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TO: Nicolas P. Retsinas, Assistant Secretary for Housing,
Federal Housing Commissioner, H

FROM: A. George Tilley, District Inspector General for
Audit, 0AGA

SUBJECT: Section 232 Nursing Homes
The Americana and Monticello Hall
Office of Housing

As part of our Operation Safe Home efforts, Seattle field office staff suggested that we look at the case of Pleasant Valley Health Services Corporation, a California-based nonprofit mortgagor, and its two HUD-insured nursing homes, Americana and Monticello Hall. Both nursing homes were insured under Section 232 of the National Housing Act, and were included in the bankruptcy of the Pleasant Valley Corporation.

We wanted to know what lessons HUD could learn from the bankruptcy of Pleasant Valley and HUD's subsequent loss on the Americana and Monticello Hall projects. Specifically, we wanted to know whether HUD can better protect its interests when insuring nursing home mortgages.

Our report shows the adverse affect to HUD when: a) the sole asset requirement is waived; b) Uniform Commercial Code documents are not properly filed; c) the language of the security agreements is overly broad; and d) project bed authority is not adequately protected.

The report also raises the issue of whether HUD's risk in insuring nursing homes is growing because of a shift in the way that long-term care is provided.

In accordance with HUD Handbook 2000.6 REV-3, within 60 days please give us, for each recommendation in this report, 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 your staff have any questions, please have them contact Robert Woodard or Dale Brown on (206) 220-5360.

Executive Summary

In October 1989, HUD committed itself to insure the mortgages of the Americana and Monticello Hall nursing homes for $1,979,500 and $700,000, respectively. Pleasant Valley Health Services Corporation (Pleasant Valley), the nonprofit owner of these nursing homes, used $1,407,833 (71 percent) of Americana's mortgage proceeds and $390,266 (55 percent) of Monticello's mortgage proceeds to pay off previous indebtedness on the projects. The remaining amounts were used for rehabilitation, financing fees, and reserves.

In December 1991, about 26 months after initial closing, Pleasant Valley sought Chapter 11 bankruptcy protection.

In December 1992, while under bankruptcy protection, Pleasant Valley defaulted on the Americana and Monticello Hall mortgages. In late 1993, HUD paid off insurance claims totalling $2,207,516, and the two nursing homes were sold in 1994. HUD's losses totalled $1,962,844, including: (1) $411,647 (net) from paying insurance claims and subsequent sales of both projects, and, (2) $1,551,197 in operating funds which were owed to the two projects by Pleasant Valley as of December 31, 1993. Our review showed that HUD's interest in the Americana and Monticello Hall mortgages was not adequately secured and raised concerns that HUD may face increasing risk in regard to its other insured nursing homes. Our review focused on lessons which would help HUD better protect its interest when insuring nursing home mortgages. These lessons are as follows:

The sole asset requirement was waived. As a result, HUD's security for its nonrecourse loans was diminished.

Project revenues were not adequately protected because of incorrect Uniform Commercial Code filings.

Even when properly filed, project revenues were not

adequately protected because the language of the security agreements was overly broad.

Project bed authority was not adequately protected. Bed authority for one project was retained by the trustee and a portion of the bed authority was later sold. As a result, the value of HUD's collateral was severely diminished.

HUD's risk in insuring nursing homes may be growing because of a shift in the way that long-term care is provided.

We recommended that HUD:

Not waive the sole asset requirement unless HUD's interests are otherwise adequately protected.

Ensure that mortgagees properly file UCC documents prior to HUD's initial commitment of insurance.

Ensure that appropriate language is used in security agreements and UCC financing statements to cover nursing home revenues under applicable state law.

Actively pursue legislation which allows HUD to secure a project's bed authority.

Direct HUD State Offices to require mortgagees to take whatever action possible to create and perfect a security interest in project bed authority under applicable state law.

We provided a draft copy of this report to the Assistant Secretary for Housing and Office of General Counsel in April 1995. We received comments from the Office of Multifamily Housing Development and Office of General Counsel in September 1995. The comments from the Office of Multifamily Housing Development are included as Appendix B of this report.

Both offices generally agreed with our conclusions, and noted how the issues raised in the report are being addressed. For example, regulatory agreements for nonprofit mortgagors have been revised to include the sole asset requirement, and a recent HUD nursing home handbook requires that a project's certificate of need be pledged as security for the mortgage. In addition, on the basis of the Office of General Counsel's knowledge of this case, the issues of proper UCC filings and appropriate security agreement language have been addressed in a recent Field Counsel training.

Abbreviations

UCC	Uniform Commercial Code
HUD	Department of Housing and Urban Development
USC	United States Code
GNMA	Government National Mortgage Association
FHA	Federal Housing Administration

Introduction

Pleasant Valley Health Services Corporation (Pleasant Valley) incorporated as a nonprofit entity in California in April 1984. The corporation was formed to operate skilled nursing facilities and healthcare centers.

In January 1986, Pleasant Valley bought four nursing homes in Washington State. Four months later, Pleasant Valley applied for HUD mortgage insurance under Section 232 of the National Housing Act for three of the four nursing homes--the Americana (82 beds), Monticello Hall (48 beds), and the Manor (55 beds). Pleasant Valley told HUD that it wanted HUD-insured financing to pay off existing indebtedness and to substantially rehabili tate the projects.

HUD committed itself to insure the Americana and Monticello Hall nursing home mortgages on October 30, 1989. (HUD declined to insure the Manor.) The Americana's mortgage was for $1,979,500; Monticello Hall's mortgage was for $700,000. Both mortgages had 40-year terms.

About 26 months after initial closing, Pleasant Valley sought Chapter 11 bankruptcy protection by filing a bankruptcy petition in California on December 11, 1991.

Under bankruptcy protection, Pleasant Valley continued to operate the two HUD-insured nursing homes. In December 1992, corporate cash flow problems led Pleasant Valley to default on the Americana and Monticello Hall mortgages, and in March 1993, the bankruptcy court appointed a trustee to manage Pleasant Valley's assets.

In late 1993, HUD paid off insurance claims totalling $2,207,516 on the

Americana and Monticello Hall mortgages. The two nursing homes were sold in 1994, and HUD received net sale proceeds of $1,795,869. As a result, the net loss to HUD was $411,647. HUD lost an additional $1,551,197 in operating funds owed to the two projects by Pleasant Valley.

Appendix A presents a detailed chronology of the development, operations, and bankruptcy of the Americana and Monticello Hall projects.

At the time of our review, project records were located at Pleasant Valley offices at 1029 Broadway, Longview, Washington, and Republic Record Storage at 1534 Date Street, Montebello, California.

As part of our Operation Safe Home efforts, Seattle field office staff suggested that we look at the Pleasant Valley case. Our review is a response their concerns. We wanted to know what lessons HUD could learn from the bankruptcy of Pleasant Valley and HUD's subsequent loss on the Americana and Monticello Hall projects.

Specifically, we wanted to know whether HUD can better protect its interests when insuring nursing home mortgages. To accomplish this objective:

We interviewed attorneys in Seattle and Washington, DC, who worked on HUD's behalf during Pleasant Valley's bankruptcy proceedings. We also reviewed changes to the bankruptcy law.

We reviewed applicable laws and regulations, reviewed project files in HUD's Seattle field office, and interviewed HUD staff in Seattle responsible for the development and loan management of the projects.

We tested project books and records at Pleasant Valley corporate offices in Longview, Washington and reviewed project records in Montebello, California. We also interviewed staff at Pleasant Valley offices.

Our review covered the period November 1991 through July 1994, and was extended as necessary to fully accomplish our objectives. We performed field work from August 1994 to February 1995. We conducted the review in accordance with generally accepted government auditing standards for performance audits.

Results of Review

Our review showed that HUD's security in the Americana and Monticello Hall mortgages was inadequate and raised concerns that HUD may face increasing risk in regard to its other insured nursing homes. In the case of the two projects we reviewed, HUD's losses totalled $1,962,844, including: (1) $411,647 (net) from paying insurance claims and subsequent sales of both projects, and (2) $1,551,197 in operating funds which were owed to the two projects by Pleasant Valley as of December 31, 1993.

Our review focused on lessons which would help HUD better protect its interest when insuring nursing home mortgages. These lessons are as follows:

The sole asset requirement was waived. As a result, HUD's security for its nonrecourse loans was diminished.

Project revenues were not adequately protected because of incorrect Uniform Commercial Code filings.

Even when properly filed, project revenues were not adequately protected because the language of the security agreements was overly broad.

Project bed authority was not adequately protected. Bed authority for one project was retained by the trustee and a portion of the bed authority was later sold. As a result, the value of HUD's collateral was severely diminished.

HUD's risk in insuring nursing homes may be growing because of a shift in the way that long-term care is provided.

HUD requires that each HUD-insured project be set up as a separate entity, and the waiver of this "sole asset requirement" increased HUD's risk of loss. When Pleasant Valley failed financially, the two HUD-insured projects were included as corporate assets in bankruptcy. In addition, Pleasant Valley used the waiver to justify commingling project and nonproject funds, contrary to the requirements of the project regulatory agreements.

According to the Chief of Seattle's Housing Programs Branch, the sole asset requirement provides HUD with some measure of safety by protecting project assets from losses incurred by an owner's other businesses and nonproject liabilities.

Although (as of October 1989) the regulatory agreement for nonprofit mortgagors such as Pleasant Valley did not specifically prohibit the owner from operating other businesses, the Department's prevailing policy (Notice H87-38, December 1987) required that all mortgagors be sole asset mortgagors. Only HUD Headquarters could waive this requirement.

The HUD field office required Pleasant Valley to create sole asset owners for the Americana and Monticello Hall projects, but Pleasant Valley's attorney tried to persuade the field office to waive this requirement. The field office recommended against a waiver. However, Pleasant Valley's attorney requested a waiver from HUD Headquarters, arguing that formation of a sole asset entity for each nursing home was not feasible.

HUD Headquarters was persuaded by the attorney's arguments (see Appendix A, page 15), and in a letter dated July 13, 1988, the Assistant Secretary for Housing waived the sole asset requirement for the Americana and Monticello Hall projects. HUD committed to insure both projects' 40-year mortgages on October 30, 1989, and Pleasant Valley continued to operate the two HUD-insured projects as part of its overall nursing home business. That business was substantial: in 1986 and 1987 the corporation had bought or leased its full inventory of 15 nursing homes in four states.

On December 11, 1991, Pleasant Valley filed for Chapter 11 bankruptcy protection. At that time, both HUD-insured projects were operating at a net profit. According to an attorney who worked on this case, since the sole asset requirement had been waived, HUD became one of several creditors of the bankrupt corporation (See Appendix A, page 17, for a description of the reasons for Pleasant Valley's bankruptcy.)

In its regulatory agreement with HUD, Pleasant Valley agreed to safeguard project assets, to segregate project funds, and to use project funds only for necessary repairs and other project purposes. Pleasant Valley did not follow these requirements. The corporation used a transfer account for each nursing home it operated, and funds from all its facilities were commingled in one corporate account.

Even before the regulatory agreement was signed, Pleasant Valley attempted to use the waiver of the sole asset requirement to justify commingling of funds.

In June 1992, the field office determined that the Americana and Monticello Hall had earned net income of $330,501 and $29,715, respectively, prior to final closing, when total costs are certified and the final mortgage amount is determined. Although Pleasant Valley was required to deposit this income into each project's residual receipts account, Pleasant Valley instead transferred the net income to its corporate account. We found no evidence that the net income of the Americana and Monticello Hall was ever deposited into residual receipts accounts.

HUD's security interest in project revenues was not adequately protected because UCC documents were filed in the wrong state.

In October 1989, HUD-prescribed documents were signed and recorded or filed. These documents were designed to protect HUD's security interest in the real and personal property of the Americana and Monticello Hall (see Appendix A, page 18, for a discussion of these documents).

After Pleasant Valley filed for bankruptcy, the Government National Mortgage Association (GNMA), the assignee of the Americana and Monticello Hall mortgages, petitioned the bankruptcy court. GNMA contended that financing statements perfecting its interest in project revenues were properly filed in the state of Washington, where project revenues were generated.

The bankruptcy court ruled against GNMA. The court stated that California law governed GNMA's security interest in project operating revenues, and neither GNMA nor the previous mortgagee had filed UCC financing statements in California. On January 10, 1993, the bankruptcy court ruled that GNMA's failure to file in the state of California (where the corporation's chief executive office was located) rendered GNMA's security interest in project revenues unperfected and unenforceable against Pleasant Valley.

As a result, Pleasant Valley was allowed to use revenues generated by the Americana and Monticello Hall to pay for nonproject expenses, including bankruptcy costs. Our review showed that total costs for the corporate bankruptcy will be about $1.8 million. In addition, the balances in each project's transfer account as of December 31, 1993 showed that Pleasant Valley owed the Americana $1.5 million and Monticello Hall $49,430. These funds were not available to meet the needs of the HUD-insured projects.

In another California court decision involving HUD's interest in nursing home revenues (HUD v. Hillside

Associates, 1990), the bankruptcy appellate court held that HUD did not have a security interest in HUD-insured project revenues even though the project's Deed of Trust and Security Agreement were properly recorded and filed in California.

In that case, the court distinguished between "rents" and "accounts," saying: "Money paid for the care of nursing home patients can no more be described as `rents' than could hospital bills. That the patients live there is incidental to the fact that the nursing home is providing them with care." The court said that the language in the security agreements was too broad to specifically embrace nursing home "accounts."

Based on this previous court decision, we conclude that even if UCC documents had been correctly filed for the Americana and Monticello Hall, overly broad language in the project security agreements might have left HUD without a valid claim on project revenues.

In the state of Washington, nursing home licenses issued by the Department of Social and Health Services specify the number of beds which the owner of a facility is authorized to operate. If an owner does not operate the full number of authorized beds, the unused beds can be sold or otherwise transferred.

While nursing homes in Washington State need bed authority to operate, court decisions indicate that bed authority is not considered property of the projects. During Pleasant Valley's bankruptcy, the bankruptcy court allowed the estate to retain and later sell part of Monticello Hall's bed authority after the project was given back to HUD. This action directly reduced Monticello Hall's market value (see Appendix A, page 20, for details.)

On October 25, 1993, the bankruptcy court allowed Pleasant Valley's trustee to abandon the Monticello project, but the trustee retained the facility's bed authority for all 48 beds and petitioned the court for permission to sell it. The trustee argued that no party had asserted a security interest in the bed authority, and that, therefore, the trustee had a legal right to sell this bed authority. According to Pleasant Valley's Chief Executive Officer, the bed authority for 9 of the 48 beds had been sold at the time of our review.

Project records showed the adverse effect on Monticello Hall's value after the bed authority was taken from the project. In June 1989, the project's estimated fair market value was $1,632,000. In 1994, HUD sold Monticello Hall for net proceeds of $145,868. (See Appendix A, pages 20-21, for further discussion of the court's and HUD's arguments pertaining to bed authority.)

The security documents that HUD uses to perfect its security interest in a project's personal property do not prohibit a reduction in bed authority. Monticello Hall's dramatic drop in value shows how a reduction in bed authority adversely affected an insured project's value and, therefore, the value of HUD's security interest.

We conclude that HUD is at risk in nursing home projects in which bed authority can be taken away. The changing health care environment to reduce health care costs indicates that the bed authority available today may not last for the 40 year term of the insured project mortgages.

A new form of regulatory agreement, with more specific language prohibiting the transfer of bed authority without HUD approval, was included in the September 1992 revision of the Section 232 Handbook (Handbook 4600.1REV-1). However, according to HUD's Assistant General Counsel, amending the regulatory agreement will provide only limited protection for HUD because such amendments do not affect the lapse of bed authority that occurs in some states upon foreclosure.

Also, where a reduction in bed authority does not violate state law, HUD might not have the practical ability to restore reduced bed authority. Since bed authority is controlled by the states, amending the regulatory agreement most likely will not adequately protect HUD's interest in bed authority. Revised regulations or legislation affecting the states would be more effective.

Because of a shift in the way that long-term care is provided, HUD's risk in insuring nursing homes may be growing. For example, Washington State's overall policy is to shift health care services from nursing homes to noninstitutional board and care facilities to try to reduce costs. By shifting health care services away from nursing homes, the state will reduce the total bed authority available in nursing homes. The 1993 state legislature found that as other long term care options become more available, the relative need for nursing home beds is more likely to decline.

Our review identified issues that indicate HUD's security interest in its nursing home projects is not adequately protected.

When HUD Headquarters waived the sole asset requirement for the Americana and Monticello Hall, HUD's risk of loss increased. The field office recognized this potential loss when the Director of the Seattle Housing Development Division wrote, "The sole asset mortgagor requirement ... is essential to the financial security of FHA-insured projects whether the mortgagor is profit motivated or not."

Pleasant Valley operated 15 nursing homes in four states, and incurred costs associated with these facilities. When poor business decisions and declining revenues dragged the corporation into bankruptcy, two viable HUD-insured nursing homes were dragged down too. In addition, the waiver of the sole asset requirement gave Pleasant Valley a justification for commingling funds.

Incorrect UCC filings also led to a loss of HUD's security interest in project revenues. In the case of the Americana and Monticello Hall projects, the mortgagee filed UCC documents in the wrong state. Especially when insuring nursing homes in which the owner and project are located in different states, HUD needs to ensure that its security interests are adequately perfected by proper filing of documents.

In addition, HUD lost a secured interest in project revenues because of overly broad language in project security agreements. This problem has been partially remedied by recent changes to the Bankruptcy Code ("The Bankruptcy Reform Act of 1994," United States Code, Title 11, approved October 22, 1994). The new law broadens the definition of "cash collateral," making HUD's claim on nursing home revenues stronger. However, the courts may still construe the language of security agreements to be too general or overly broad if HUD does not ensure that agreements are drafted to adequately secure all nursing home revenues.

Furthermore, HUD's collateral in its nursing home projects may not be adequately protected because some states may allow project bed authority to be stripped away. Although each state manages its nursing home program differently, HUD's risk in this area may be substantial. For example, under Ohio State law the certificate of need and nursing home license do not survive foreclosure. As a result, when HUD forecloses on an Ohio nursing home, HUD cannot sell the facility as a nursing home, and the value of the facility is drastically reduced. The case of Monticello Hall shows that HUD's risk of loss extends to Washington State as well.

HUD's Assistant General Counsel offered the following explanation of HUD's risk pertaining to the transfer of bed authority:

"The maximum mortgage amount for a nursing home is dependent in part upon the number of beds to be licensed. Because the number of beds affects gross project income, it tends to have a direct correlation to the market value of the facility. Thus, a reduction in bed authority might have an adverse impact on the value of the facility which constitutes HUD's security."

Such an adverse impact was certainly felt in the case of Monticello Hall. As stated above, the property was appraised at $1,632,000 in June 1989 and was sold without its bed authority in July 1994 for $155,000 (net proceeds of $145,868 were disbursed to HUD). The value of HUD's collateral in Monticello Hall declined over 90 percent when the bed authority was transferred to the trustee.

Finally, HUD's risk of loss when insuring nursing homes may increase because of changes in the health care marketplace. As states struggle with ways to reduce the cost of long-term health care, reducing the number of nursing home beds will become an increasingly attractive option. As a result, in states in which bed authority can be transferred, HUD's collateral in nursing homes is at risk, and HUD may find its insured nursing homes defaulting at a higher rate.

Auditee Comments

HUD's Office of Insured Multifamily Housing Development generally agreed with our conclusions. In regard to the waiver of the sole asset requirement, they agreed that the requirement for a sole asset mortgagor should not be waived. Although HUD guidance and agreements did not previously contain the sole asset requirement for nonprofit mortgagors, the most recent revision of HUD's nursing home handbook (Handbook 4600.1 REV-1, Sept 1992) and a revision to regulatory agreement (Form HUD-92466-E) both include this requirement.

The Office of Insured Multifamily Housing Development also stated that the current form of regulatory agreement contains language that protects HUD's interest in nursing home project assets, and noted that commingling of funds is not permitted without HUD approval.

They also said that, according to the Office of General Counsel, legislation may not allow HUD to retroactively secure a project's bed authority. However, for current Section 232 projects, the Office of Insured Multifamily Housing Development noted that the recent revision to HUD Handbook 4600.1 REV-1 requires the certificate of need to be pledged as security for the mortgage (paragraph 2-4). Also, the regulatory agreement has been revised to require written approval from HUD for any reduction in the number of beds at a facility.

Finally, the Office of Insured Multifamily Housing Development stated that the Department is very aware of the changing health care environment, and is redesigning the Section 232 program for nursing homes and other residential health care facilities. Such changes pertain to fees, premiums, and basic underwriting considerations, including reductions in loan-to-value limits and shorter mortgage terms. They noted that all changes in the health care field will not necessarily produce an adverse impact on the nursing home industry, and that the Section 232 program enables facilities to obtain financing that would otherwise be unattainable.

Recommendations

We recommend that you:

1A. Not waive the sole asset requirement unless HUD's interests are otherwise adequately protected. For example, if a project is not set up as a sole asset entity, HUD might require the owner to pledge additional assets as collateral for the loan.

1B. Ensure that the mortgagee properly files UCC documents prior to HUD's initial commitment of insurance. If the owner and project are in different states, HUD needs to ensure that its security interest in project revenues is perfected under the UCC rules of each state.

1C. In conjunction with the Office of General Counsel, ensure that appropriate language is used in security agreements and UCC financing statements to cover nursing home revenues under applicable state law.

1D. In conjunction with the Office of General Counsel, actively pursue legislation which allows HUD to secure a project's bed authority.

1E. Direct HUD State Offices to require mortgagees to take whatever action possible to create and perfect a security interest in project bed authority under applicable state law. Where permissible, HUD should include bed authority, however designated in a particular state, as an item covered by the security agreement and UCC financing statement for project personalty and accounts. In addition, HUD should consider amending applicable regulatory agreements to state expressly that "personal property of the project" includes bed authority.

Chronology of the Development, Operations, and Bankruptcy of The Americana and Monticello Hall

Background of HUD's Section 232 program

Section 232 of the National Housing Act authorizes a program of insurance for the development of residential care facilities. According to HUD's Commissioner's Executive Reports, as of December 1994, HUD's portfolio of insured Section 232 projects nationwide is 828 projects with an unpaid principle balance of $3,548,000,000.

The purpose of HUD's Section 232 program is to conserve and increase the supply of nursing homes, intermediate care facilities, and board and care homes by providing credit enhancement through insurance of mortgages for new or substantially rehabilitated projects. These residential care facilities are defined as follows:

Nursing homes provide for the accommodations of convalescents or other persons who are not acutely ill or in need of hospital care, but who require skilled nursing care and related medical services. Nursing homes are licensed by the state and are required to have a certificate of need and the required bed authority to operate.

Intermediate care facilities provide for the accommodation of persons who require minimum but continuous care, but are not in need of continuous medical or nursing services. These facilities are licensed by the state.

Board and care homes provide room, board and continuing oversight. Continuous oversight must include the availability of both scheduled and unscheduled assistance for defined special needs of the occupants on a 24-hour basis. These facilities are licensed by the state, but a certificate of need and license are not needed for their operation unless required by state or local law.

To provide insurance, HUD must determine there is a need for the project; the project will be financially viable; and the owner has the ability and experience to develop, build, and operate the facility.

The regulatory agreement for profit motivated mortgagors specifically prohibits the mortgagor from operating any other business without HUD approval. According to the Chief of Seattle's Housing Program's Branch, the sole asset requirement provides HUD with some measure of safety by protecting project assets from losses incurred by an owner's other businesses and nonproject liabilities.

In addition, a HUD-insured loan is a nonrecourse loan which limits the amount HUD can recover from the mortgagor. A nonrecourse loan is the type of security loan which bars the mortgagee (or HUD) from action against the mortgagor if the security value (the insured project's value) falls below the amount required to repay the loan.

Prior to September 1992, the regulatory agreement for nonprofit mortgagors did not specifically prohibit an owner from operating other businesses. However, the department delineated its prevailing policy in Notice H 87-38 issued in December 1987. This notice required that nonprofit mortgagors be set up as sole asset mortgagors. HUD Headquarters approval was necessary to waive this requirement, and in 1992 the regulatory agreement for nonprofit mortgagors was revised to include the sole asset requirement.

Summary of events

On October 30, 1989, HUD committed to insure the Americana and Monticello Hall mortgages for 40-year terms. HUD-insured the amount of the advances Pleasant Valley received. Advances from the two insured loans were used to pay off previous indebtedness and for the rehabilitation of the two projects. For the Americana, advances to pay off previous indebtedness totalled $1,407,833 of the $1,749,613 advanced. For Monticello Hall, the advances to pay off previous indebtedness totalled $390,266 of the $642,082 advanced. The remaining amounts advanced for both projects were for rehabilitation, financing fees, and reserves.

In December 1991, Pleasant Valley filed for Chapter 11 bankruptcy. On August 19, 1993, HUD paid an insurance claim of $1,643,456 on the Americana's mortgage; and on December 8, 1993, HUD paid an insurance claim of $564,060 on Monticello Hall's mortgage. Total claims paid by HUD were $2,207,516.

In 1994, both projects were sold and HUD received net proceeds of $1,650,000 from the sale of the Americana and $145,869 from the sale of Monticello Hall. Net proceeds for both projects were $1,795,869, resulting in a loss to HUD of $411,647 ($2,207,516 - $1,795,869).

DEVELOPMENT PHASE

In 1986, Pleasant Valley bought four nursing homes, including the Americana and Monticello Hall projects, under a single sales contract from WEBKO, a Washington State partnership. According to the contract, by January 1990 Pleasant Valley was required to pay WEBKO a balloon payment for the outstanding balance.

Four months after signing its contract with WEBKO, Pleasant Valley submitted initial applications for HUD mortgage insurance under Section 232 of the National Housing Act for the Americana and Monticello Hall projects. According to Pleasant Valley's Chief Financial Officer, Pleasant Valley wanted HUD insurance to help acquire long term, low interest financing. This financing was needed to pay off an existing encumbrance and to perform substantial rehabilitation to the Americana (built in 1950) and Monticello Hall (built in 1940).

On April 18, 1986, the field office received Pleasant Valley's initial applications for mortgage insurance. The field office reviewed the applications to determine the eligibility and feasibility of the projects. After an initial review and a joint inspection of the projects, the field office rejected Pleasant Valley's applications for mortgage insurance because of serious concerns about the long term viability of the projects and the marketability of the projects' beds at the proposed rates.

In response, Pleasant Valley hired a health care consultant to support its position that both projects were economically viable on a long term basis. In an August 26, 1986 letter, the consultant assured HUD that "each [nursing] home is a free standing economically viable unit", each was "operating close to capacity", and operated "without the aid of a central office." In addition, Pleasant Valley's attorney met with HUD staff and persuaded the field office to proceed with the mortgage insurance process for these two projects.

As a result, the field office invited Pleasant Valley to submit a full feasibility application for each project. The field office conducted a project analysis and appraisal before approving mortgage insurance. HUD's regional economist recommended that the field office approve the rehabilitation proposals for Americana and Monticello Hall. He wrote that "neither [of the projects] ... present any market demand problems ... [and] current occupancy in both projects approaches 100 percent." The field office analysis showed that both projects were operating near full occupancy.

As part of this process, HUD required Pleasant Valley to create sole asset owners for the Americana and Monticello Hall projects to comply with Department policy and protect HUD's interests. Pleasant Valley objected to this requirement. In meetings and correspondence with the field office from March through July 1988, Pleasant Valley's attorney tried to persuade the field office to recommend that the sole asset requirement be waived. After considering the attorney's arguments, the field office did not recommend a waiver.

Pleasant Valley's attorney then requested a waiver from HUD Headquarters. The attorney argued that formation of a sole asset entity for each nursing home was not feasible, because:

Pleasant Valley purchased all the facilities under one contract that would not provide for the release of individual facilities;

The purchase contract contained a nonassignment clause. The seller could foreclose if any attempt were made to assign the facilities to another entity; and

The projects should be "grandfathered in" since the applications and expenditures of funds predated Notice H 87-38 by about two years.

HUD Headquarters was persuaded by the attorney's arguments. In a letter dated July 13, 1988, the Assistant Secretary for Housing waived the sole asset requirement for the Americana and Monticello Hall projects. As a result, Pleasant Valley remained the owner of the two projects and operated them as part of an overall nursing home business. Pleasant Valley's Chief Executive Officer told us that in 1986 and 1987 the corporation had bought or leased 15 nursing homes including the Americana and Monticello Hall projects.

After another year of deliberations and processing review, HUD committed to insure the Americana and Monticello Hall 40-year mortgages on October 30, 1989. The Americana's mortgage was for $1,979,500; Monticello Hall's mortgage was for $700,000. On that date, Pleasant Valley signed the required closing documents. These documents included the deed of trust, the regulatory agreement and the security agreement, documents designed to protect HUD's interest in the projects and the projects' assets.

Rehabilitation work on the Americana and Monticello Hall started in November 1989. By September 1990, Pleasant Valley had received five advances totalling $1,749,613 from the Americana's $1,979,500 mortgage. The advances to pay off previous indebtedness totalled $1,407,833 of the $1,749,613 advanced. By November 1990, Pleasant Valley had received seven advances totalling $642,082 from Monticello Hall's $700,000 mortgage. The advances to pay off previous indebtedness totalled $390,266 of the $642,082 advanced. The remaining amounts advanced for both projects were for rehabilitation, financing fees, and reserves.

However, neither project went through final endorsement, when total costs are certified and the final mortgage amount is determined. Absent final endorsement, HUD insured the amount of the advances Pleasant Valley received.

OPERATIONAL PHASE

As a condition for insurance, an owner agrees to safeguard project assets and use project funds only for the operation or future needs of the project. Specifically, in its regulatory agreements with HUD, Pleasant Valley agreed to segregate all project funds from any other funds of the owner and only use project funds for necessary repairs and other project purposes. Before the regulatory agreements were signed, Pleasant Valley sought to have them amended to allow for commingling of funds. Pleasant Valley management reasoned that, because HUD waived the sole asset requirement and allowed Pleasant Valley to own multiple facilities, the prohibition against commingling (paragraph 9(a)) should also be waived.

The field office did not agree and was not willing to modify the regulatory agreements, stating that:

"With or without separate accounting, this practice [depositing project funds in a common account with other monies] would constitute commingling of funds and a patently clear violation of the fiduciary obligation owed by the owner to the project."

Pleasant Valley failed to comply with its regulatory agreement and did not segregate the Americana's and Monticello Hall's funds from its other operations, but used a portion of those funds for nonproject purposes.

Pleasant Valley's accounting staff told us that the corporation used a transfer account for each nursing home it operated. The balance in each transfer account showed the amount Pleasant Valley borrowed from or lent to a project. Funds from all the nursing homes operated by Pleasant Valley were commingled in one corporate account.

Pleasant Valley did not maintain separate accounts for the net income generated by the Americana and Monticello Hall projects. In 1992, the field office determined that the Americana and Monticello Hall had earned net income of $330,501 and $29,715, respectively, prior to final closing. Although Pleasant Valley was required to deposit this income into each project's residual receipts account, we found no evidence that these funds were ever deposited into such accounts.

BANKRUPTCY PHASE

On December 11, 1991, Pleasant Valley filed for Chapter 11 bankruptcy in the Central District Court, Los Angeles, California. Since the sole asset requirement had been waived, the Americana and Monticello Hall projects were considered corporate assets and were included as such in Pleasant Valley's bankruptcy. HUD became one of several creditors of the bankrupt corporation.

Pleasant Valley's Chief Executive Officer told us that when the corporation bought or leased 15 nursing homes, adequate site inspections and cash flow analyses were not performed. He added that the people who formed Pleasant Valley bought high maintenance facilities and overstaffed operations. Also, accounts receivable got out of control and maintenance was deferred.

The Chief Executive Officer's explanation is supported by Pleasant Valley's 1990 corporate annual audit report to the field office. The report questioned whether Pleasant Valley would continue as a going concern due to "significant operating losses and a net capital deficiency during the past four years." In its review of this report, the field office noted that the corporation "has experienced poor operation results and bad investment of capital expenditures in 1990."

According to an attorney for Pleasant Valley's unsecured creditors, Pleasant Valley went from owning six or seven facilities to owning fourteen or fifteen in a two year period. To help finance these acquisitions, Pleasant Valley obtained about $4 million in unsecured financing. Its inability to make payments on this additional financing was the immediate cause of bankruptcy.

According to Pleasant Valley's Chief Executive Officer, Pleasant Valley management stopped making mortgage payments due to corporate cash flow problems.

On August 19, 1993, HUD paid an insurance claim of $1,643,456 on the Americana's mortgage; and on December 8, 1993, HUD paid an insurance claim of $564,060 on Monticello Hall's mortgage. Total amount paid off on the two defaulted mortgages was $2,207,516.

Project revenues were not adequately protected in bankruptcy

To protect HUD's security interest in the real and personal property of Americana and Monticello Hall, the following documents prescribed by HUD were signed and recorded or filed:

The Deed of Trust. In Washington State, this document takes the place of and serves the purpose of a mortgage. It establishes the mortgagee's collateral (security) in the real property of the project together with the project's rents, issues, and profits.

The Security Agreement. This agreement between the mortgagee and the owner, when properly filed, grants the mortgagee a security interest in the personal property of the project. Specifically, it establishes the mortgagee's (and HUD's, by extension) collateral in the project's "rents, issues, profits and income."

HUD required the mortgagee to obtain a perfected security interest in the personal property of the project. To "perfect" the mortgagee's security interest, proper filing is required. "Perfection" deals with the steps legally required to give the mortgagee an interest in the project's property. The UCC financing statements, for both the Americana and Monticello Hall, were filed in Washington State.

The Regulatory Agreement. In this agreement between HUD and the owner, the owner agrees to comply with HUD requirements. These requirements include promptly making mortgage payments and segregating project funds from any other funds of the corporation or person. It requires that project income and other funds only be used for purposes of the project.

After filing for bankruptcy, Pleasant Valley began to dispose of its projects. In February and March 1992, the bankruptcy court allowed Pleasant Valley to dispose of three projects in Oregon, two in Georgia, and two in Alabama. In addition, one of the Washington projects ceased operation and was closed. On March 17, 1993, the bankruptcy court appointed a trustee to manage Pleasant Valley's assets. At that time, the trustee began operating Pleasant Valley's seven remaining nursing homes which included the Americana and Monticello Hall projects.

During March 1992, Pleasant Valley petitioned the bankruptcy court for authorization to use its cash collateral, the security interest held by Pleasant Valley's creditors in the revenues of its facilities. The bankruptcy court authorized Pleasant Valley to use its cash collateral on this and two later occasions.

When the bankruptcy court again considered authorizing Pleasant Valley's use of cash collateral later in 1992, GNMA, the assignee of the Americana and Monticello Hall mortgages, raised the issue of the validity of its lien against the revenues of the Americana and Monticello Hall projects. GNMA argued, for the first time, that it had a valid claim in the Americana and Monticello Hall revenues. GNMA contended that security agreements perfecting GNMA's security interest in the project revenues were properly filed in the state of Washington where the projects were generating revenues.

The bankruptcy court ruled against GNMA and cited the following:

The law of the jurisdiction in which Pleasant Valley, the debtor, is located governs the perfection and the effect of perfection or nonperfection of the security interest in personal property. Pleasant Valley was incorporated in California and manages the main part of its business from there. Therefore, California is the state where creditors would be reasonably expected to search for credit information about Pleasant Valley.

GNMA failed to file, in California, UCC financing statements for the personal property of the Americana and Monticello Hall facilities.

As a result, on January 10, 1993, the bankruptcy court ruled that GNMA's failure to file in the state of California rendered its security interest in the project revenues unperfected and unenforceable against Pleasant Valley.

Our review of corporate and project records showed the following:

From October 1991 through July 1994, Pleasant Valley paid $1,108,327 for bankruptcy related costs. In addition, Pleasant Valley's Chief Executive Officer estimated that the trustee would be paid an additional $700,000 from the sale of the corporation's remaining projects. Total costs for the corporate bankruptcy are estimated at $1,807,327 ($1,108,327 + $700,000).

As of December 31, 1993, based on the balances in each project's transfer account, Pleasant Valley owed the Americana $1,501,767 and owed Monticello Hall $49,430.

Another California court decision involving HUD and nursing home revenues was HUD v.Hillside Associates, 1990. In that case, the bankruptcy appellate court held that HUD did not have a security interest in HUD-insured project revenues, for the following reasons:

Nursing home revenues are not "rents." Money paid to care for nursing home patients can no more be described as "rents" than can hospital bills. Although patients live there, it is incidental to the fact that the nursing home is providing them with care.

The Security Agreement must include a definition of personal property that specifically includes nursing home accounts. The court looked with disfavor on descriptions which "cover everything and describe nothing." The court held that the language in the Security Agreement was too broad to specifically embrace "accounts" and, therefore, did not protect HUD's interest.

Bed Authority is not considered personal property of the projects Recognizing that each state may regulate its nursing home program differently, the state of Washington requires and controls the three items needed to operate a nursing home in Washington State: the certificate of need which establishes the need for the proposed number of beds, the bed authority to operate a specific number of beds, and the license to operate the facility.
Specifically, the nursing home license issued by the state Department of Social and Health Services specifies the number of beds authorized to be operated at the facility. Some owners may choose to operate less than the full number of beds they have authority for. The unused beds can be sold, given away, transferred, traded or otherwise conveyed to someone else.

On October 25, 1993, the bankruptcy court allowed the trustee to abandon the Monticello project. The trustee subsequently moved all the patients out of the facility, and turned the building over to HUD on November 4, 1993. However, the trustee retained the right to the facility's bed authority for its 48 beds and petitioned the bankruptcy court to sell Monticello Hall's bed authority.

Section 363(b)(1) of 11 USC (Bankruptcy Code) permits the trustee to sell the debtor's property other than in the ordinary course of business, as long as the sale is in the estate's best interests and the price is fair and reasonable. In addition, 11 USC Section 363(f) allows the trustee to sell the estate's property free and clear of claimed liens.

The trustee believed that the conditions in the bankruptcy code were met. Since no party had asserted a security interest in the bed authority of Monticello Hall, the trustee believed it could be sold. The bankruptcy court agreed and authorized the sale. Although the trustee had the authority to sell the bed authority for all 48 beds associated with Monticello Hall, the trustee sold the bed authority for nine beds for a total price of $31,500 in August 1994. The sale was approved free and clear of all liens, encumbrances, or other interests pursuant to 11 USC Section 363.

Project records showed the adverse effect on Monticello Hall's value after the bed authority was taken from the project. In June 1989, the project's estimated fair market value was $1,632,000; a foreclosure appraisal issued in February 1994 gave an "as-is" value of $220,000. In 1994, HUD sold Monticello Hall for net sales proceeds of $145,869. According to the Chief of the Housing Programs Branch in Seattle, Monticello Hall's decline in value was a direct result of the trustee's retention (and later sale) of the project's bed authority.

No requirement for owner/lessee to maintain a certain number of beds.

In 1992, a Washington State trial court and Court of Appeals ruled in the Restorative Care Center case that a reduction in bed authority by the lessee/operator of a HUD-insured nursing home does not violate the regulatory agreement between the lessee and HUD.

In this case, the lessee/operator voluntarily downsized Restorative Care Center's bed authority from 250 to 189 beds. The owner filed suit against the lessee, arguing that a reduction in the project's bed authority violated the lessee's regulatory agreement with HUD which was incorporated in the lease. The owner also argued that since the voluntary downsizing was permanent, the project's market value was reduced as well as its collateral value to HUD.

The court rejected the owner's arguments, noting that, although the project's regulatory agreement required the owner to maintain a license to operate the project, the regulatory agreement did not require that a license of any particular size be maintained. Therefore, the lessee could legally reduce the number of beds.

In a July 1992 memorandum commenting on the Restorative Care Center case, HUD's Assistant General Counsel evaluated alternatives available to HUD to protect its interests in nursing home bed authority. He concluded that the most effective way is through legislation. However, he was not certain whether such legislation could apply retroactively to existing facilities.

Risk of reducing or transferring bed authority may increase

As previously stated, the state of Washington has the responsibility to license and control the bed authority for nursing homes. According to the Assistant Secretary for Washington State's Aging and Adult Services Administration, the state's relationship is with a nursing home's operator, and the state's responsibility is to the patients. The state has no responsibility and no direct interest in contractual obligations between the operator and lenders or other entities.

The 1993 Washington State legislature found that as other long term care options become more available, the relative need for nursing home beds is more likely to decline. The Health Services Administrator for the Department of Health stated that Washington State has a target of 45 beds per 1,000 people aged 65 and older. Currently, the state as a whole is over this target. The state's overall policy is to limit institutional care for the elderly, for three primary reasons:

1. to ensure there is a full range of long-term care

services available to Washington State residents,

2. to contain the costs of Medicaid reimbursement and use existing funding more efficiently, and

3. to cause a shift of resources from institutional to noninstitutional (e.g. home) care.

Actions HUD has taken

In January 1992, HUD revised its Section 232 regulatory agreement (Form HUD-92466) to include the sole asset requirement for nonprofit mortgagors. Also, in September 1992 HUD issued revised Handbook 4600.1 REV-1 (Section 232 Mortgage Insurance for Residential Care Facilities) which includes the following requirements:

Any state certificate of need must be pledged as security for the term of the mortgage and may not be transferred to another project upon assignment or foreclosure. Operating licenses and provider agreements also must stay with the project and may not be transferred.

HUD must agree in writing to any voluntary reduction in bed capacity.

Potential obstacles

According to HUD's Assistant General Counsel who addressed the issue of bed authority in 1992, amending the regulatory agreement will provide only limited protection for HUD. He stated that amendments would not affect the lapse of bed authority that occurs in some states upon foreclosure. Also, where a reduction in bed authority does not violate state law, HUD might not have the practical ability to restore reduced bed authority. Since bed authority is controlled by the states, amending the regulatory agreement most likely will not adequately protect HUD's interest in maintaining the bed authority of nursing homes. In addition, attorneys in the Restorative Care Center case noted that new regulatory agreements have no effect on facilities presently participating in HUD's nursing home program.