PROVIDER REIMBURSEMENT REVIEW BOARD
HEARING DECISION

99-D32

PROVIDER -RN Home Care Ltd.
Westland, Michigan

Provider No. 23-7201

vs.

INTERMEDIARY -
Blue Cross and Blue Shield Association/
Blue Cross and Blue Shield United of
Wisconsin

DATE OF HEARING-
July 7, 1998

Cost Reporting Periods Ended -
December 31, 1990, December 31, 1991, December 31, 1992 and December 31, 1994

CASE NOs. 95-1564, 97-1191, 97-1192, and 97-1195

INDEX

ISSUES:

1. Was the Intermediary's adjustment to the asset valuation of the employee stock ownership plan ("ESOP") proper? (For 1990, 1991 and 1992 only)

2. Was the Intermediary's adjustment to interest expense proper? (For 1992 and 1994 only)

STATEMENT OF THE CASE AND PROCEDURAL HISTORY:

RN Home Care, Ltd ("Provider") is a Medicare certified home health agency ("HHA") located in Westland, Michigan. The Medicare Intermediary for the Provider for the years under appeal was Blue Cross and Blue Shield United of Wisconsin ("Intermediary"). The Intermediary issued Notices of Program Reimbursement ("NPRs") for the calendar years ended December 31, 1990 ("1990"), December 31, 1991 ("1991"), December 31, 1992 ("1992"), and December 31, 1994 ("1994"). It disallowed the Provider's ESOP asset valuation that was a basis for the Provider's pension plan for 1990, 1991, and 1992. Further, it disallowed interest expense on the Provider's BIDCO loan (explained below) for 1992 and 1994. The Provider appealed these adjustments to the Provider Reimbursement Review Board ("Board"). The Provider's filings meet the jurisdictional requirements of 42 C.F.R. §§ 405.1835-.1841. The Provider was represented by Ronald R. Ruark, Esquire. The Intermediary was represented by Bernard M. Talbert, Esquire, of Blue Cross and Blue Shield Association ("BCBSA").

Issue No.1 : ESOP Valuation

FACTS:

The Provider established an ESOP in 1990 to serve as a pension plan for its employees. The Plan allowed the owners to take cash out of the Provider as they sold their stock to the ESOP. The Company purchased the stock of the Provider from its owners and contributed it to the ESOP.
The Provider's plan contributed 15% of all eligible employees' salary to the ESOP. To determine the number of shares contributed, the Provider contracted with an independent appraiser, The Lefco Group ("Lefco"), to determine a price per share of outstanding stock. The number of shares sold by the owners to the ESOP in a given year is the potential ESOP

contribution. During 1990, 1991, and 1992, the value per share was computed at $11.95[1], $17.13[2], and $20.11[3], respectively, per share by Lefco.

Due to the fact that the Provider's financial statement reflected a negative accumulative deficit in 1992, the Intermediary had a second appraisal done by another independent appraiser, Deloitte & Touche, LLP. The results of this appraisal significantly reduced the value of the company. For 1992, the results of this second appraisal reduced the value of a share of stock from $20.11 per share to $5.25 per share.[4] The resulting adjustment factor of -73.89% was applied to the 1990 and 1991 ESOP valuation calculated by the Provider. This resulted in Intermediary valuations of $3.12 per share in 1990 and $4.47 in 1992. The Provider was sold on December 31, 1995 for $12.14 per share.

The value per share was calculated as follows:

IN THOUSANDS

	1990 (B)		1991 (C)	1992 (D)
Total Present Value of:				
Cash Flow	$1335.3		$1450.0	$1860.0
Terminal Value	$1054.0		$1974.5	$2161.3
Total Value	$2389.3		$3424.5	$4021.3
Outstanding Shares	200		200	200
Value per Share	$11.945		$17.13	$20.11
Consisting of :				
Add on Value	(A)	$7.210	$8.52	$9.30
Terminal Value	4.735		8.61	10.81
Total Value	$11.945		$17.13	$20.11

1 See Exhibit 4 of the 1990 Provider's Position Paper

2 See Exhibit 3 of the 1991 Provider's Position Paper

3 See Exhibit 5 of the 1992 Provider's Position Paper

4 See Exhibit 5 of the Intermediary's 1992 Position Paper.

(A) Value of "add on" included because the Provider would most likely be purchased by a hospital or similar health care concern. Due to the latter institutions' administrative and general expense "add ons", the Provider would realize additional revenues.

(B) See Exhibit I of Lefco's 1990 Appraisal (Exhibit 4 of the Provider's 1990 Position Paper).

(C) See Exhibit H of Lefco's 1991 appraisal (Exhibit 3 of the Provider's 1991 Position Paper).

(D) See Exhibit H of Lefco's 1992 appraisal (Exhibit 5 of the Provider's 1992 Position Paper).

PROVIDER'S CONTENTIONS:

The Provider contends that the Lefco evaluation was reasonable. The Provider sold substantially all of its assets on December 31, 1995 for approximately 2.4 million dollars, which being converted to a stock sale equals approximately $12.00/share based on 200,000 outstanding shares. That was substantially more than the Deloitte & Touche, LLP valuation that the Intermediary promotes. This is the single most important piece of evidence before the Board. The Intermediary has taken the irrational stand that the Provider should have been valued at $3.00 or $4.00 a share. The sale of the Provider on December 31, 1995, contradicts the Intermediary's argument. The Intermediary cannot give a rationale or cogent explanation of how an agency that is supposedly valued at $4.00/share could sell for $12.00/share.

The Provider notes that the $12.00/share selling price was achieved in spite of the fact that the Intermediary forced the Provider out of business by capriciously and arbitrarily revoking the provider-based status of clinics in Florida. The Intermediary forced the Provider to sell quickly because of the massive debt that this capricious revocation created. In spite of this, the Provider still sold for $12.00/share. Moreover, the $12.00/share selling price was achieved in spite of the fact that the Health Care Financing Administration ("HCFA") imposed more stringent reimbursement policy, i.e., a cost cap freeze upon the entire home health industry beginning in 1995. That policy dramatically reduced the desirability of purchasing a home health agency. Unless the Intermediary can successfully argue that Lefco should have foreseen this change in reimbursement policy, its argument is meritless.

The Provider further argues that Lefko is an independent firm and well established in the field. This is uncontested. It used proper valuation techniques and considered all possible relevant factors. The Intermediary seriously misrepresented the Lefko valuation methodology at the Board hearing. Further, the Lefco valuation speaks for itself. It considered many factors, including the sale of comparable companies, in its valuation. The Intermediary attempted to characterize the Lefko valuation as improperly focusing on the desirability of a home health agency as a tool for obtaining cost report advantages. This mischaracterization is not supported in any way by the valuation before the Board. In addition, the Provider retained an Atlanta law firm to review the valuation methodology. That firm approved the valuation, and the sale was completed.

The Provider further argues that no evidence of any fraud exists. This is important. HCFA understandably scrutinizes ESOP transactions where owners profit and then leave the industry. This did not happen in this case. The owners of the Provider did not profit by the ESOP transactions. Instead, the money was returned to the company to fund its operating budget. This is uncontested. These factors strongly support the Provider's position that the ESOP sale was accomplished appropriately and was based upon an independent valuation that the subsequent sale confirmed.

The Provider contends that there is not much of a difference in methodology between the Lefco and Deloitte & Touche, LLP valuations. Certainly Lefco may have emphasized certain things that Deloitte and Touche, LLP did not. The Deloitte & Touche, LLP appraisal is open to the argument that subsequent events may have influenced its methodology. However, to say that Lefco did not emphasize or did not consider comparable companies in the market simply is not supported by the facts. It flies in the face of :(1) page 28 of the 1992 valuation (2) Schedule G, and (3) the concluding comments in the evaluation where it recognized that several facts must be considered.[5]

The Provider argues that the Intermediary’s witness is not an appraisal expert. That witness admits that all that can be done in this type of situation is to check out the company that you are going to get the valuation from and hope they will do a good job. The subsequent facts on the sale of the company indicate that Lefco did a good job.[6]

The Provider questions how the valuation itself affects the contribution? If the valuation was excessively high, then it simply means that the ESOP program would have bought more stock sooner. The Provider’s intent was to give the ESOP all of its stock and to establish control of the ESOP for the employees over the particular company. Further, the Lefco valuation considers that factor in making its valuation. That is the reason there was no minority discount in the appraisal because Lefco understood that when the intent is to give all the stock to the company, minority discounts were not as readily applicable.

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[5] Transcript (“Tr”) at 124.

[6] Tr. at 124 and 125.

INTERMEDIARY CONTENTIONS:

The Intermediary contends that it is properly following the principle of the Medicare regulations at § 42 C.F.R § 413.9 and Provider Reimbursement Manual, HCFA Pub. 15-1 ("HCFA Pub 15-1") § 2102.1:

42 C.F.R. § 413.9 states:

> All payments to providers of services must be based on the reasonable cost of services covered under Medicare and related to the care of beneficiaries. Reasonable costs include all necessary and proper costs in furnishing the services, subject to principles relating to specific items of revenue and cost.

Id.

HCFA Pub. 15-1 § 2102.1 states:

> Implicit in the intention that actual costs to be paid to the extent they are reasonable is the expectation that the provider seeks to minimize its cost, and that its actual costs do not exceed what a prudent and cost-conscious buyer pays for a given item of service. If costs are determined to exceed the level that such buyers incur, in the absence of clear evidence that the higher costs were unavoidable, the excess of costs are not reimbursable by the Program.

Id.

The Intermediary questions the validity of the Provider's claimed cost based on what a prudent and cost-conscious buyer would pay for the stock. Upon receipt of an appraisal by Deloitte & Touche, LLP, the Intermediary's doubts were confirmed. There was no evidence from the Provider that the higher price per share that they used was unavoidable, and that the second Deloitte & Touche, LLP, appraisal was not valid. Lacking this evidence, the Intermediary had no choice but to adjust to the lower of the appraisal findings. Also, when the Lefco valuation was done, it included a factor for the possibility that the Provider could be purchased by a hospital in the future and become "hospital based." Using this reasoning, they added to the valuation an "add-on" because a "hospital based" agency is valued at a greater amount than a free-standing agency. The Intermediary cannot accept a valuation based on something that might happen in the future. The value must be based on factual situations that exist at the time when the valuation was made.

The Intermediary notes that the appraisals were done under different theories with three distinct issues. For 1992, Lefco did a discounted cash flow approach, looking at the future revenue stream and came to a value of approximately $10.81. The $9.30 "add on" resulted in a total valuation of $20.11 per share. The theory which accounts for this $9.30 difference is based on an argument that one can quantify the difference between freestanding and hospital-base HHAs. The theory is that a hospital would pay incremental amounts on a discounted basis for a home health agency because of potential incremental hospital overhead. The Intermediary rejects this theory because it has a shaky legal foundation and is very speculative. Valuations should be done on a conservative approach.

The Intermediary notes that Lefco got to the $10.81 terminal value using a discounted cash method. Deloitte & Touche, LLP, assigned a value of $7.50 by looking at comparable sales for other similar types of businesses. Further, since the ESOP has a minority interest in the Provider's stock that is not traded on any kind of a market, Deloitte & Touche, LLP, recommended that a discount between 20 to 40 percent be applied to the value of the stock to arrive at the appropriate value of the ESOP. The minority discount realistically represents the value of the stock from the perspective of an ESOP.

The Intermediary notes that the Provider makes a big point that the emphasis should be on the fact that from the home health agency's perspective they paid out $422,000. It does not matter what the other side of that is, i.e., whether the ESOP purchased 20,000 or 80,000 shares. The need is to focus on the $422,000 payment in 1992. The Intermediary rejects this theory because one is looking for value received under a cost reimbursement principle, not like with the add-on issue. Based on this, the ESOP would probably own the whole company probably before 1992. Therefore, the Intermediary's valuation is more accurate. Using 1992 as an example, $110,000 is more realistic assignment of value as a home health agency cost for measuring the contribution to the ESOP.

Issue No.2 - BIDCO Interest Expense

FACTS:

During 1991, the Provider obtained a line of credit of up to $350,000[7] from BIDCO Jackson, Ltd. ("BIDCO"). Per correspondence between BIDCO and the Provider, the proceeds of the loans were to fund the Provider's ESOP and to make a partial payment to Medicare for a 1990 overpayment. The Intermediary disallowed the interest on this loan as a nonallowable use of funds per HCFA Pub. 15-1 § 2150.

The Intermediary disallowed $71,889 in 1992 and $31,426 for 1994. That resulted in a reduction in Medicare reimbursement of approximately, $63,000 in 1992 and $30,000 in

[7] See Intermediary Exhibit 6 (1992)

1994.

PROVIDER'S CONTENTIONS:

The Provider contends that the Intermediary denied the BIDCO interest expense solely because the Provider used the money to fund its ESOP program. In denying the BIDCO interest expense the Intermediary relied solely upon the September 27, 1991 letter from the BIDCO program to Kevin Ruark, President of the Provider. The letter states: "It is agreed the proceeds will be used to fund RN's 1990 ESOP program and a partial payment to Medicare for the 1990 overpayment." Id. The Intermediary ignored the September 1, 1994 letter[8] that clarified the issue.

The Provider argues that two important factors should decide this issue. First, the Intermediary agrees with the Provider that the ESOP at issue was a pension plan. This was a critical admission. It also admitted that it is perfectly permissible to fund a pension plan under the reimbursement rules. Having made these two critical admissions, the Intermediary's witness was then asked why are the expenses used to fund this particular pension plan not a reasonable expense? The witness gave no explanation of any kind. The Provider argues that since the ESOP is a legitimate pension plan, the Provider's fiancing of the ESOP is a legitimate and proper business expense.

INTERMEDIARY CONTENTIONS:

The Intermediary contents that it properly disallowed interest expense related to the BIDCO loan per HCFA Pub.15- 1, § 2150 (2)(B)(3) which states that interest incurred for the purpose of a purchase of common stock is not allowable. Specifically, it states:

> [c]osts related to the acquisition of the capital stock of a provider, whether or not such facilities are participating or subsequently will participate in the Medicare Program, are not allowable.

Id.

The Intermediary also requested an opinion from BCBSA on this issue. The latter responded that this interest expense should not be allowed because there is a link between the loan for which the interest is incurred and the funding of the ESOP. The Intermediary is following a

8 See Provider's Post-Hearing Brief Exhibit (Unnumbered)

classic Medicare position that borrowing to finance the purchase of stock is not an allowable interest expense.

The Intermediary notes that the Provider completed a cash flow analysis which is very difficult to follow. All of the loans were not for just financing normal working capital needs. Further, the ESOP was a discretionary payment made to the owners of the stock. There is a direct correlation between the amount borrowed and the discretionary payment into the ESOP.

CITATION OF LAW, REGULATIONS AND PROGRAM INSTRUCTIONS:

1. Law: Title XVIII of the Social Security Act:

   § 1861(v) (1) (A) - Reasonable Cost.

2. Regulation 42 C.F.R:

   §§ 405.1835 - .1841 - Board Jurisdiction

   § 413.9 - Cost Related to Patient Care

3. Program Instructions - Provider Reimbursement Manual, Part I (HCFA Pub. 15-1):

   § 2102.1 - Reasonable Costs

   § 2150 et seq. - Home Office Costs - Chain Organizations

   § 2140 - Deferred Compensation

   § 2144 - Fringe Benefits

FINDINGS OF FACT, CONCLUSIONS OF LAW AND DISCUSSION:

The Board, after considering the law, regulations, program instructions, facts, parties' contentions, and post-hearing briefs finds and concludes as follows:

Issue No. 1 - ESOP Valuation

The Board finds:

(1) The actual contribution made by the Provider for 1990 was not in the record. The 1991 and 1992 contributions to the ESOP were $248,499 and $352,252.[9]

(2) The Provider was sold in December 1995 for $2,400,000.

(3) The Provider had 200,000 shares of stock outstanding for the years in dispute (1990, 1991 and 1992) and in the year of sale (1995).

(4) The 1990 valuation of RN's stock by the Provider's appraiser was $11.945 per share[10]. This included a terminal value of $4.735 per share and an "add-on" value of $7.21 per share.

(5) The 1991 valuation of RN's stock by the Provider's appraiser was $17.13[11]. This included a terminal value of $8.61 per share and an "add-on value" of $8.52 per share.

(6) The 1992 valuation of RN's stock by the Provider's appraiser was $20.11. This included a terminal value of $10.81 and an "add-on" value of $9.30 per share.

(7) There was no ESOP contract included in the record.

(8) The 1990 and 1991 cost reports were reopened to reflect the impact of the Intermediary's ESOP adjustments. The 1990 adjustment was for $584,000. There was no itemization of the ESOP contribution in 1990.

(9) The parties believe that the issue in this case is the proper share valuation by year for the ESOP. The Board believes that the key issue is that the amounts claimed as allowable ESOP are reasonable and appropriate.

Based on these findings of fact, the Board concludes that ESOP contributions are allowable up to 15% of appropriate salary expense. HCFA Pub. 15-1 §§ 2140 (Deferred Compensation) and 2144 (Fringe Benefits) allow reimbursement for such costs. Regarding the dispute

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[9] See 1993 Lefco Appraisal, Exhibit C-1 (Provider Exhibit Unmarked)

[10] See Exhibit 4 of the Provider's Position Paper

[11] See Exhibit 3 of the Provider's 1991 Position Paper

between the Provider and Intermediary on the correctness of appraisals, the Board concludes that the Provider's appraisal was timely done by a reputable appraisal firm and is acceptable. On the other hand, the Intermediary's appraisal was done three years after the fact. In examining the Lefco appaisal, however, the Board concludes that the "add-on" amounts are inappropriate. There is no evidence in the record that establishes the correctness of the appraiser assumption that the Provider intended to sell its stock to a hospital. The "add-on" amounts were significant in amount and had no basis in fact.

Issue NO.2 - BIDCO Interest Expense

The Board finds that the BIDCO interest expense incurred by the Provider is reasonable and allowable. Although the loan proceeds were commingled with other Provider operating funds, the Board finds that reasonable evidence exists in the record to support the Provider's financing of its ESOP. First, as addressed in Issue #1 above, the ESOP contribution is an allowable cost. Thus, it appropriately flows that the costs of financing this allowable cost would also be allowed. Thus, the interest expense would be allowed. Further, the Board finds that the ESOP contribution was essentially a cash payment for an operating expense (pension plan). It was not incurred for the purchase of stock as the Intermediary purports. Finally, the Board finds that HCFA Pub. 15-1 § 2150.2 (B) (3) does not apply to this situation at all.

DECISION AND ORDER:

Issue No. 1- ESOP Valuation:

The Provider's ESOP contribution is allowable up to 15% of allowable salaries. The Lefco appraisals used by the Provider to value the ESOP contributions were appropriate except for the "add on" amounts. The Intermediary's adjustments are modified.

Issue No.2 - BIDCO Interest Expense

The interest expense incurred by the Provider to finance its ESOP is allowable. The Intermediary's adjustment is reversed.

BOARD MEMBERS PARTICIPATING:

Irvin W. Kues
James G. Sleep
Henry C. Wessman, Esq.
Martin W. Hoover, Jr., Esq.
Charles R. Barker

Date of Decision: March 25, 1999

FOR THE BOARD:

Irvin W. Kues
Chairman