MEMORANDUM FOR: Karen E. Armes
Acting Regional Director, Region IX

FROM: Robert J. Lastrico
Western District Audit Manager

SUBJECT: Facey Medical Foundation
Mission Hills, California
FEMA Disaster Number 1008-DR-CA
Public Assistance Identification Number 037-90636
Audit Report Number W-02-03

The Office of Inspector General (OIG) audited public assistance funds awarded to Facey Medical Foundation, Mission Hills, California (Foundation). The objectives of the audit were to determine: (1) whether the Foundation was an eligible private nonprofit applicant and (2) whether the Foundation had legal responsibility for repair work required after the Northridge Earthquake.

The Foundation received a public assistance award of $272,411 from the California Office of Emergency Services (OES), a FEMA grantee, for debris removal, emergency protective services, and repairs to facilities damaged by the Northridge Earthquake that occurred on January 17, 1994. The award provided 90 percent FEMA funding for one large project and 6 small projects.¹ The audit covered the period January 17, 1994, through January 11, 2001, and included a review of one large project with an award of $224,181 (FEMA share only).

We performed the audit under the authority of the Inspector General Act of 1978, as amended, and according to generally accepted government auditing standards. The audit included a review of FEMA’s and OES’ records on the project, a meeting with Foundation officials, and other auditing procedures we considered necessary under the circumstances.

¹ According to Federal regulations in effect at the time of the disaster, a large project was defined as a project costing $42,400 or more, and a small project was defined as one costing less than $42,400.
RESULTS OF AUDIT

Regarding the first objective, there are two components to applicant eligibility: first, the organizational status of the applicant must be considered; and second, it must be determined whether a facility, which is owned and operated by the private nonprofit organization, qualifies as a private nonprofit facility. The audit determined that the Foundation met the organizational component of applicant eligibility. However, Federal regulations do not specifically address the eligibility of tax-exempt integrated healthcare delivery systems, such as the Foundation, and FEMA itself has come to differing conclusions regarding applicant eligibility. Therefore, we could not determine whether the Foundation met this second component of eligibility.

Regarding the second objective, the audit determined that the Foundation did not have legal responsibility for the Mission Hills Medical Office Building damaged by the earthquake. Therefore, we question $224,181 in FEMA funds provided to the Foundation to cover the costs of repairing that damaged facility.

The following paragraphs provide background concerning the award and pertinent facts and criteria supporting our audit conclusions regarding applicant eligibility and legal responsibility.

Background

Section 406(a) of the Stafford Act authorizes the President to make contributions (grants/subgrants) to a person who owns or operates a private nonprofit facility damaged or destroyed by a major disaster. Those contributions are made for the repair, restoration, or reconstruction of such facility, and for associated expenses incurred by such person. Although Section 406(a) authorizes such contributions, Federal regulations limit eligibility to facilities that are both owned and operated by the private nonprofit organization. In addition, the facility must have been located in the disaster area, the damage must have been caused by the disaster, and the private nonprofit organization must be legally responsible for repairs.

In 1998, FEMA disaster officials decided that the Foundation’s Mission Hills Medical Office Building was not eligible for public assistance funding and initiated action to deobligate the previous award. The Foundation appealed that determination and on February 22, 1999, FEMA Region IX officials concluded that the Foundation lacked legal responsibility for the repairs, an essential criterion for eligibility under Federal public assistance program regulations.

The Foundation filed a second appeal that was denied by the former Executive Associate Director, Response and Recovery Directorate, on February 23, 2000. The basis of the second appeal determination was that:

- The applicant lacked the requisite legal responsibility over the facility, and
- The facilities would not be eligible for Federal disaster assistance, even if the Foundation were legally responsible for earthquake repairs, because all of the medical services offered in the Medical Office Building were performed on a “for-profit” basis. To be eligible for assistance, FEMA policy in effect at the time of the disaster stated that a medical office
building, even if owned by an eligible private nonprofit organization, must be used at least 50 percent for private nonprofit, medical service activities. Based on the information obtained, the former Executive Associate Director determined that 100 percent of the floor space was used by a for-profit medical practice.

Subsequent to the second appeal determination, the Foundation made a personal appeal to the former FEMA Director. On January 11, 2001, the former Director determined that the Foundation could retain $224,181 in the disaster assistance initially approved for the Mission Hills Medical Office Building, notwithstanding: (1) earlier determinations by FEMA program officials that the work in question was not eligible, and (2) objections raised by FEMA’s Office of the General Counsel. At the time this decision was made, there was no appeal before the agency and Federal regulations provided that a second appeal decision constituted a final agency action. Although there was no appeal before the agency, the former Director stated he was settling an appeal based on materials provided by the Foundation. The former Director concluded that the Foundation could be considered a direct healthcare provider, and irrespective of written leases, it had demonstrated responsibility for the damaged facility. Unlike the earlier administrative appeal decisions, the former Director did not explain which materials supported applicant eligibility, nor did he explain why the agency’s previous determinations were incorrect.

Applicant Eligibility

There are two components to applicant eligibility. First is the organizational status of the applicant, and second is a determination as to whether a damaged or destroyed facility qualifies as a private nonprofit facility.

Organizational Status. According to Federal regulation 44 CFR 206.221(f), a private nonprofit organization is any non-governmental agency or entity that has: (1) a tax exemption ruling from the U.S. Internal Revenue Service (IRS), or (2) evidence from the State that it is a nonprofit organization or entity doing business under State law.

In April 1993, the IRS ruled that based on information submitted by the Foundation, the Foundation would be classified as a nonprofit public benefit corporation, organized to operate an integrated healthcare delivery system to provide a full range of healthcare services to the community. The Foundation’s bylaws of May 1993 identify it as a California nonprofit organization organized exclusively to receive and administer funds for charitable, scientific, and educational purposes and to promote health by caring for and treating persons suffering from mental or physical illness, disease, or disability. The documentation provided indicated that the Foundation met the organizational component of applicant eligibility.

Private Nonprofit Facility. At the time of the disaster, FEMA’s published Medical Office Building policy indicated that to be eligible for disaster assistance, a medical office building, even if owned by an eligible private nonprofit organization, must be used at least 50 percent for private nonprofit, medical service activities. Federal regulation 44 CFR 206.221(e)(4)

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2 At one time, Federal regulations provided that a second appeal decision could be appealed to the Director of FEMA. However, as a result of changes in the regulation, no third level appeal was permitted from a second level appeal decided after May 8, 1998.
identifies eligible medical facilities as those that include outpatient facilities and any similar facilities offering diagnosis or treatment of mental or physical injury or disease (The regulations do not specifically address the eligibility of tax-exempt integrated healthcare delivery systems, such as the Foundation).

Hastings, Luce and Wynstra, Fundamentals of Health Law 19 (1995) note that tax exempt integrated healthcare delivery systems take many forms, but the “foundation model” is one of the most common. Under this model, a single corporation, (a foundation which is typically a nonprofit corporation under state law), is created to obtain all assets needed to operate clinics and physician offices, and possibly one or more hospitals. The foundation acquires the services of physicians who provide professional medical care within the system, either through direct employment or independent contract. The foundation then becomes the provider of healthcare services, both medical and hospital, and inpatient and outpatient. It enters into all payer contracts, provides all nonprofessional personnel for the system, maintains all assets, and collects all revenues for services provided.

The Mission Hills facility was operated in accordance with this model in most material respects. A “for-profit” contracting medical group provided medical services at the facility. The Foundation records showed that the Foundation employees, such as registered nurses, clinical social workers, physical therapists, and medical technicians, also provided allied health services to the general public. However, the Foundation did not maintain all of the assets. The leasehold interest in the Mission Hills facility was in the hands of an affiliated “for-profit” entity at the time of the disaster. In spite of this difference, the Mission Hills facility more closely resembled an outpatient facility, as defined in Federal regulation 44 CFR 206.221(e)(4), than a medical office building, which typically leases space to individual physicians or unaffiliated groups of physicians in return for rental payments.

FEMA’s regulations do not specifically address the eligibility of tax-exempt integrated healthcare delivery systems such as the Foundation. In addition, the former Director and senior Program officials came to differing conclusions regarding applicant eligibility. Therefore, by separate correspondence, we are recommending that the Assistant Director, Response and Recovery Directorate determine whether FEMA’s eligibility regulations for healthcare facilities require revision in light of this and other significant changes that have taken place in the healthcare delivery system since the regulations were promulgated.

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3 Federal regulation 44 CFR 206.221(e)(4) states that the term “outpatient facility” should be defined in the manner prescribed by Section 645 of the Public Health Service Act, codified at 42 USC 291o(f) (incorrectly referred to as 42 USC 2910 in the Code of Federal Regulations). Section 645 of the Public Health Service Act defines an “outpatient facility” as a facility (located in or apart from a hospital) for the diagnosis or diagnosis and treatment of ambulatory patients (including ambulatory inpatients) – (1) which is operated in connection with a hospital, or (2) in which patient care is under the professional supervision of persons licensed to practice medicine or surgery in the State, or, in the case of dental diagnosis or treatment, under the professional supervision of persons licensed to practice dentistry in the State; or (3) which offers to patients not requiring hospitalization the services of licensed physicians in various medical specialties, and which provides to its patients a reasonably full-range of diagnostic and treatment services.

4 The Foundation’s bylaws refer to the “contracting medical group” (i.e., Facey Medical Group) as the group of physicians and surgeons providing healthcare services to the Foundation’s patients.
Legal Responsibility

Under Federal regulation 44 CFR 206.223(a)(3), an item of work must be the legal responsibility of an eligible applicant to be eligible for financial assistance. Project documents showed that the Foundation did not have legal responsibility for repairing disaster damage to the Mission Hills facility, because it was not a party to the lease agreement that was in effect on the date of the disaster. This lease, executed in April 1991, was between San Fernando Professional Building, as lessor, and the Facey Medical Group (Group), a for-profit entity, as lessee.

Foundation officials acknowledged that the 1991 lease did not include the Foundation in the agreement. However, they explained that a November 1991 “Service Agreement” between the Group and the Foundation made the Foundation responsible for repairs to the Mission Hills facility.\(^5\) They noted the Foundation paid for all disaster damage not covered by insurance or reimbursed by FEMA, and the lessor was aware the Foundation had assumed all lessee responsibilities. To prove the latter point, Foundation officials provided us with a copy of a $101,424 check received directly from the lessor for an insurance reimbursement from the lessor’s own insurance.

While the Foundation asserts that the “Service Agreement” and the lessor’s canceled check show it had assumed responsibility for the operation, maintenance and repair of the Mission Hills facility, neither document clearly shows that the Foundation had a legal duty to the lessor for rent payments due from the Group or for repairing the premises after the earthquake. Other pertinent information is discussed below:

- Exhibit 1.1 of the “Service Agreement” confirms the lease agreement between San Fernando Professional Building and the Group. While the “Service Agreement” sets forth the agreed-to responsibilities of the Foundation and Group, including the operation, maintenance, and repair of the Mission Hills facility by the Foundation, the agreement does not set aside the Group’s legal responsibility to adhere to the terms and conditions of its lease.

- On September 30, 1992, the Group, with agreement from the lessor, assigned its Mission Hills facility lease to Pacific Health Resources (PHR), another for-profit corporation\(^6\) and on February 26, 1997, PHR, with agreement from the Group and lessor, assigned its right, title, and interest in the lease to the Foundation.

Based on the documents discussed above, the Foundation did not assume legal responsibility for the lease until February 1997. While the Group and PHR may have intended for the Foundation to have this legal responsibility including the assumption of all obligations thereof, the legally binding “Assumption Agreement” was executed over 3 years after the Northridge Earthquake. Irrespective of the fact that the Foundation operated and maintained the facility under the terms of the ”Service Agreement”, and in fact paid the rent for the Group, the legal responsibility for

\(^5\) The 1991 “Service Agreement”- outlined the responsibilities of both parties (affiliates) for the operation of the seven medical office locations.

\(^6\) PHR is an affiliate of the Foundation and wholly owned subsidiary of UniHealth America that is the sole corporate member of 11 tax-exempt acute care hospitals and 1 acute psychiatric care hospital.
the facility rested with the Group until such time all involved parties agreed to the assumption of those responsibilities by the Foundation. Therefore, regardless of the former Director’s determination that the Foundation had legal responsibility for repairs, we are questioning the award of public assistance funds to the Foundation because it did not have legal responsibility for the Mission Hills facility at the time of the earthquake. As discussed below, we question the award on the basis of Federal regulations and FEMA guidelines in effect at the time of the disaster and previous General Accounting Office (GAO) rulings regarding grant awards made in error.

- The former Director’s reversal of the former Executive Associate Director’s decision contravened Federal regulation 44 CFR 206.206(e)(1) and (e)(3), which gave the former Executive Associate Director the last word on funding decisions that are appealed. In addition, the conclusion that the Foundation did have legal responsibility for the facilities did not comport with FEMA’s longstanding, consistently applied construction of the legal responsibility doctrine, as explained in the second level appeal decision.

- GAO has taken the position that regulations, when properly promulgated and within the bounds of the agency’s statutory authority, have the force and effect of law and may not be waived on a retroactive or ad-hoc basis. Further, GAO has also taken the position that grant funds erroneously awarded to an ineligible grantee must be recovered by the agency responsible for the error, including expenditures the grantee incurred before receiving notice that the agency’s initial determination had been made in error. In addition, GAO has noted that an erroneous agency determination that an applicant was eligible for grant assistance may not be used as the justification for not requiring repayment of the monies in question.

**RECOMMENDATION**

We recommend that the Acting Regional Director, in coordination with OES, disallow $224,181 awarded to Facey Medical Foundation inasmuch as it did not have legal responsibility for the Mission Hills Medical Office Building when the Northridge Earthquake occurred.

**DISCUSSION WITH MANAGEMENT AND AUDIT FOLLOW-UP**

We discussed our audit results with Foundation and OES officials on November 14, 2002. These officials stated they would wait for the issuance of the report to evaluate their appeal options. We also discussed the results of our audit with Region IX officials on November 19, 2002.

Pursuant to FEMA Instruction 1270.1, please advise this office by January 20, 2003, of actions taken to implement our recommendation. Should you have any questions concerning this report, please contact me at (510) 627-7011. Key contributors to this assignment were Nathan Bergerbest and Humberto Melara.

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8 51 Comp. Gen. 162 (1971).
9 51 Comp. Gen. 162, 165 (1971)