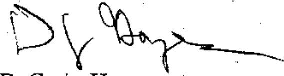
herein, we would further urge your office to modify the recommendations of the draft Audit Report, such that no further action be considered against the project, or its Owner, at this time.

Very truly yours,

CARMICHAEL REHABILITATION CENTER



D. Craig Hayes
Acting Treasurer