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INDEPENDENT STATE AUDITOR'S REPORT ON CERTAIN ACTIVITIES OF THE DEPARTMENT OF PUBLIC HEALTH'S LICENSING AND MONITORING OF THE NEWCARE HEALTH CORPORATION (NEWCARE)

OFFICIAL AUDIT REPORT

NOVEMBER 16, 2000

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INTRODUCTION

Background

In accordance with Chapter 111, Section 5, of the Massachusetts General Laws, the Department of Public Health (DPH) was established to "take cognizance of the interests of life, health, comfort and convenience among the citizens of the commonwealth…" Chapter 111, Section 71, of the General Laws requires DPH to license and monitor long-term care facilities (LTCFs), including nursing homes, within the Commonwealth by stating, in part:

> The department shall issue for a term of two years, and shall renew for like terms, a license, subject to revocation by it for cause, to any person whom it deems responsible and suitable to establish or maintain a nursing home, which meets the requirements of the department established in accordance with its rules and regulations….

In order to meet these mandated responsibilities, DPH has promulgated 105 Code of Massachusetts Regulations (CMR), which establishes minimum standards with which all LTCFs, including nursing homes, must comply. Additionally, DPH has established within its organizational structure a Division of Health Care Quality (DHCQ) whose responsibilities include:

- Licensing and certifying approximately 6,000 health facilities, including LTCFs, to ensure the delivery of quality health care services;
- Investigating complaints against health care facilities and providing the mechanism by which criminal action may be taken by the Attorney General; and
- Investigating complaints of patient abuse and neglect in LTCFs.

DPH does not provide funding for the operation of nursing homes. Rather, the state's Division of Medical Assistance (DMA), through the federal Medicaid program, funds approximately 70% of LTCF costs. The remaining 30% of funds come from either the federal Medicare program or private funding. Since DMA is the primary funding source for LTCFs, it is responsible for the financial monitoring of the Medicaid accounts.

Although DMA performs fiscal monitoring of LTCFs, DPH regulations require it to perform monitoring at LTCFs in order to assess each facility's compliance with DPH health and safety requirements and various quality-of-care conditions. In order to do this, DPH conducts an annual performance survey of each LTCF operating in Massachusetts. A DPH survey team, consisting of a registered nurse, a social worker, a dietician, and others as needed, completes an annual performance survey package, which includes 44 specific areas of review that are categorized into five general categories: administration, nursing, residents' rights, food service, and environment. DPH has established a statewide rating system for LTCFs in which a point is given for each of the 44 specific areas that passed inspection and a total score is developed from the results of the three most recent surveys at each facility (for a possible 132 points). These results are available to the public through DPH's Internet site or in hard copy upon request. In addition to this annual survey, the DPH survey team investigates any complaints filed by either a patient, family member or outside source against an LTCF, as necessary.

Regarding the initial licensure of LTCFs, DPH has established a procedure to determine the suitability for ownership and management of LTCFs by individuals or companies. This process requires all applicants to obtain a Determination of Suitability to operate a LTCF. The first step in the process is the applicant's submission of a "Notice of Intent to Acquire" (NOIA), an eight-page questionnaire that includes the following five sections: (1) General Information; (2) Ownership Information; (3) Financial Information; (4) Historical Survey and Compliance Information; and (5) Suitability Standards. DPH's Suitability Coordinator reviews the questionnaire and supporting documents to ensure that the applicant has submitted all required information. Subsequent to receiving all applicable information, DPH has 90 days to complete a comprehensive review of the NOIA and its supporting documentation to determine whether an applicant is to be deemed suitable. This comprehensive review includes a verification of the submitted data, a Criminal Offender Record Inquiry (CORI) review of all officers of the applicant's organization, a review of the applicant's financial capacity to operate the facilities, and a history of the applicant's providing long-term care in Massachusetts and facilities in other states. All exceptions noted by DPH are reviewed with the applicant, and any additional information submitted by the applicant to remedy the exceptions are reviewed by DPH prior to any decision.

When an applicant is deemed suitable or suitable with conditions, DPH forwards to the applicant a license application and Medicare application, after which the applicant has 45 days to complete the purchase of the nursing home. In addition, 48 hours after the completion of the purchase, the applicant must submit to the Suitability Coordinator the license application and Medicare application along with other required documents as stated in the license application package, such as the bill of sale of the property. The Suitability Coordinator reviews the documents to ensure that they are accurate and complete and forwards them to DPH's Survey Processing Unit, where DPH creates two transmittal letters. The first letter is sent to all applicable state agencies, and the second letter is sent to Medicare to notify it of the license granting. The license is then issued by DPH and forwarded to the applicant. The license is valid for two-year period and is renewed automatically subject to the LTCF's achieving an acceptable annual performance survey.

On March 20, 1997, the OHI Corporation (OHI) entered into purchase agreements, subject to the approval of the United States Bankruptcy Court, to purchase four nursing homes located in western Massachusetts: Summerfield Elms Manor, Inc.; Summerfield Oak Manor, Inc.; Summerfield Pine Manor, Inc.; and H-C Health Services, Inc., d/b/a Meadowood. On April 8, 1997, these four nursing homes filed separate voluntary petitions for relief with the Bankruptcy Court in Massachusetts. Subsequently, on September 9, 1997, OHI filed NOIA applications with DPH to get a Determination of Suitability. According to DPH officials, OHI encountered difficulties in obtaining a Determination of Suitability from DPH due to its failure to procure the necessary financing to purchase the nursing homes. As a result, on November 26, 1997, OHI withdrew its NOIA applications and notified the four nursing homes that it would be unable to complete the purchases.

On January 26, 1998, the Bankruptcy Court approved the assignments of the purchase agreements that OHI had entered into with the four LTCFs to NewCare Health Corporation (NewCare) of Atlanta, Georgia. On February 20, 1998, DPH received four NOIA applications from NewCare Mass Nursing, Inc., c/o NewCare Health Corporation of Atlanta, Georgia for the Summerfield Elms Manor, Summerfield Oak Manor, Summerfield Pine Manor, and Meadowood nursing homes.

On March 5, 1998 DPH's Suitability Review Office acknowledged the receipt of NewCare's NOIAs but subsequently informed NewCare that its applications were incomplete and that DPH required additional information, including information about NewCare's non-Massachusetts operations. In addition, based upon research by the DPH's Suitability Coordinator and the documentation submitted by NewCare, DPH had developed serious reservations about NewCare's suitability to finance and operate nursing homes in Massachusetts. Specifically, on January 3, 1984, a complaint was filed with the National Association of Security Dealers, Inc., (NASD) alleging that the then President of NewCare effected transactions for the account of an institutional customer that were not authorized by the customer. A decision was rendered on July 16, 1984 wherein the then President of NewCare was censured, barred from association with any member of NASD in any capacity, and fined $10,000. Moreover, on July 11, 1985, a $50,000 fine was levied against this individual for additional NASD violations.

DPH officials stated that other concerns they had relative to NewCare's suitability included a bankruptcy filing of Harbor Town Securities, a security firm started by the then President of NewCare, which filed for bankruptcy protection a year after its formation; $3.6 million in overdue taxes and penalties owed by Retirement Care Associates, Inc., and several other companies formerly associated with the then President of NewCare; and a law suit filed in Pinellas County, Florida against the then President of NewCare by the former CEO of NewCare. Finally, DPH questioned whether NewCare had sufficient financial resources to provide adequate services. Specifically, according to NewCare's first quarterly financial statement for fiscal year 1998 that it filed with the Securities and Exchange Commission, NewCare had an operating loss of $1.9 million, outstanding long-term debt of $40 million, and shareholder equity of only $6.8 million for the quarter.

On October 20, 1998, DPH finished its analysis of the NOIAs submitted by NewCare and determined that, although the NOIA's were complete, the aforementioned concerns remained regarding NewCare's suitability for licensure. However, it was DPH's understanding that the four facilities would close in bankruptcy should NewCare not be granted a license. According to DPH officials, in order to ensure continuity of care to the facilities' residents, DPH decided to grant conditional suitability to NewCare on a probationary basis subject to nine conditions. The conditions to NewCare's Determination of Suitability included in the Conditional Suitability Agreement (Agreement), which was signed by the President of NewCare on October 21, 1998, are as follows:

> (1) Upon receipt of a completed license application for the facilities known as Meadowood Nursing Home, Summerfield Elms Manor, Summerfield Oak Manor and Summerfield Pine Manor (each, a "Facility," collectively, the "Facilities"), the Department shall issue to NewCare of Massachusetts, Inc. ("NewCare") licenses for the Facilities which shall be probationary licenses renewable each year for a period of three years (the "Probationary Period"). During the Probationary Period, neither NewCare nor an affiliate will file with the Department a Notice of Intent to Acquire another facility nor enter into an agreement to manage a facility in the Commonwealth.
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> (2) If, during the Probationary Period, the Department determines, after informal dispute resolution, that conditions at a Facility constitute (a) substandard quality of care, as defined in federal regulations, the Director may extend the Probationary Period for up to one year, (b) jeopardy, as defined in federal regulations, the Director may order (i) that such Facility engage a management company, acceptable to the Department, which shall manage the day to day operation of the Facility with the contractual authority to, inter alia, collect receivables from Medicare, Medicaid and other third parties, and pay the expenses of the facility, that the management company shall also be given the authority to expend funds from the escrow account referenced in paragraph 4 below, that the management company shall have no authority to sell the Facility, and that the term of management agreement will be until the Facility is sold, or such shorter term determined by the Department, and (ii), that one or more of the Facilities be sold within eighteen months, or later at the discretion of the Director.
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> (3) NewCare shall submit to the Department for its approval the name of the person chosen to supervise NewCare facilities in the Commonwealth (the "Regional Manager") which approval shall not be unreasonable withheld, conditioned or delayed.
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> (4) Within 14 days of filing a license application NewCare shall establish and, during the Probationary Period, replenish, an escrow account for the Facilities in the amount of $500,000, which may be used by the Regional Manager or a Management Company under the circumstances described in paragraph 2, above, to pay expenses of the Facilities and to which he or she shall have complete and easy access without delay or conditions. NewCare shall replenish the escrow fund up to the amount of $500,000 within fourteen (14) calendar days of receiving notice from the Regional Manager or management company of a reduction in the fund balance. If the Regional Manager's or management company's access to the escrow fund becomes impaired in any way, or if the escrow fund is depleted below $150,000, the Regional Manager or management company shall immediately notify the Department.

(5) Within 14 days of filing a license application, and during the term of Probationary Period, NewCare shall engage a long term care consultant who shall develop a comprehensive plan for quality assurance and educational services. The comprehensive plan shall include strategies and timelines for establishing an effective quality assurance program and for developing education services that identify educational needs and create education plans tailored to address each specific need identified.

(6) Within three (3) months of purchasing the Facilities, NewCare will establish a line of credit for the operational costs of the facilities in the amount of $1,200,000, or seventy percent (70%) of the receivables of the Facilities, whichever is greater. Upon request, the Department will review this condition within one year.

(7) NewCare shall not appeal the Department's determination that NewCare's suitability and responsibility to operate long term care facilities in Massachusetts (the "Determination") is dependent on its compliance with the conditions set forth herein. Material violation of any condition set forth herein that adversely affects the Department's goals in imposing the conditions shall be in and of itself sufficient cause for a finding that NewCare is not suitable or responsible to operate a long term care facility in Massachusetts and shall be sufficient cause for revocation of each and every license issued to NewCare. NewCare shall have full appeal rights including without limitation an adjudicatory hearing with respect to any decision made by the Department under this paragraph. During the Probationary Period NewCare shall not appeal any determination under Paragraphs 1, 2, 3, or 6 made by the Department nor any decision of the Director consistent with this approval.

(8) It is the Department's belief that sufficient facts exist for it to conclude that NewCare is neither suitable nor responsible for licensure. NewCare neither admits nor denies that sufficient grounds exist under 105 CMR 153.012 for Department action thereunder. However, in consideration of the Department's issuance of a probationary license, NewCare agrees not to contest the Department's conclusion.

(9) During the Probationary Period, Newcare may file determination of need applications for renovations or replacement of facilities.

On December 14, 1998, DPH requested that NewCare provide evidence of compliance with the terms of the Agreement, and on December 31, 1998, DPH requested in writing that NewCare submit evidence of compliance with Conditions 4 and 6, the two financial components of the Agreement. On January 29, 1999, NewCare, through its attorneys, notified DPH that an escrow account had been established and funded as of January 26, 1999. Subsequently, on February 12, 1999, NewCare submitted evidence that it had established a line of credit with HCFP Funding, Inc., for approximately $1.5 million. This submission completed the nine conditions that were stated in the provisional licensing agreement. Subsequently, DPH granted NewCare a conditional license effective December 1, 1998.

On June 1, 1999, Lenox Healthcare, Inc., (Lenox), located in Pittsfield, Massachusetts, entered into a management services agreement with NewCare for management of the four Massachusetts facilities. Lenox informed DPH that the NewCare Regional Manager responsible for the four Massachusetts nursing homes had resigned. DPH notified NewCare in a June 8, 1999 letter that it must submit a replacement for DPH approval, as stated under Condition 3 in the Agreement. In addition, DPH requested that NewCare provide information regarding the status of the accounts referenced in Conditions 4 and 6 of the agreement.

On or about June 22, 1999, NewCare designees NewCare Mass Nursing, Inc.; NewCare Health Corp.; and numerous related entities filed Voluntary Petitions of Relief under Chapter 11 of the United States Bankruptcy Code, (Case Nos. 99-44160-44181-HJB).

In a letter dated July 14, 1999 to DPH, Lenox officials stated that they had determined that NewCare had not complied with Conditions 4 and 6 of the Agreement. Moreover, at a July 28, 1999 meeting with DPH, Lenox produced the “trust activity account” statement held by the trustees of the escrow account, which showed that although $500,000 was deposited into the escrow account on January 27, 1999, two days later the entire amount of $500,000 was withdrawn. The escrow account remained unfunded since that time.

With the approval of the Bankruptcy Court, a decision by Lenox on behalf of NewCare was made on August 11, 1999 to close three of the nursing homes: Elms Manor, Pine Manor, and Oak Manor. DPH, after careful consideration, approved the closure plan. The effective date of the closure was November 22, 1999, and the closure plan was developed in accordance with DPH and DMA regulations. According to DPH officials, the closure was developed to ensure a safe, orderly, and clinically appropriate transfer of each resident with minimum stress for residents, family, and facility staff.

Audit Scope, Objectives, and Methodology

The scope of our audit was to examine certain aspects of DPH’s licensing and monitoring of NewCare. Our audit was conducted in accordance with applicable generally accepted government auditing standards and included such audit procedures and tests as we considered necessary to meet these standards. Our specific audit objectives were to: (1) determine DPH's responsibilities pertaining to the licensure and monitoring of LTCFs; (2) assess DPH's process in granting a conditional license to NewCare, Inc.; and (3) determine whether DPH's administrative activities relative to its licensure of LTCFs could be improved. Further, prior to the conduct of our audit fieldwork, certain concerns were raised in the media relative to NewCare's operations. As such, during the course of our audit fieldwork, we attempted, to the extent possible, to substantiate the validity of the concerns and report the results of our testing in these areas in this report (see Other Matters).

In order to achieve our objectives, we held discussions with DPH officials to obtain an understanding of how DPH administers its licensure process for LTCFs and monitors these facilities. In addition, we spoke with NewCare's legal counsel who was involved with the filing of the license for NewCare; representatives from Lenox, the current management company overseeing the operations at the nursing homes in question; and the prior Regional Manager of NewCare who was responsible for managing the four LTCFs in question. We reviewed applicable laws, regulations, policies, and procedures pertaining to DPH's licensure and monitoring operations. We also examined all the documents maintained by DPH relative to its activities with NewCare in Massachusetts and visited the officials of Lenox to review any documentation it may have been maintaining relative to the administration of the LTCFs by NewCare during our audit period.

Our audit did not include an assessment of the quality of care being provided by the LTCFs or the qualification of staff in these facilities. Rather, our review was designed to assess DPH's administrative activities relative to the licensing and oversight of NewCare's management of the four LTCFs in Massachusetts.

AUDIT RESULTS

Inadequate Controls over the Licensure and Monitoring of NewCare

Our audit revealed that the Department of Public Health (DPH) may not have taken all of the measures possible to ensure that the NewCare Health Corporation (NewCare) complied with all the terms and conditions of its provisional licensure agreement. Specifically, one of the conditions of NewCare's provisional licensing agreement was that it establish and maintain an escrow account of $500,000 as a reserve to pay for expenses of the nursing homes it was operating in Massachusetts and to replenish the balance when this escrow account fell below $150,000. However, although DPH approved this escrow agreement, it did not take measures to ensure that it adequately monitored NewCare's compliance with this agreement. As a result, two days after DPH was notified by NewCare's attorney that the escrow account was established and funded, NewCare withdrew the entire $500,000 without DPH's knowledge or consent and did not replenish the balance, jeopardizing DPH's ability to ensure the continued operation of the four nursing homes being managed by NewCare. DPH officials contend that although DPH took reasonable measures to protect its interests, the attorney representing NewCare in this matter did not act appropriately in terms of professional conduct. DPH has therefore referred this matter to the Board of Bar Overseers for investigation.

As noted in the Background section of this report, Condition 4 of the "Conditional Suitability Agreement" (Agreement), dated October 20, 1998, stated that NewCare shall establish and replenish an escrow account for the facilities in the amount of $500,000, which may be used by NewCare's Regional Manager or a Management Company to pay expenses of the facilities and to which they shall have complete and easy access without delay or conditions. The condition further stated that if the escrow account is depleted below $150,000, the Regional Manager or Management Company (Lenox) shall immediately notify DPH. This condition was developed to ensure that sufficient funds would be available to operate the facilities being managed by NewCare in Massachusetts.

On December 16, 1998, a “Shortfall Escrow Agreement” (escrow agreement) was prepared by NewCare’s attorneys. The parties to the escrow agreement were NewCare as the principal and the law firm representing NewCare on this matter as the escrow agent. The escrow agreement was forwarded to DPH, where DPH’s legal counsel had the opportunity to review/approve it or request changes if deemed necessary.

During our audit, we reviewed the terms and conditions of the escrow agreement and spoke with representatives from the law firm that represented NewCare in this matter as well as representatives from DPH’s legal counsel. Based on our review of these documents and our conversations with these individuals, we found two significant problems with the escrow agreement that DPH approved. First, although DPH required the escrow agreement as a condition of licensure, DPH did not take measures to ensure that it was a party to the escrow agreement. Therefore, according to a representative of the law firm representing NewCare in this matter, there was no obligation on the part of the escrow agent (NewCare’s law firm) to notify DPH of any transactions in the escrow account. Consequently, although DPH’s conditional licensure agreement established specific conditions relative to the establishment and maintenance of this escrow account, by not making sure it was a party to the escrow agreement, DPH limited its ability to monitor the transactions that were processed through the escrow account or NewCare’s compliance with these conditions.

Second, DPH did not ensure that the escrow agreement contained adequate provisions to ensure that NewCare’s activities were consistent with those agreed to when DPH issued NewCare its conditional license to operate these four facilities. Specifically, in Condition 4 of the conditional suitability agreement, NewCare’s regional manager is given the responsibility of monitoring the escrow account, requesting replenishment of the account, and immediately notifying DPH if the account was depleted below the $150,000 minimum. However, in the escrow agreement, there is no specific mention of the regional manager or any other party reporting to DPH the status of the escrow account. As a result, NewCare was able to withdraw the entire $500,000 escrow balance and not replenish it, without DPH's knowledge or consent.

Regarding this matter, representatives from DPH's legal counsel stated that the escrow agreement, in at least four places, references the suitability agreement between DPH and NewCare. Therefore, DPH officials contend that the escrow agreement incorporates the provisions of this suitability agreement.

Regarding the withdrawal of $500,000 from the escrow account, DPH officials provided the following comments:

> As explained below, the entire $500,000 was withdrawn from the escrow account, not by NewCare for expenses of the facilities as required by the terms of the escrow agreement, but by HealthCare Financial Partners for purposes having nothing to do with the needs of the facilities. These funds were withdrawn in absolute contravention of, and despite the measures taken by DPH, not as a result of the agency's failure to take appropriate measures.
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> On December 31, 1998 DPH acknowledged receipt of a copy of the escrow agreement and requested evidence that the account had been funded. DPH informed NewCare that the transfer of ownership would not be processed until documentation of account funding was provided.
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> On January 26, 1999, without DPH's knowledge, NewCare, a lender called HealthCare Financial Partners, and an attorney for [the law firm representing NewCare in this matter] signed a loan agreement. The purpose of the loan agreement was to fund the escrow account, for three days, until January 29, 1999. In this agreement, an attorney for NewCare's law firm agreed that, notwithstanding the requirements of the Suitability Agreement, NewCare, would "not have access to the funds" without HealthCare Financial Partners "prior written consent" and that upon Lender's direction, NewCare's law firm shall return funds in the Escrow Account to Lender." DPH became aware, and received a copy, of this agreement in June 1999.
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> As of the December 16th escrow agreement, NewCare's law firm had, as the escrow agent, agreed in the escrow agreement to release funds only to NewCare and only for the "expenses of the facilities." As of January 26, 1999, NewCare's law firm also agreed as a signatory to the loan agreement and in direct contravention of the escrow agreement, to release the funds in the escrow account to HealthCare Financial Partners at their direction.
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> On January 29, 1999, the attorney for NewCare's law firm wrote a letter to DPH and faxed a copy of a credit advice confirming receipt of $500,000 into the account on January 26, 1999, which he stated was "to be held in escrow for NewCare Mass Nursing, Inc. in accordance with the escrow agreement." He then stated that this satisfied the one remaining precondition to licensure.
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> At this point, a significant misrepresentation had been made to DPH. DPH had no reason to doubt that the escrow account had received funds to be held in accordance with the terms of the escrow agreement. No additional measures or conditions would have rectified this.

> On this same day, January 29, 1999, Healthcare Financial Partners wrote to the attorney for NewCare's law firm by facsimile and instructed him to release the funds directly to them by wire transfer that day, which he did on or about February 1, 1999.
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> By the terms of the Escrow Agreement, only NewCare could request release of those funds and only for expenses of the facilities. NewCare did not request release of any funds. The escrow agent had no authority under the terms of the escrow agreement to release those funds to HealthCare Financial Partners. HealthCare Financial Partners was able to withdraw the entire $500,000 escrow balance and not replenish it without DPH's knowledge or consent, not because the safeguards in the escrow agreement were not in place, but because the provisions of the escrow agreement were violated.
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> Based on the significant misrepresentations that were made, DPH approved the transfer of the facilities.

On January 26, 2000, we met with a representative of the law firm that represented NewCare in these matters. This individual told us that, because DPH was not a party to the escrow agreement, his law firm had no responsibility to report any escrow account activities to DPH. In fact, the attorney with whom we spoke stated that his contacting DPH would have represented a potential violation of the client/attorney privilege that his firm had with its client, NewCare. This attorney stated, however, that he did notify NewCare that by fully depleting the escrow account, it was no longer in compliance with the conditions of its probationary license. Finally, regarding the responsibilities of the regional manager, the representative from the law firm stated that he had informed DPH that all bill payments were generated from NewCare's corporate offices in Atlanta and that therefore the regional manager would have no responsibility or control over payments or expenses or any way of knowing the balance in the escrow account.

Clearly, given its concerns relative to NewCare's financial condition, DPH should have more prudently monitored NewCare's compliance with the conditional license agreement. In addition, DPH should have required that DPH be a party to the escrow agreement or at least that an independent escrow agent be established. By allowing NewCare's attorney to be the escrow agent, in the opinion of this attorney, DPH created a client/attorney relationship whereby the escrow agent could not report any violations of the agreement to DPH.

On October 6, 1999, DPH referred this matter to the Board of Bar Overseers for investigation. As of August 17, 2000, the investigation by the Board had not yet been completed.

Recommendation: In the future, DPH should take measures to ensure that it establishes adequate controls that will allow it to monitor and assess each vendor's compliance with any conditional license it issues. At a minimum, DPH's legal counsel should review each agreement document to ensure that it adequately protects DPH's and the Commonwealth's interest and, when necessary, should ensure that DPH is a party to the agreement. In addition, DPH should work with the Legislature to draft legislation that would require DPH to hold and control any escrow for any entity granted a provisional license.

Auditee's Response: In response to our draft audit report, DPH stated, in part:

> It is DPH's position that we took reasonable measures to protect our interests given our assumption that the Regional Manager would act in a responsible and professional manner and that NewCare's attorneys would act in accordance with the Massachusetts Rules of Professional Conduct….
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> The escrow agreement references the Suitability Agreement, describing it as "a conditional finding of suitability issued by the Massachusetts Department of Public Health on October 20, 1998." (The escrow agreement refers to this letter as the "Suitability Approval".) The escrow agreement references the "Suitability Approval" no less than four times, including in the following, specific provision that required that the disbursement be for "expenses of the Facilities, as described in the Suitability Approval":
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>> II. (b) Requests of Disbursements. NMN (NewCare) may request a disbursement from the Escrow Fund to pay expenses of the Facilities, as described in the Suitability Approval, by giving to Escrow Agent notice of such request in writing (the "Disbursement Request") describing the amount of the request. The Escrow Agent shall pay the request as directed….
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> The escrow agreement clearly incorporated the requirements of Condition 4, as they pertain to release of the funds in the escrow agreement….
>
> NewCare withdrew the $500,000 in violation of the escrow agreement, and quite possibly in violation of the attorney's professional code of ethics and his responsibility as escrow agent. As escrow agent, the attorney entered a separate, contradictory agreement about which DPH had no knowledge. DPH should not be faulted for its reasonable reliance upon both the terms of the agreement it knew about and the professional responsibilities of a member of the Massachusetts Bar. Arguably, with a different reporting mechanism, DPH could have had knowledge of this withdrawal sooner, but could not reasonably be expected to have prevented the withdrawal….
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> DPH reasonably relied on attorneys practicing in a reputable Boston law firm to hold the funds in question in an escrow account under certain conditions. Misrepresentation of the initial funding

of the escrow account and subsequent violation of the escrow agreement had nothing to do with DPH's status as a signatory to the agreement. DPH did not "create an attorney/client relationship whereby the escrow agent could not report any violations of the agreement to DPH."

A current legal authority states, "(f)or there to be an escrow, there must be a contract between the parties. However, the escrow document is not a substitute for the original contract between the parties, but is merely an auxiliary instrument created to help implement or execute the primary agreement." Given the existence of the Suitability Agreement and the incorporation of that agreement in the escrow agreement, it is reasonable to assume that DPH did not have to be a signatory to the escrow agreement in order for [NewCare's law firm] to have fiduciary duty with respect to DPH.

It should be noted in this regard that an attorney for one party to an escrow agreement often acts as the agent for both parties. "Several authorities now hold that if the agent's or attorney's acting as custodian of the deed or paper is not antagonistic to his principal's interest, and the property was placed with him or her not as a delivery but as an escrow, the agent or attorney of the grantor, obligee, or payee of an instrument may act as the depository of the instrument, but becomes the agent of both parties for the purposes of the escrow….

In the case of NewCare, the purpose of the escrow agreement was to comply with the directive set forth in Condition 4 of the Suitability Agreement. The funds were not supposed to go to DPH under any condition. For this reason, DPH has not been a signatory on the escrow agreements set up in similar circumstances in the past. Escrow agreements have been used successfully and without incident by DPH in similar situations in the past….

DPH maintains that attorneys for the entity supplying funds for an escrow account are appropriate escrow agents. However, the use of other agents is possible. DPH suggests that the NewCare situation was highly unusual and only able to occur due to questionable actions on behalf of the law firm in question. We do not agree that a law firm that maintains an escrow agreement cannot be expected, with a high level of confidence, to abide by the conditions of that agreement as escrow agent because the firm's client is a party to the agreement.

DPH agrees that it could have required a term of the escrow agreement that it be notified on a periodic basis of any transactions, and agrees that it will include such a provision in the future. It should be noted, however, that DPH did require that a regional manager (approved by the Division of Health Care Quality on the basis of their knowledge of her reputation and trust in her abilities and integrity) notify DPH when the escrow account was below $150,000. This requirement, which was set forth in Condition 4 of the Suitability Agreement, was not complied with.

In addition, the regional manager, who is a licensed Massachusetts nursing home administrator, was knowledgeable about the escrow account; she received a copy of the January 29, 1999 letter from [NewCare's law firm] to DPH stating that the account had been funded….

As discussed above, an attorney at [NewCare's law firm] was responsible for a key misrepresentation of material fact to DPH. The services of the lawyer in question were used to make a misrepresentation to DPH concerning the deposit of funds into the escrow account, and subsequently to take the money out of the account in contravention of the terms of the escrow agreement.

> The attorney was under an ethical obligation pursuant to the Massachusetts Rules of Professional Conduct not to misrepresent the nature of the funds being deposited in the escrow account, and further, to affirmatively correct the misrepresentation that all conditions had been met. It was this misrepresentation which induced the Department to issue the license. Rule 1.6 (b)(3) provides that a lawyer may reveal confidential information to the extent the lawyer believes necessary to rectify the situation, regardless of an attorney/client relationship with NewCare….
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> After consulting with the Board of Bar Overseers concerning the relevant facts surrounding the NewCare escrow agreement, the DPH Office of General Counsel was advised that a referral to the Board was warranted. This referral was made by letter dated October 6, 1999. An investigation by the Board has not yet been completed….
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> The escrow account was established precisely because bill payments were generated from Atlanta. The escrow account was established in order to have funds available in Massachusetts and to ensure these funds were accessible to the local regional manager. No DPH representative has any recollection of the lawyer stating that the regional manager would have no way of knowing the balance in the escrow account. There is no reason why this would be factually accurate, and this statement is totally inconsistent with the terms of the Suitability Agreement. Further, DPH would never have signed the Suitability Agreement or approved the licenses if this representation had been made by [NewCare's law firm]….
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> DPH legal counsel did review the suitability and escrow agreement documents and determined that they did adequately protect DPH's and the Commonwealth's interest. What subsequently transpired in this matter was highly unusual and is currently the subject of a pending investigation at the Board of Bar Overseers.

Auditor's Reply: Our report clearly identifies the measures taken by DPH to protect its interests relative to this issue. Our report also accurately discloses comments made by a representative of the law firm that represented NewCare in this matter. Since, as detailed in our report, certain activities of this law firm are currently being investigated by the Board of Bar Overseers, we did not comment on the propriety of these activities. Rather, our comments were limited to our assessment of DPH's activities in this matter.

We do not agree with DPH's assertion that the escrow agreement clearly incorporated all the requirements of Condition 4 as they pertain to the release of funds in the escrow agreement. This provision in the escrow agreement does address the general distribution of funds from the account. However, in Condition 4 of the Conditional Suitability Agreement, NewCare's regional manager is given the responsibility of monitoring the escrow account, requesting replenishment of the account, and immediately notifying DPH if the account was depleted below the $150,000 minimum. However, in the escrow agreement, there is no mention of the regional manager or the responsibility for reporting to DPH the status of the escrow account. As a result, as detailed in our report, NewCare was able to withdraw the entire $500,000 escrow balance and not replenish it, without DPH’s knowledge or consent.

In its response, DPH contends that it relied on the integrity of NewCare, NewCare’s law firm, and the regional manager to properly manage the activities of the funds in the escrow accounts. While under normal circumstances, this may have been a reasonable management approach, we do not believe that it was prudent in this instance for DPH to assume that this was an effective way of managing and overseeing this process. Specifically, as noted in our report, DPH had serious concerns about NewCare’s ability to finance and operate nursing homes in Massachusetts. These concerns were based on a number of questionable financial activities involving the agency. Specifically, as detailed in our report, on January 3, 1984, a complaint was filed with the National Association of Security Dealers, Inc., (NASD) alleging that the then President of NewCare effected transactions for the account of an institutional customer that were not authorized by the customer. A decision was rendered on July 16, 1984 wherein the then President of NewCare was censured, barred from association with any member of NASD in any capacity, and fined $10,000. Moreover, on July 11, 1985, a $50,000 fine was levied against this individual for additional NASD violations. DPH officials stated that other concerns they had relative to NewCare’s suitability included a bankruptcy filing of Harbor Town Securities, a security firm started by the then President of NewCare, which filed for bankruptcy protection a year after its formation; $3.6 million in overdue taxes and penalties owed by Retirement Care Associates, Inc., and several other companies formerly associated with the then President of NewCare; and a law suit filed in Pinellas County, Florida against the then President of NewCare by the former CEO of NewCare. Finally, DPH questioned whether NewCare had sufficient financial resources to provide adequate services. Specifically, according to NewCare’s first quarterly financial statement for fiscal year 1998 that it filed with the Securities and Exchange Commission, NewCare had an operating loss of $1.9 million, outstanding long-term debt of $40 million and shareholder equity of only $6.8 million for the quarter.

In our opinion, given the serious concerns DPH had relative to NewCare, it would have been more prudent of DPH to be more proactive in its administration of this matter. For example, DPH could have taken measures to ensure that the escrow agreement was less ambiguous relative to the duties and responsibilities of the regional manger. Additionally, DPH could have required NewCare to submit more detailed documentation relative to the financing of the escrow account before it issued NewCare its conditional license. Such measures would have helped to ensure that the interests of DPH, its clients, and the Commonwealth are adequately protected.

OTHER MATTERS

Several concerns relative to NewCare's operations were raised by citizens and the media, both prior to and during the conduct of our audit fieldwork. A description of these concerns, followed by the results of our audit work relative to these matters, are detailed below:

a. Employee Payroll Deductions: There was a concern that payroll deductions of the nursing home staff for state taxes, federal taxes, and Social Security were withheld but not submitted to the proper depository. When requested to provide the audit team with payroll records for the period in question, Lenox officials stated that these records were maintained at NewCare's Corporate Headquarters in Atlanta, Georgia, and were therefore not available for our review. However, Lenox's controller stated that no concerns were noted by employees of the facilities regarding nonpayment of their payroll taxes. In addition, the court appointed Bankruptcy Examiner stated that the payroll records were compiled by a payroll service in Atlanta, and assured us that they were complete and accurate.

b. Patient Fund Accounts: A question was raised as to whether patient funds at the four NewCare facilities were maintained and expended properly. We attempted to review the patient account records for the clients in the four nursing homes during the period in question. However, Lenox stated that they could not locate the patient account records for the four facilities. Also, no audit trail existed for our review, since DPH does not review patient accounts as a standard procedure. Rather, when a complaint is submitted to DPH concerning patient accounts, DPH's Complaint Unit investigates the allegation. As such, DPH did not have sufficient documentation for us to review in order to determine the validity of this concern. However, our review of DPH's files for the four facilities indicated that there had not been any complaints pertaining to patient accounts filed during the period covered by our audit.

c. Medicaid Charges: There was a concern over the propriety of certain charges to Medicaid. As noted in the Background section of this report, it is Medicaid's responsibility, through the Division of Medical Assistance, to ensure that financial records for nursing homes are audited. During our audit, we attempted to review various records relative to billings submitted by NewCare for Medicaid reimbursements. However, Lenox was unable to obtain sufficient documentation to perform our audit testing in this area.

d. Insurance Premiums: In June 1999, more than 100 NewCare employees were informed that their health, dental, and disability insurance coverage had been canceled due to nonpayment. These individuals were informed by their insurance company that they were personally responsible for the cost of any medical treatment incurred during the period April 22, 1999 to July 30, 1999. There was no record of NewCare's making any premium payments since January 1999, despite having made payroll deductions from employee paychecks. This issue was resolved on October 27, 1999, when a Judge at the United States Bankruptcy Court agreed to a motion stating that Health New England, the insurer, agreed to reinstate coverage for NewCare employees for the gap period provided that the Bankruptcy Examiner pays the unpaid premiums.