



Folts, Inc., Herkimer, NY

Section 232 HUD-Insured Loan Program

**Office of Audit, Region 2
New York-New Jersey**

**Audit Report Number: 2016-NY-1010
September 29, 2016**



To: Roger Lewis, Director, Office of Residential Care Facilities, OHP
Craig T. Clemmensen, Director, Departmental Enforcement Center, CACB

//SIGNED//

From: Kimberly Greene, Regional Inspector General for Audit, 2AGA

Subject: Folts, Inc., Herkimer, NY Did Not Administer the Folts Adult Home and Folts Home Projects in Accordance With Their Regulatory Agreements

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of the Folts Adult Home and Folts Home projects' Section 232 HUD-insured loan program.

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

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

If you have any questions or comments about this report, please do not hesitate to call me at (212) 542-7984.



Audit Report Number: 2016-NY-1010

Date: September 29, 2016

Folts, Inc., Herkimer, NY Did Not Administer the Folts Adult Home and Folts Home Projects in Accordance With Their Regulatory Agreements

Highlights

What We Audited and Why

We audited Folts, Inc.'s management of the Folts Adult Home and Folts Home projects to address our concern with U.S. Department of Housing and Urban Development (HUD)-assisted health care facilities. We selected this auditee as the result of a risk assessment of nursing homes located in New York State, which considered HUD's risk indicators and factors such as loan default; internal control issues; and financial statements not being filed. The objective of our audit was to determine whether the projects were administered in accordance with their regulatory agreements.

What We Found

Project owners and two receivers failed to administer the projects in compliance with the projects' regulatory agreements. Specifically, they failed to make required mortgage payments, incurred costs that were not eligible for the projects' operations, and inadequately supported costs. As a result, two mortgages with outstanding principal balances of approximately \$11.9 million have been assigned to HUD with HUD expected to pay claims on both mortgages, more than \$1.8 million was charged for ineligible costs, and more than \$2 million in expenditures lacked documentation showing that the expenditures were necessary for the projects' operations.

What We Recommend

We recommend that the Director of HUD's Office of Residential Care Facilities instruct project officials to (1) develop an adequate liquidation plan for the two assigned mortgages, (2) reimburse the projects from nonproject funds for the more than \$1.8 million in ineligible expenses, and (3) provide documentation to justify more than \$2 million in unsupported costs.

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Background and Objective

Folts, Inc. is the sole corporate member of Folts Adult Home, Inc., and Folts Home, Inc., both of which have Federal Housing Administration (FHA)-insured mortgage loans. Folts Adult Home is an 80-bed not-for-profit adult home that provides adult care facilities and services to accommodate adults with physical or other limitations who are not acutely ill or in need of hospital care in areas where adequate housing for such groups does not exist. Folts Home is a not-for-profit corporation that operates a 163-bed nursing facility. Both facilities operate under Section 232 of the National Housing Act. Folts Adult Home has a more than \$7.8 million loan with an unpaid principal balance of more than \$7.2 million. Folts Home has a more than \$6 million loan with an unpaid principal balance of more than \$4.7 million.

The Section 232 program provides FHA-insured mortgage loans to facilitate the construction or substantial rehabilitation of nursing homes, intermediate care facilities, board and care homes, and assisted living facilities. The program is administered by HUD's Office of Residential Care Facilities in the Office of Healthcare Programs. Section 232 requires that all owners and operators of insured properties execute a regulatory agreement, which governs the operation of the project. Owners and operators are responsible for any violations of the regulatory agreement.

We reviewed data from the Folts Adult Home and Folts Home projects spanning the period January 2012 through February 2016. During that time, there were three separate groups operating these projects: (1) the owners (owner-operator), from January 2012 through September 2013; (2) FCADH, LLC, and FRNC, LLC, from October 2013 through February 13, 2015; and (3) HomeLife at Folts-Claxton, LLC, and HomeLife at Folts, LLC, since February 14, 2015. The owners entered into receivership agreements with the second (receivership group one) and third (receivership group two) operating groups in violation of their regulatory agreements.

Financial data in the U.S. Department of Housing and Urban Development's (HUD) Online Property Integrated Information Suite¹ showed that both projects have had ongoing financial concerns and have operated at a loss for most years since 1998. Additionally, HUD granted financial relief to both projects in 2008. The projects were referred to HUD's Departmental Enforcement Center based on review of the projects' 2008, 2009, 2011, and 2012 annual project financial information. The compliance issues noted included (1) acquisition of liabilities and encumbering project assets, (2) failure to start repaying a sinking fund loan, (3) unauthorized loans of project funds, (4) failure to properly account for resident funds and using the funds to pay operating expenses, and (5) unauthorized distributions from project funds.

¹ The Online Property Integrated Information Suite supports FHA's risk management, default prevention, and loss mitigation activities by providing loan and portfolio performance data analysis, business intelligence reporting, and risk management training.

Previously completed audited financial statements also disclosed operating concerns at both projects. The 2012 financial statements disclosed a going concern that both projects will be able to continue to operate because liabilities exceeded assets and the projects had experienced losses in the past 2 years. In addition, both projects had the following findings: (1) mortgage payments that were not made on a timely basis; (2) failure to replenish reserve funds for funds that were withdrawn during the year, despite an agreement with HUD to do so; (3) journal entries posted with insufficient or nonexistent supporting documentation; and (4) failure to maintain a supporting schedule showing the activity in the accounts due between the related organizations.

The objective of our audit was to determine whether the projects were administered in accordance with their regulatory agreements. Specifically, we wanted to determine whether officials (1) made timely payments on the mortgages, (2) made payments on unauthorized loans, (3) paid for unnecessary and unreasonable project expenditures, and (4) documented that expenditures were made for a reasonable operating expense or necessary repair of the project.

Results of Audit

Finding: Officials Did Not Administer the Projects in Accordance With Their Regulatory Agreements

Project officials did not comply with the regulatory agreements. Specifically, they did not ensure that (1) mortgage payments were paid as required, (2) project funds were used for eligible costs, and (3) costs were properly supported. These conditions occurred because the owners disregarded the provisions in the regulatory agreements and the receivers believed that they were not bound by the requirements in those regulatory agreements. As a result, two mortgages with outstanding principal balances of approximately \$11.9 million have been assigned to HUD with HUD expected to pay claims on both mortgages, more than \$1.8 million in project funds was not available for the projects' normal operations and debt service, and HUD lacked assurance that more than \$2 million was used for eligible costs.

Project Officials Had Not Made Mortgage Payments

Project officials failed to make timely mortgage payments. Beginning with the payment due in February 2013, the project officials stopped making mortgage payments. On October 1, 2013, the owners entered into receivership agreements for both projects (receivership group one). Although HUD objected to the owners' action, it worked with them and receivership group one to arrange for a sale and change in operator to the receiver. However, before this was finalized, in March 2014, HUD denied the change in operator, and the sale fell through. HUD's reason for rejecting the change in operator was that there were no provisions for the proposed operator to make mortgage payments. In April 2014, the owners entered into an asset purchase agreement with HomeLife Companies, Inc. In November 2014, the owners entered into receivership agreements with companies that had the same principals as HomeLife Companies, Inc. The receivership agreements did not become effective until February 2015 (receivership group two). The change in receivers put additional stress on the projects' operations. The transition from the first receiver group to the second resulted in a number of issues, such as the ownership of surplus cash and the transition of Medicaid funds to the new receiver. HUD had not approved a change in operator for receivership group two, and the owners did not complete the sale. Neither the owners, receivership group one, nor receivership group two had made mortgage payments since March 2013. The projects' officials had not submitted an adequate plan of action with definitive milestone goals to ensure that HUD's interests in the properties were adequately protected. Although the projects had financial hardships, each operating group spent project funds on costs that were unnecessary for project operations, which could have been used to reduce the mortgage principal and interest, pay taxes and insurance, and fund the reserves to make repairs at each project.

Officials Used Project Funds for Ineligible Costs

Officials used project funds totaling \$1.8 million for ineligible expenses consisting of nonproject expenses and costs not reasonable for the operation of the projects. Officials incurred \$252,823

in charges to the projects' operations that related to owner-affiliated companies' expenditures, including payment of unauthorized loans. Project funds were used by the owner operating group to pay for items such as salaries, fund-raising activities, and construction costs, which were non-project-related expenditures. Folts Home had borrowed funds from Folts Foundation, a company affiliated with the owners, which was not authorized by HUD. In addition, Folts Home rented office space from Folts Apartments, another owner-affiliated company, for which it owed past rents. The project funds used for Folts Foundation and Folts Apartments expenditures represented reductions to the amounts owed by Folts Home to these entities for loans and past-due rents. The improper payment of owner-affiliated expenses had continued with subsequent operators. Receivership group two officials also paid for construction costs at Folts Apartments with project funds. Although the projects had problems making timely mortgage payments and failed to replenish reserve funds, officials continued to make payments for affiliated entities' expenditures. Also, the owner-operator group used project funds for a nonproject property acquired by an affiliate of the owner, and receivership group two officials used project funds to pay the taxes on this property.

Officials charged more than \$1.5 million to the projects for costs that were not reasonable for the projects' operations. For example, officials of receivership group one continued to use project funds after the group had been replaced as the operator. The officials charged \$152,045 for commercial general liability, directors' and officers' liability, and excess liability – tail coverage insurance that was invoiced after receivership group one had been removed as the operator and which will expire in 2018. These officials also incurred at least \$90,886 in related companies' expenses and legal fees 6 months after they had been removed as the operator.

Additionally, receivership group one officials charged the projects costs that had not been incurred or for services that had not been provided to the projects. For example, the projects were charged \$135,208 for estimated tax liability and additional administrative services incurred by Upstate Services Group, LLC, an affiliated company of receivership group one. However, officials did not provide evidence of tax liability related to the projects. Officials claimed that additional administrative services were necessary because records of the projects were in disarray before receivership. As a result, they needed to perform nearly all of the business office functions for a large portion of 2013, which should have been done before the receivership. However, Upstate Services Group, LLC, charged the projects for all of its incurred costs. There was no evidence of additional services provided for the projects. Even if officials did provide evidence that these were actual costs and services rendered, each would have not been eligible costs charged to the projects.

Also, owner-operator officials charged unnecessary interest, late fees, and penalties to the projects. These charges included more than \$1 million to the Internal Revenue Service for penalties and interest on unpaid payroll taxes. In addition, there were \$45,285 in late fees on the mortgage note and \$22,626 in interest payments for an unapproved line of credit.

Costs Were Not Adequately Supported

Project officials failed to adequately support that more than \$2 million in expenditures was necessary and whether contracted services were adequately procured. Below are a few examples of the expenditures:

- More than \$500,000 in legal fees was charged to the projects from each of the operating groups. The costs were considered unsupported because either the invoices were not provided or the invoices did not identify how the services were necessary for the projects' operations.
- Doctor fees totaling \$66,000 were charged for a board member of the projects. The documentation did not identify the services provided, how many patients were visited, or how the costs were determined.
- Receivership group two officials charged \$54,688 for 3 months of contracted services for the director of nursing and the director of social services. The officials did not provide procurement documentation indicating whether the cost for such services was reasonable for those positions. In addition, costs such as application fees, licensing fees, and travel expenditures, were included in the charges for this vendor.
- Receivership group two officials paid \$23,302 for costs incurred by the group's administrator and director of finance. These costs included travel and lodging costs that were not supported as relating to project operations.

Both receivership groups charged the projects for services from affiliated companies without adequate support. The receivership agreements provided that the receiver shall not engage in any practice that may result, directly or indirectly, in any financial gain to itself in its capacity as receiver. For instance, the charges to the receivership groups and their affiliated companies included

- Receivership group one officials engaged Upstate Services Group, LLC, to perform administrative services. Upstate Services Group allocated its expenses among all of the facilities it served. The projects were charged based on the number of beds at each facility, compared to the overall number of beds from all of the facilities it served. While this may be an acceptable method of allocating costs, there was no documentation showing that the services provided were at a cost that would normally be paid for such services, nor was there documentation of the services provided.
- Fiscal Care Services, LLC, was to provide accounts receivable management, billing, and collections services. The principals in receivership group one had ownership interest in this vendor. Officials claimed that the services were not procured and that there was not a contract. Also, the invoices did not indicate what the projects received for the amounts charged and whether these costs were in line with costs normally paid for such services.
- HomeLife Companies, an affiliate company of receivership group two, charged for consulting fees that were not supported, and receivership group two officials did not document whether the expenditures were reasonable for the project operations.

Conclusion

Project officials had not made a mortgage payment since March 2013. As a result, two mortgages with outstanding principal balances of approximately \$11.9 million have been

assigned to HUD with HUD expected to pay claims on both mortgages. Project officials made payments on unauthorized loans, paid for ineligible project expenditures, and failed to document in their books and accounts that expenditures were made for reasonable operating expenses or necessary repairs of the project. As a result, officials charged more than \$1.8 million (\$252,823 + \$1,559,954) for ineligible purposes and more than \$2 million for unsupported costs. We attributed these deficiencies to the owners' disregarding the provisions in the regulatory agreements and the receivers' belief that they were not bound by the requirements of the regulatory agreements.

Recommendations

We recommend that the Director of HUD's Office of Residential Care Facilities instruct project officials to

- 1A. Develop an adequate liquidation plan related to the two mortgages assigned to HUD.
- 1B. Reimburse the proper project account from nonproject funds for any of the \$1,812,777 (\$252,823 + \$1,559,954) in ineligible expenses paid with project funds. Those ineligible expenses that were charged but not paid should be removed from the projects' books and accounts.
- 1C. Provide documentation to justify \$2,047,444 in unsupported costs. Any costs determined to be ineligible and paid from project funds should be reimbursed by the responsible party to the proper project account from nonproject funds. Any costs determined to be ineligible that were charged but not paid should be removed from the projects' books and accounts.
- 1D. Submit an acceptable change in operator to protect HUD's interest in the properties.
- 1E. Seek HUD's approval before repaying loan advances to affiliated companies.
- 1F. Strengthen controls to provide greater assurance that disbursements for project expenses comply with the regulatory agreements.

We also recommend that the Director of HUD's Departmental Enforcement Center, in coordination with the Director of HUD's Office of Residential Care Facilities,

- 1G. Pursue double damages remedies against the responsible parties for the disbursements made in violation of the projects' regulatory agreements.

We further recommend that the Director of HUD's Departmental Enforcement Center

- 1H. Pursue civil money penalties and administrative sanctions, as appropriate, up to and including debarment, against responsible parties for their part in the regulatory violations cited in this report.

Scope and Methodology

We performed onsite audit fieldwork from September 2015 through April 2016 at the projects located at 104 North Washington Street, Herkimer, NY. In addition, our onsite audit work was conducted at the offices of receivership group one at 1 Hillcrest Center, Spring Valley, NY. The audit scope covered the period January 1, 2012, through February 29, 2016, and was extended as necessary. We relied in part on computer-processed data primarily for obtaining background information on the officials' expenditure of project funds. We performed a minimal level of testing and found the data to be adequate for our purposes. To accomplish our audit objective, we

- Reviewed relevant HUD regulations, handbooks, and files to gain an understanding of the applicable regulations and policies.
- Reviewed the regulatory agreements between HUD, Folts Adult Home, and Folts Home.
- Reviewed the receivership agreements with FCADH, LLC, FRNC, LLC, HomeLife at Folts-Claxton, LLC, and HomeLife at Folts, LLC.
- Interviewed officials of HUD's Office of Residential Care Facilities, the projects' owners, Upstate Services Group, LLC, and HomeLife Companies to gain an understanding of the control environment and operations at the facilities.
- Analyzed loan information from the loan servicer and the latest audited financial statement for fiscal year 2012 to gain an understanding of the financial condition of the projects.
- Reviewed board meeting minutes and resolutions and the policies and procedures of Folts Adult Home and Folts Home to gain an understanding of the projects' operations.
- Analyzed vendor invoices, general ledgers, and bank statements from January 2012 to February 2016 for owners and receivers.
- Reviewed data in HUD's Online Property Integrated Information Suite and HUD's Integrated Real Estate Management System.²

² HUD's Integrated Real Estate Management System is the official source of data on the Office of Multifamily Housing Programs' portfolio of insured and assisted properties. It provides automated support to collect and maintain data and enables program centers and hubs and Enforcement Center staff to perform servicing functions and implement enforcement actions as needed.

We selected a nonrepresentative sample of expenditures made by the three operating groups: owner-operator, receivership group one, and receivership group two. We performed limited testing on the general ledger accounts for each operator for the audit period January 1, 2012, through February 29, 2016. We reviewed 100 percent of expenditures that appeared to be related to identity-of-interest entities' transactions, repayment of loans, and transactions that may not be normally necessary for project operations, such as interest and penalties, legal fees, consulting fees, and travel expenditures. However, the results of our sample cannot be projected to the universe.

While we used data obtained from HUD's Online Property Integrated Information Suite and Integrated Real Estate Management System for informational purposes, our assessment of the reliability of the data in the systems was limited to the data reviewed. Therefore, we did not assess the reliability of these systems.

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

Internal Controls

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

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

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

Relevant Internal Controls

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

- Program operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.
- Compliance with laws and regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.
- Safeguarding resources – Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse.
- 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.

We assessed the relevant controls identified above.

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

Significant Deficiencies

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

- The owners and designated operators did not have adequate controls over compliance with laws and regulations when they violated the terms of their regulatory agreements.
- The owners and designated operators did not have adequate control over safeguarding resources when they used project funds to pay for ineligible expenditures.

Appendixes

Appendix A

Schedule of Questioned Costs and Funds To Be Put to Better Use

Recommendation number	Ineligible 1/	Unsupported 2/
1B	\$1,812,777	
1C		\$2,047,444
Totals	1,812,777	2,047,444

- 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.
- 2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a 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.

Appendix B

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments

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VIA ELECTRONIC MAIL

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Re: *Folts, Inc., Herkimer, NY Section 232 HUD-Insured Loan Program*

Dear Ms. Greene:

Our firm represents Folts, Inc., Folts Home and Folts Adult Home, Inc. ("Folts"). Please accept this letter as Folts' response to the Office of the Inspector General Draft Audit Report (the "Report") recently provided to Dr. Anthony Piana and Mr. James Morey, the Board Chairmen of Folts Home and Folts Adult Home, Inc., respectively. We have reviewed the Report and offer the following responses.

Background

The Report covers the period of January 1, 2012 through February 2016 and correctly identifies that Folts has had three different operators during that time: (1) Folts, as the owner/operator, from January 1, 2012 through September 30, 2013; (2) FRNC, LLC and FCADH, LLC ("Receiver #1"), as receivers, from October 1, 2013 through February 13, 2015; and (3) HomeLife at Folts, LLC and HomeLife at Folts-Claxton, LLC ("Receiver #2") from February 14, 2015 to present.

As HUD is aware, Folts' financial difficulties were the result of several years of mismanagement and fraud perpetrated by its former CEO, [REDACTED], and former COO, [REDACTED]. Those individuals improperly maintained and manipulated the books and records for each of the facilities, commingled the operating funds and routinely misled the Board members with inaccurate monthly financial statements and false assurances that obligations, such as the quarterly state and federal income taxes, were paid. [REDACTED] and [REDACTED] were also using cash from other skilled nursing facilities operated by them to supplement Folts' cash needs when necessary. The improper

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Auditee Comments

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bookkeeping methods and manipulated financial reports were uncovered in late September 2012, and both individuals were fired on October 15, 2012. After their termination, the Boards and Folts' acting administrator confirmed the mismanagement and resulting lack of cash needed to maintain operations. At that point, the mortgage payments on both mortgages were current, and remained so until February 2013. Thereafter, the health, safety and welfare of the Folts residents became the Boards' primary focus, and the diminished available cash was used to meet payroll obligations and pay vendors supplying food and other basic necessities to the residents.

Folts had been attempting to refinance the HUD-insured mortgages during late 2012-early 2013; however, that process was halted due to Folts' inability to provide reliable financial information or have the cash flow necessary to amortize the refinanced loans. HUD became actively involved in the Folts payment default situation during April 2013. Our firm was retained by Folts on or round April 3, 2013. After a thorough analysis of the situation, our firm recommended that both Folts entities file chapter 11 bankruptcy petitions in order to seek a willing purchaser for the facilities and to resolve the numerous pending creditor issues. This recommendation was rejected by HUD as a violation of the Regulatory Agreement.

The Folts operations are subject to numerous provisions of the New York Public Health Law and related regulations and the New York Not-for-Profit Corporation Law, which could not be disregarded by Folts or HUD as they sought to stabilize their operations, restructure the mortgage notes or sell the facilities. During late April 2013, HUD determined that Folts should retain an experienced operator to improve the facilities, both operationally and financially. (**Exhibit 1**). The Boards concurred with HUD's assessment. On April 30, 2013, HUD provided a list of prospective operators/purchasers to us. (**Exhibit 2**). Only one entity on that list, Peregrine Health Management Company of Syracuse, New York ("Peregrine"), was located in Upstate New York. One other entity, a finance company, was located in New York City. All of the other entities were located in other states, mostly in the mid-west and on the west coast. On May 20, 2013, the Boards met with representatives from Peregrine and Upstate Services Group ("USG"), and thereafter selected USG to be the operator/administrator of Folts. The Folts and USG thereafter attempted to negotiate an Administrative Services Agreement ("ASA") to memorialize USG's retention as operator, but were advised by the NYS Department of Health ("DOH") that it could not approve the retention of an operator under an ASA, it could only appoint a receiver.

In light of its worsening financial situation, on June 20, 2013, Folts submitted its request to the DOH requesting the appointment of a voluntary receiver to operate the Folts facilities. (**Exhibit 3**). The DOH determined that the appointment of a receiver was warranted and granted Folts' request for the appointment of a receiver of Folts Homes on July 18, 2013 (**Exhibit 4**) and of Folts Adult Home, Inc. on July 25, 2013 (**Exhibit 5**).

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Comment 1

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments

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Folts, the DOH and USG thereafter worked to obtain formal approval of USG's selection as receiver and negotiate a Receivership Agreement for each entity. USG was selected based upon its prior experience in operating skilled nursing facilities and the fact that it was interested in purchasing both facilities. The USG Receivership (Receiver #1) was approved effective October 1, 2013. HUD was aware of, and assisted with, the receivership appointment throughout the process.

Receiver #1 took over the operations of Folts on October 1, 2013. Receiver #1 then engaged in discussions with HUD regarding potential PPCs restructuring the Folts mortgages. Receiver #1 also filed certain information in support of Folts' application to transfer operations to Receiver #1. On or around October 22, 2013, HUD sent us an updated list of operators/prospective purchasers, which was identical to the first list, except that Peregrine, a California firm and a Wisconsin firm were removed from this list. (Exhibit 6). On October 24, 2013, HUD provided us with the names of two prospective purchasers who had contacted HUD about the Folts facilities: [REDACTED] of Center Management Group and [REDACTED] of HomeLife Companies, Inc. (Exhibit 7). Our office followed up with both and provided them with Folts' financial information after they signed Confidentiality Agreements. After reviewing the information, [REDACTED] declined to proceed further, and [REDACTED] contacted us to arrange for a site visit.

Unfortunately, the negotiations between HUD and Receiver #1 terminated in January 2014 and Receiver #1 withdrew its interest in purchasing the facilities. [REDACTED], on behalf of Receiver #2, visited the Folts facilities during early February 2014 to conduct due diligence. He thereafter indicated Receiver #2's interest in purchasing the facilities, and on April 17, 2014, Folts entered into an Asset Purchase Agreement with Receiver #2. Receiver #2 began the DOH approval process in May 2014, which was granted during November 2014 and became effective as of February 14, 2015 when Receiver #2 was substituted for Receiver #1. HUD was kept informed, was involved and assisted with the retention of Receiver #2 throughout the DOH approval process.

Following its removal as receiver of Folts, Receiver #1 refused to turn over accrued, surplus operating funds totaling approximately \$750,000.00 to Receiver #2. On July 1, 2015, Receiver #1 commenced an interpleader action in the United States District Court for the Northern District of New York and deposited the surplus funds with the Clerk of the Court. The interpleader action remains pending. Receiver #2 continues to operate Folts, but has not taken steps to close on its proposed purchase of the Folts assets.

Responses to Findings and Recommendations

As a preliminary matter, enclosed herewith is the Receiver #1's response to the Report. It is Folts' understanding that counsel for Receiver #2 has submitted a detailed response directly to HUD with regard to the Report.

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Comment 2

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments

Comment 3

Comment 4

Comment 4

Comment 5

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Based upon its review of the Report, Folts hereby responds to the findings and allegations associated with its ownership and operation of the facilities as follows:

1. *Folts failed to pay mortgage payments since February 2013.*

Response: The mortgage payments were not made due to the financial mismanagement and fraud perpetrated by [REDACTED] and [REDACTED], and resulting cash flow shortage. Beginning in February 2013, the Folts entities used their available cash to pay basic operational expenses in order to ensure the health, safety and welfare of their residents.

2. *Folts incurred \$252,823 in charges for the projects' operations that related to owner-affiliated companies' expenditures, including the payment of loans.*

Response: Folts is unable to respond to this finding absent additional detail concerning the dates and amounts of the alleged charges, and the name of the affiliated entity on whose behalf the charges and loan payments were made.

3. *Project funds were used for salaries, fund-raising activities and construction costs, which were non-project-related expenditures.*

Response: Folts is unable to respond to this finding absent additional detail concerning the dates and amounts of the alleged payments, and the name of the non-project entity on whose behalf the payments were made.

4. *Folts Home borrowed funds from Folts Foundation, Inc.*

Response: Folts did not borrow funds from The Folts Foundation, Inc. (the "Foundation"). The Foundation was established in 1987 "to assist Folts Home... and grant funds to Folts Home at such times and under conditions and circumstances as may be determined by the Corporation." Certificate of Incorporation of Folts Foundation, Inc., ¶ 3(a). (**Exhibit 8**). Sometime during 2010, Folts Home was designated by the DOH as the recipient of a HEAL-NY Grant in the amount of \$1,000,000.00 for the purpose of acquiring and renovating a building in the nearby rural village of Richfield Springs at which Folts Home would operate an adult day care facility. The Grant terms required Folts Home to first expend funds in connection with the project, and then seek reimbursement from the HEAL Grant. The initial working capital for this project was funded during May 2012 when Folts Home obtained a Line of Credit in the amount of \$270,000.00 from the Bank of Cooperstown, the president of which was the husband of former Board member [REDACTED]. Folts Foundation, Inc. pledged cash collateral totaling \$270,645.00 to Bank of Cooperstown to secure the repayment of the Line of Credit. The Resolution by Folts Foundation, Inc.

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authorizing this transaction was prepared and signed by [REDACTED], as chairperson of the Foundation Board, without the knowledge or consent of the other Foundation Board members. (Exhibit 9). Folts Home defaulted on its payments under the Line of Credit during May 2013, and the Bank of Cooperstown applied the cash collateral to the defaulted loan balance on May 30, 2013. (Exhibit 10).

5. *Folts Home rented office space from Folts Apartments, Inc., for which it owed past rents.*

Response: Folts is unable to respond to this finding absent additional detail concerning the dates and amounts of the alleged payments made to Folts Apartments, Inc.

Comment 4

6. *Folts used project funds for a non-project property acquired by an affiliate.*

Response: Folts is unable to respond to this finding absent additional detail concerning the amount of the funds used, the locations of the non-project property involved, the date(s) of the alleged payments, and the name of the non-project entity on whose behalf the alleged acquisition was made.

Comment 6

7. *Folts charged unnecessary interest, late fees and penalties to the projects, including more than \$1 million to the Internal Revenue Service for penalties and interest on unpaid payroll taxes. Folts also charged late fees totaling \$45,285.00 on the mortgage notes and \$22,626.00 in interest payments for an unapproved line of credit.*

Response: The accrual of unnecessary interest, late fees and penalties owed to the Internal Revenue Service was the result of [REDACTED] diversion of operating funds and failure to pay withholding taxes due the IRS and New York Department of Taxation during the first, second and third quarters of 2012. As discussed above, [REDACTED] deliberately withheld information from the Folts Boards concerning the non-payment of withholding taxes and the accrual of interest and penalties.

Comment 7

8. *Legal fees in excess of \$500,000.00 were charged to the project.*

Response: Folts is unable to respond to this finding absent additional information concerning the dates and amounts of individual payments of legal fees. During the pre-receivership period representing Folts (April 3, 2013 to September 30, 2013), the law firm of Bond, Schoeneck & King, PLLC ("Bond") provided financial review and restructuring services and was paid fees and expenses totaling \$27,120.68. Bond wrote off uncollectable fees and expenses

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totaling \$80,842.74 on November 15, 2013 in connection with this matter. During the tenure of Receiver #1 and Receiver #2, Bond's legal fees and expenses were paid from operations accordance with the permission granted by HUD in email correspondence from [REDACTED] dated May 19, 2014. (Exhibit 11).

9. *Doctor fees totaling \$66,000.00 were charged for a board member of the projects.*

Response: Board Member [REDACTED] was employed as the Medical Director of Folts during a portion of the audit period. Upon information and belief, the \$66,000.00 fee paid to him represented his salary for that position. Folts has not been able to locate [REDACTED] employment contract. Any charges that would have been incurred in connection with the treatment of individual residents was billed by him to the treated resident's insurance company.

With the exception of the failure to make mortgage payments and the payment of legal fees, all of the alleged violations of the HUD Regulatory Agreement occurred during the tenure of [REDACTED] and [REDACTED], and were the result of their mismanagement, manipulation of financial records and deliberate concealment of financial information and transactions from the Folts Boards.

Thank you for your consideration.

Very truly yours,

BOND, SCHOENECK & KING, PLLC



Camille W. Hill

Enclosures

cc: Patrick Anthony (w/ enc.)
Dr. Anthony Piana (w/ enc.)
James Morey (w/ enc.)

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OIG Evaluation of Auditee Comments

- Comment 1 The auditee submitted exhibits with their response; however, the exhibits are too voluminous to include in the report and are available upon request.
- Comment 2 The auditee requested that the written comments from receivership group one and receivership group two be included in the report; however, these written comments are too voluminous to include in the report and are available upon request. Receivership group officials indicated that they were not provided the specifics regarding the questioned costs. However, project officials were given specific details on these costs during the audit and were not responsive. Also, receivership group officials continue to assert that the regulatory agreements did not apply to them, even though, we presented officials with the specific citations from the regulatory agreements.
- Comment 3 The auditee agrees that mortgage payments were not made. As cited in our report, due to the owners' failure to make timely mortgage payments, the mortgage notes were assigned to HUD. Therefore, we recommended that the Director of HUD's Office of Residential Care Facilities instruct project officials to develop an adequate liquidation plan for those two mortgages assigned to HUD (Recommendation 1A).
- Comment 4 The auditee stated that they are unable to respond without additional details on the charges. However, project officials were given specific details on these costs during the audit and were not responsive. Based upon the comments, we have provided auditee and receivership group officials with the specific costs cited in the report. The auditee should work with HUD during the resolution process to determine the validity of the costs.
- Comment 5 The auditee stated that the project did not borrow funds from Folts Foundation; however, the 2012 financial statements indicated there were outstanding loans. The auditee discussed a grant and line of credit that had nothing to do with the questioned costs pertaining to owner-affiliated companies.
- Comment 6 The auditee agreed that unnecessary interest, late fees and penalties were owed to the Internal Revenue Service due to the failure to pay withholding taxes by former employees who diverted funds and concealed it from the Board. However, project funds should not have been used to pay these interest, late fees and penalties. Therefore, the owner should reimburse the proper project account from nonproject funds for any ineligible expenses paid with project funds. Those ineligible expenses that were charged but not paid should be removed from the projects' books and accounts.
- Comment 7 The auditee provided additional documentation with its written comments regarding legal fees; however, the documentation was not sufficient to make a

determination on eligibility. Therefore, the auditee will need to work with HUD to determine the validity of these costs during the audit resolution process.

Comment 8 The auditee stated that the board member doctor was employed as the medical director; however, they have been unable to locate the employment contract. Therefore, the questioned costs remain in the report, and the auditee will need to provide documentation to HUD during the audit resolution process.

Appendix C

Criteria

Regulatory Agreement

We extracted the pertinent paragraphs from the executed regulatory agreements.

Clause (1)

Mortgagor [borrower] shall promptly make all payments due under the Note and Mortgage; and shall hold the [HUD] Secretary harmless under its Contract of Mortgage Insurance.

Clause (4)(b)

Mortgagor shall not without the prior written approval of the Secretary: assign, transfer, dispose of, or encumber any personal property of the project, including rents, and shall not disburse or pay out any funds except for usual operating expenses and necessary repairs.

Clause (7)

Mortgagor shall not permit adjudication in bankruptcy, the taking of possession of the mortgaged property or any part thereof by a receiver.

Clause (9)(a)

If the mortgagor has any business or activity other than the project and operation of the mortgaged property, it shall maintain all income and other funds of the project segregated from any other funds of the mortgagor and segregated from any funds of any other corporation or person. Income and other funds of the project shall be expended only for the purposes of the project.

Clause (9)(c)

Mortgagor shall make no payment for services, supplies, or materials unless such services are actually rendered for the project or supplies or materials are delivered to the project and are reasonably necessary for its operation. Payments for such services or materials shall not exceed the amount ordinarily paid for such services, supplies, or materials in the area where the services are rendered or the supplies or materials furnished.

Clause (9)(d)

The mortgaged property, equipment, buildings, plans, offices, apparatus, devices, books, contracts, records, documents, and other papers relating thereto shall at all times be maintained in reasonable condition for proper audit and subject to examination and inspection at any reasonable time by the Secretary or his duly authorized agents. Mortgagor shall keep copies of all written contracts or other instrument which affect the mortgaged property, all of any of which may be subject to inspection and examination by the Secretary of his duly authorized agents.

Clause (9)(e)

The books and account of the operations of the mortgaged property and other the project shall be kept in accordance and examination by the Secretary of his duly authorized agents.

Clause (18)

The instrument shall bind, and the benefits shall insure to, the respective parties hereto, their legal representatives, executors, administrators, successors in office or interest, and assigns, and all owners of the mortgaged property, so long as the contract of mortgage insurance continues in effect, and during such further time as the Secretary shall be the owner of reinsurer or the Mortgage, or obligated to insure the Mortgage.

Clause (20)

Mortgagor warrants that it has not, and will not execute any other agreement with provisions contradictory of, or in opposition to, the provisions hereof, and that, in any event, the requirements of this Agreement are paramount and controlling as to the rights and obligations set forth and supersede any other requirements to conflict therewith.

Title 12 United States Code, Section 1715z-4a, Double Damages Remedy for Unauthorized Use of Multifamily Housing Project Assets and Income

(a)(1)(A)

The Secretary of Housing and Urban Development may request the Attorney General to bring an action in a United States district court to recover any assets or income used by any person in violation of a regulatory agreement that applies to a multifamily project, nursing home, intermediate care facility, board and care home, assisted living facility, or hospital whose mortgage is or, at the time of the violations, was insured or held by the Secretary under title II of the National Housing Act.

(a)(2)

The term “any person” shall mean any person or entity that owns or operates a property, as identified in the regulatory agreement, including any officer, director, or partner of an entity owning or controlling the property; any nursing home lessee or operator; any other person or entity that controls the property regardless of that person or entity’s official relationship to the property; or any heir, assignee, successor in interest, or agent of any person or entity described in the preceding subparagraphs.