PROVIDER REIMBURSEMENT REVIEW BOARD
HEARING DECISION

2000-D68

PROVIDER -
Mercer Street Friends
Trenton, New Jersey

Provider No. 31-7062

vs.

INTERMEDIARY -
Blue Cross and Blue Shield Association/United Government Services

DATE OF HEARING-
August 25, 1999

Cost Reporting Period Ended -
June 30, 1996

CASE NO. 99-0286

INDEX

<u>ISSUES</u>:

1. Was the interest paid on working capital loans from the Friend Center Fund and commercial banks necessary and allowable?

2. Was interest paid to Cadwalder Properties, a related party, allowable as an ownership cost under 42 C.F.R. ' 413.153?

<u>STATEMENT OF THE CASE AND PROCEDURAL HISTORY</u>:

Mercer Street Friends (AProvider@) is a home health agency (AHHA@) located in Trenton, New Jersey. The Provider is a unit of Mercer Street Friends Center (AMSFC@), a non-profit corporation, operated and controlled by the Trenton Monthly Meeting of the Society of Friends. By the terms of its by-laws, the Board of Trustees of Mercer Street Friends must be approved by the Trenton Monthly Meeting and more than one-half of the Board must be Friends. The Quakers are recognized as a Religious Society. (<u>City of Boerne, Petitioner v. Flores</u>, 521 U.S. 507 (1997) and <u>Hamilton v. Regents of the U. of Cal</u>., 293 U.S. 245 (1934)). For the fiscal year ended June 30, 1996 (AFY 96@), the Provider had total visits of 59,232 with total costs just under $3,000,000. About 39,000 of the visits were to Medicare patients.

The Provider borrowed money from, and paid interest to, the Friends Center Fund, Inc., a non-profit corporation. As stated in Provider Exhibit 5, the purposes of the fund are:

> To provide financial and other resources to support the mission, programs, expansions, continued existence and needs other than routine operating expenses of the Mercer Street Friends Center, a community oriented, multi-service tax-exempt, charitable nonprofit corporation based in Trenton, New Jersey.

As stated in the Affidavit of Judith Trachtenberg[1], several large donations were

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1 <u>See</u> Provider Exhibit 3.

made to MSFC. There was a concern that the money would be used on routine operating expenses. Therefore, certain assets of MSFC were placed in the Friends Center Fund as an endowment fund. In the by-laws of Friends Center Fund[2], it is mentioned that upon dissolution, all funds would return to MSFC. At least one-half of the trustees must be members of the religious society of Friends.

The Provider also paid interest to Cadwalder Properties for improvements to the space it uses. As shown from the Articles of Incorporation of Cadwalder[3], the purpose of this organization was to hold title to property and collect income and turn over the entire amounts thereof to Mercer Street Friends Center. There is no provision requiring any percentage of the board to be Quakers. As in the case of the Friends Center Fund, assets of Mercer Street Friends Center were placed in Cadwalder Properties for the purpose of returning any net income to Mercer Street Friends Center. On dissolution, all assets were to return to Mercer Street Friends Center. In fact, Cadwalder was dissolved in October 1996. As stated in the bylaws, on dissolution the assets returned to Mercer Street Friends Center.

The Friends Center Fund lent money and was paid interest at or below market rate:

- by the Provider for working capital loans;
- by Cadwalder for financing improvements, including the space used by the Provider, and this interest was included as cost by the Provider; and
- to an aide division of Mercer Street Friends Center that, in turn, provided services at cost to the Provider.

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[2] <u>See</u> Provider Exhibit 6.

[3] <u>See</u> Provider Exhibit 9.

The Provider appealed the adjustments made by United Government Services ("Intermediary") to the Provider Reimbursemwnt Review Board ("Board"). The Provider=s filing meets the jurisdictional determination of 42 C.F.R. ''405.1835-.1841. The Provider was represented by John W. Jansak, Esquire, of Harriman, Jansak and Wylie. The Intermediary was represented by Bernard M. Talbert, Esquire, of Blue Cross and Blue Shield Association.

Issue No. 1- Working Capital Interest

FACTS:

In regard to Adjustments 7 & 16, a stipulation by the parties was entered into the record.

> The Intermediary and Provider agree the only issue in dispute is the extent to which the working capital loans were necessary. It is agreed the interest (though paid to a related party) meets the donor-restricted funds exception of 42 CFR ' 413.153(c)(2).

Thus, the only issue is whether the interest on loans made by the Friends Center Fund, as well as some commercial banks, by the Provider were reasonable and necessary under the Medicare regulations. The interest expense on commercial loans disallowed by the Intermediary was $42,984. The interest expense on loans from the Friends Center Fund was $70,414. These resulted in a reduction in Medicare reimbursement of approximately $74,000.

PROVIDER=S CONTENTIONS:

The Provider contends that in May 1998, it sent the Intermediary an analysis of its working capital (cash flow) needs showing why it had borrowed money from Friends Center Fund, a restricted fund endowment. The accounts receivable analysis[4], showed the cash flow needs at the beginning of July 1995 and through June 30, 1996. It clearly showed that as cash came in to the Provider, the need for borrowing went down. It is important to note that at the beginning of the period July 1, 1995, Medicare owed $101,000 for June ›95, $44,000 for FYE ›95 and $7,000 for FYE ›94. Other payors owed $425,000 for a total accounts receivable cash shortfall of $577,000. Consequently, at the beginning of FY 96 (July 1, 1995), there was a substantial accounts receivable causing a cash flow shortfall.

The Provider notes that accounts receivable increased during the year from $577,000 to $867,000 at the end of the year.[5] Thus, there was a need for additional cash flow borrowing because of the increase in the volume of business. Other payors= receivables started the year at $425,000 and ended the year at $646,000. A large part of the problem was slow payment by non-Medicare payors.[6] No rebuttal evidence was made by the Intermediary to show the Provider=s exhibits were inaccurate. There was no audit done to determine the amount of interest, how it was calculated or how it was computed.[7] Thus, the Intermediary=s case is apparently based on a hunch or surmise. In contrast, the Provider rendered an accounting analysis in May 1998[8] which the Intermediary could have audited if it was so inclined. Instead, it did not audit the books and records available.

The Provider observes that the Intermediary=s witness testified that she believed the accounts receivable should total about one month=s receivable.[9] However, she admitted there were no audit findings to rebut the findings as

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4 See Intermediary Exhibit I-A.

5 Id.

6 Transcript (ATr.@) at 47 and 48.

7 Tr. at 112, 119.

8 See Provider Exhibit 1-A.

9 Tr. at 123.

shown in Exhibit 32.[10] In addition, she agreed Medicaid was largely responsible for other third party receivables and was a slow payer.[11] Under the Medicare principles, all accounts receivable are merged into one pool. She could point to no rule that indicated this was an improper action on the part of the Provider. She did argue that bad debts were included in these accounts, and bad debts should not be included as allowable costs.[12] However, until a receivable is deemed uncollectible and approved as a write-off by the appropriate agency committee, it remains a receivable and contributes to the need for cash flow financing to run the business.

Regarding the Provider's additional cash flow needs as it relates to equipment and property necessary for the provision of services to the patient, the Intermediary argued that capital loans should be excluded from the allowable interest calculations. The Provider argues that is incorrect. HCFA Pub. 15-1 ' 202.1 states that interest is clearly allowable whether classified as current borrowing or long-term borrowing.

The Provider further argues that the Medicare methodology of payment to providers contributed to the cash shortfall because it paid for equipment and furniture based on depreciation. However, the equipment had to be paid for faster than Medicare would allow reimbursement.[13] Moreover, the Provider did not have any excess funds of its own.[14] The Provider could not simply ask for the money to be shifted over from the Friend Center Fund that it needed. It can only make an appeal to the Friend Center Fund for a loan. The Provider has no authority over whatever assets the Friend Center Fund had.[15]

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[10] Tr. at 124.

[11] Tr. at 121.

[12] Tr. at 125.

[13] Tr. at 50 and 51.

[14] Tr. at 52.

[15] Tr. at 52.

The Provider observes that the notes incurred by the Provider are paid at prime interest rate, i.e., the bank prime of New Jersey National. It is adjustable every July 1 and January 1 to the current prime. Documents as requested by the Intermediary show[16] that the financing was at the prime rate of 8.25%. The footnote[17] from the certified audited financial statements as of June 30, 1996, indicates that the interest rates were 7 1/4 - 8 1/4 % at June 30, 1996. The interest rate average was 7.4% for all loans. Clearly, no loan was above the bank prime. The bank borrowing was at prime plus .75%.

INTERMEDIARY'S CONTENTIONS:

The Intermediary contends that the adjustment was proper, and that the interest expense was not reimbursable by the Medicare Program because it was not a necessary expense in accordance with the Medicare guidelines and regulations. The audit conducted by the Intermediary revealed that the Provider=s net revenues for the period exceeded its operating expenses which resulted in excess revenues. During this same period, the Provider entered into substantial loans from two commercial bank institutions. The interest paid on these loans totaled $42,984 which was claimed by the Provider on its FY 96 cost report. The expense was found to be a non-essential cost which is not reimbursable by Medicare. Further, the use made by the Provider of the borrowed funds is not ascertainable. Therefore, whether these funds were used to pay for costs related to patient care has not been documented nor substantiated by the Provider.

The Intermediary notes that HCFA Pub 15-1 '200 et seq. sets forth the basis upon which interest expense may be found to be a reimbursable Medicare cost. This guideline specifically states that to be allowable under the Medicare program, interest must be:

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16 See Post Hearing Brief (APHB@) Exhibits B, C.

17 See Provider Exhibit B.

- Supported by evidence of an agreement that funds were borrowed, and that payment of interest and repayment of the funds are required;

- Identified in the accounting records;

- Related to the reporting period in which the costs are incurred; and

- Necessary and proper for the operation, maintenance, or acquisition of your facility.

The Intermediary submits that the loan proceeds were not necessary for the operation or maintenance of the agency. The interest expense is not reimbursable by the Medicare program. HCFA Pub 15-1 ' 202.2 sets forth the definition of the term Anecessary@as used in the above guideline. This section states:

> Necessary means that the interest be incurred on a loan made to satisfy a financial need of the provider and for a purpose reasonably related to patient care... Likewise, when borrowed funds create excess working capital, interest expense on such borrowed funds is not an allowable cost.

Id.

The term Aexcess working capital@, while not defined in this section, is, however, defined at HCFA Pub. 15-1 ' 1202.3. This section speaks to net working capital and states that working capital in excess of that needed for the necessary and proper operation of patient care activities is considered to be excessive. Therefore, the interest expense on this loan is not reimbursable by Medicare.

The Intermediary further contends that the Provider should have requested an adjustment to its Medicare Periodic Interim Payment (APIP@) to cover its cost of patient care. The Provider contends that it was required to borrow funds to cover working capital requirements. Reimbursement during this cost report period was made to the Provider on the PIP method in accordance with the regulations at 42 C.F.R. ' 413.64. Payments were made on a biweekly basis under this method. The Provider=s Medicare costs for the period totaled $3,000,000.

The Intermediary observes that the obvious question concerns the necessity for borrowing funds which cost $42,984 in interest for the period covered by the cost report. The regulations at 42 C.F.R. ' 413.64 (a) set forth the payment principles. The regulation states:

> Providers of services paid on the reasonable cost of services furnished to beneficiaries will receive interim payments approximating the actual costs of the provider. These payments will be made on the most expeditious schedule administratively feasible, but not less often than monthly. A retroactive adjustment based on actual costs will be made at the end of the reporting period.

Id.

Subsection (h)(5) further states:

> Payment will be made biweekly under the PIP method unless the provider requests a longer fixed interval (not to exceed 1 month) between payments. The payment amount will be computed by the intermediary to approximate, on the average, the cost of covered inpatient or home health services rendered by the provider.

Id.

Subsection (h)(6) states:

> A provider=s periodic interim payment amount may be appropriately adjusted at any time if the provider presents or the intermediary otherwise obtains, evidence relating to the provider=s costs or Medicare utilization that warrants such adjustment.

Id.

Based on these regulations, the Provider should have requested an adjustment to its periodic interim payment if the Medicare biweekly reimbursement did not cover the cost of service to beneficiaries. There is no evidence in the record to support such action on the part of the Provider.

The Intermediary takes the position that the working capital needs of the Provider could have been met in other ways. Therefore, there was no need to incur interest expense on the loans undertaken by the Provider. Moreover, there was a lack of documentation and explanation as to where these loans came from. Since the PIP payments are always running two weeks behind, there is a $102,000 per month shortfall. Any working capital loan should be limited to that amount for Medicare purposes. That would limit allowable interest to $13,000 based on an eight percent interest rate. The Provider=s cost report Worksheet A averaged about $350,000 per month. That results in an interest cost of $30,000. The Provider is claiming a cost of $113,000 on loans of approximately $1.1 million.[18]

Issue No. 2 - Interest Paid to Cadwalder Properties

FACTS:

Cadwalder Properties Inc. (ACadwalder@), a related party, received assets from MSFC and returned all income to MSFC. Cadwalder owned various buildings, in one of which the Provider had space. On its cost report, the Provider reported Cadwalder=s costs of ownership including interest paid to Friends

[18] Tr. at 13-16.

Center Fund. The Intermediary, however, reduced the space cost by the interest paid by Cadwalder Properties to Friends Center Fund. The amount of the adjustment was $10,994. This resulted in a reduction in Medicare reimbursement of $7,000.

PROVIDER=S CONTENTIONS:

The Provider contends that although Cadwalder is a secular tax vehicle, the reality is all its assets and profits return to a religious entity. Thus, the interest paid by the Provider to Cadwalder was to be returned to the religious entity MSFC, a part of the Trenton Monthly Meeting of the Friends Society and must be considered allowable under HCFA Pub. 15-1 ' 220. In 1996, two members of the three-member board were also on the Mercer Street Friends Center Board.[19] In fact, Cadwalder was dissolved in 1996, and all assets returned to Mercer Street Friends Center.

The Provider contends that the Intermediary=s adjustment should be reversed by the Board. The interest was on loans for funds used for improvements paid for by Cadwalder for the space used by the Provider. The interest paid by Cadwalder was allowable since both entities are controlled by the Trenton Monthly Meeting, and all funds are returned to the Trenton Monthly Meeting. Moreover, Cadwalder was set up by Mercer Street Friends and was under its control because the sole purpose for the creation of Cadwalder as a trust vehicle was to hold assets on behalf of Mercer Street Friends. Cadwalder was incorporated under ' 501 (c)(2) of the Internal Revenue Code as a non-taxable, title holding company. The interest that was disallowed by the Intermediary in this case, however, was interest related to borrowing by Cadwalder from Friends Center Fund.[20]

The Provider contends that because of the related party relationship between the Provider and Cadwalder, the rent paid to Cadwalder by the Provider must be reduced to cost. The reduction to cost was reflected in the Medicare cost report filed. However, the Intermediary disallowed interest cost paid by

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[19] See Provider Exhibit 14.

[20] See Exhibit 1-A.

Cadwalder to Friends Center Fund for loans used for renovations solely for the benefit of the Provider. Because the Friends Center Fund is stipulated to being a donor restricted fund and because Cadwalder is specifically related to the Provider, incorporated to Astand in the shoes of Mercer Street Friends@, a loan by the Friend Center Fund to Cadwalder Properties is in actuality a loan to Mercer Street Friends Center. In this regard the Intermediary did not argue that the funds were unnecessary, but that the interest was paid to a related party. In actuality, Cadwalder was created by the Mercer Street Friends which is a religious organization. Thus, Cadwalder is under total control of a religious organization, and interest it claimed should be allowed under the religious organization exception.

The Provider argues that in the alternative, following the flow of the loan transactions, the borrowing was in actuality from Friends Center Fund which is a restricted fund. Borrowing, from a restricted fund, i.e., by Mercer Street Friends through the Cadwalder conduit from Friends Center Fund, meets the exception as provided in 42 CFR ' 413.153(b)(3) and, therefore, is an allowable cost.

INTERMEDIARY=S CONTENTIONS:

The Intermediary contends that the adjustment was proper and should be upheld by the Board. The interest was not an allowable cost to a related party and was not reimbursable by the Medicare program. Although the Provider contends that the interest was paid to the governing body of a religious order, the Intermediary disagrees with its assertion for the following reasons. First, the interest paid by the Provider to the Friends Center Fund does not come within the purview of the HCFA Pub. 15- 1 ' 220. The Provider contends that the interest expense was allowable because it was paid on a loan from the governing body of a religious order and therefore falls within the related party interest expense exception set out in the above program instruction section. The governing body religious order of which the Provider speaks is known as Friends Center Fund. There is no evidence in the record to support that the fund is either an organization or any type of governing body.

The Intermediary observes that the Friends Center Fund is a fund which has as its purpose to raise money for its affiliates. It appeared to the Intermediary=s auditor to be primarily involved in fundraising activities rather than acting as the governing body of a religious order. It is not a governing body of a religious order as contemplated by the Medicare guidelines. The Board's decision in Lutheran Hospitals and Homes Society of America Group &Appeal v. Blue Cross and Blue Shield Assoc., PRRB Dec. No. 84-D 152, July 20, 1984, Medicare and Medicaid Guide (ACCH@) & 34,181 is instructive in the instant case. The Board held that the (ASociety@) was not a religious order in that case because:

> ...the Society is not a religious institution, order, or organization but a nonprofit hospital corporation governed by a 16-member board of directors, most of whom are of the Lutheran faith... The assets of the Society were not those of any church or organized religious congregation. The Society was not sponsored by any church or organized congregation. The sole purpose of the Society was to run its facilities and not to function as a religious body.

Id.

The guideline relied upon by the Provider requires that a provider be owned and operated by members of religious orders in order for interest expense to be allowable. Since the loans were made by the Friend Center Fund, a charitable organization, to the related party Provider, at no time does the fund appear to exert any dominion, ownership or control over the Provider. Moreover, the Provider is a non-profit corporation which is not owned and operated by Friends Center Fund. The Provider has been granted Federal tax exempt status for Acharitable@ purposes, not as a religious organization. No other documentation has been submitted evidencing the status as claimed by the Provider. Therefore, HCFA Pub. 15-1, ' 220 does not apply. The interest expense is not an allowable component of the related party=s costs.

The Intermediary further argues that the interest expense was incurred with respect to a loan made by a related party and is therefore not a Aproper@ cost. The Intermediary agrees that reasonable costs incurred by a related organization with respect to the furnishing of services or facilities to the provider could be an allowable cost under the Medicare program where the cost is Aproper@. HCFA Pub. 15-1, ' 1005 would control as to the inclusion of reasonable costs as stated. For instance, the facility mortgage interest expense would be allowable as would interest on a loan to maintain or renovate the facility. However, where a loan is made to the related party landlord by a related party, the interest expense on such a loan would not be allowable because the interest cost is not considered Aproper@ within the meaning of the Medicare regulations and guidelines. Finally, since the interest expense was for a loan to renovate a facility where only a part thereof was occupied by the Provider, the interest expense would not be allowed under HCFA Pub. 15-1 ' 1010 because the cost is not for facilities for the Provider, but rather for facilities shared with other tenants.

CITATION OF LAW, REGULATIONS AND PROGRAM INSTRUCTIONS:

1. Law -Internal Revenue Code:

' 501 (c)(2) - NonProfit Corporation

2. Regulations - 42 C.F.R.:

'' 405.1835-.1841 - Board Jurisdiction

' 413.17 - Costs To Related Organizations

' 413.64 - Payments to Providers: Specific Rules

' 413.64(a) - Reimbursement On A Reasonable Cost Basis

' 413.64 (h), et seq. - Periodic Interim Payment Method of Reimbursement

' 413.153 - Interest Expense

' 413.153 (b)(3) - Proper

' 413.153 (c), et seq. - Borrower - Lender Relationship

3. Program Instructions - Provider Reimbursement Manual - HCFA Pub. 15-1 ':

' 200, et seq.	-	Principle
' 202.1	-	Interest
' 202.2	-	Necessary
' 220	-	Interest Paid To A Motherhouse or Other Governing Body Of A Religious Order
' 1005	-	Determination Of A Related Organization=s Costs
' 1010	-	Exception To The Related Organization Principle
' 1202.3	-	Net Working Capital

4. Cases:

City of Boerne, Petitioner v. Flores, 521 U.S. 507 (1997)

Hamilton v. Regents of the U. Of Cal., 293 U.S. 245 (1934)

Lutheran Hospitals and Homes Society of America Group & Appeal v. Blue Cross and Blue Shield Assoc., PRRB Dec. No. 84-D 152, July 20, 1984, Medicare and Medicaid Guide ("CCH") & 34,181.

FINDINGS OF FACT, CONCLUSIONS OF LAW AND DISCUSSIONS:

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

Issue No. 1 - - Working Capital Interest

The Board finds that the Intermediary improperly denied all of the interest expense for working capital loans. Both parties admit that all payors lag in paying the Provider for services rendered. This includes private pay, Medicaid and Medicare patients. For the latter group, the Board recognizes a one-month lag in payment. Therefore, there is a legimate need to borrow working capital.

The Board notes that the Intermediary proposed allowing interest expense on one months operating expenses.[21] The Board finds this approach reasonable in light of the Provider=s operations and financial history. Thus, the Board finds working capital needs of approximately $366,000 per month and an interest rate of 8% appropriate and reasonable. Thus, $29,280 is allowed.

The Board notes that the Provider claimed $113,000 in interest expense which the Intermediary disallowed. This included $43, 000 to commercial banks and $70,000 to the Friends Center Fund. The Board finds that the $29,280 it is allowing is for working capital interest relates to the commercial lending interest. The Friends Center Fund interest is not allowed. The Board finds that the Provider and the Friends Center Fund are related parties under Medicare regulations at 42 C.F.R. ' 413.17. The parties in their joint stipulation agree that the various corporate entities and fund are related under Medicare principles. The Board finds that 42 C.F.R. ' 413.153 does not allow loans from a related party. That section does allow certain exceptions to related party interest such as interest paid on loans from donor-restricted funds and motherhouse interest. The Board finds neither of these two exceptions applicable in this case. There is no evidence to support the fact

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[21] Tr. at 136, 137

that the Friends Center Fund was a donor-restricted fund. In addition the facts do not support an exception based on a Amotherhouse@ loan. The organizations existing are not religious institutions in and of themselves. They are nonprofit care corporations, not religious orders.

Issue No.2 - Interest Paid to Cadwalder Properties

The Board finds that Cadwalder Properties Inc. and the Provider are related parties under Medicare regulations at 42 C.F.R. ' 413.17. As such the interest expense incurred by the Provider on its loan from Cadwalder is a normal intercompany transaction between related parties. However, 42 C.F.R. ' 413.153, the specific regulation dealing with interest expense, does not allow a provider to claim the cost of interest of a related party. 42 C.F.R. ' 413.153 (c)(1) specifically allows interest only to parties that are not related to lenders or organizations through ownership or control. As such the interest is denied.

The Provider wishes the Board to consider the regulatory exception (motherhouse interest) that would result in recognizing the Cadwalder interest as allowable. In examining the facts in this case, the Board concludes that Cadwalder does not meet the requirements to be a motherhouse. It is essentially a holding company which has title to various Friends: activities and collects revenues. It is not a religious institution in and of itself.

DECISION AND ORDER:

Issue No. 1 - Working Capital Interest

Working capital interest expense is allowed on one-month:s average expenses. The Intermediary:s adjustment is modified.

Issue No.2 - Interest Paid to Cadwalder Properties

The interest claimed as a related party cost on a loan from Cadwalder is not allowed. The Intermediary:s adjustment is sustained.

Board Members Participating

Irvin W. Kues
Henry C. Wessman, Esq.
Martin W. Hoover, Jr., Esq.
Charles R. Barker
Stanley J. Sokolove

FOR THE BOARD

Irvin W. Kues
Chairman