PROVIDER REIMBURSEMENT REVIEW BOARD
HEARING DECISION

ON THE RECORD
2001-D10

PROVIDER -
Southwest Texas Methodist Hospital
San Antonio, Texas

Provider No. 45-0388

vs.

INTERMEDIARY -
Blue Cross and Blue Shield Association/
TrailBlazer Health Enterprises, LLC

DATE OF HEARING-
October 4, 2000

Cost Reporting Period Ended -
September 30, 1990

CASE NO. 93-1355

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ISSUE:

Whether the Intermediary erred in determining that there was no capital related interest with respect to interest expense incurred on that portion of the 1989 bonds used to repay the Provider for assets purchased six to twelve months prior to the bond issuance?

STATEMENT OF THE CASE AND PROCEDURAL HISTORY

Southwest Texas Methodist Hospital (AProvider@) is a general, short-term hospital located in San Antonio, Texas. It began a major construction project, South Tower, during fiscal year ended September 30, 1989. Bexar County Health Facilities Development Corporation issued the Series 1989 Hospital Variable Rate Demand Revenue Bonds in March, 1989 in the amount of $45,000,000 on behalf of the Provider. The purpose of the 1989 Bonds was to finance the South Tower building and equipment and to repay operating funds for capital expenditures in prior years. As part of a previous resolution of this issue, the Intermediary re-analyzed the sources and uses of the funds provided by the 1989 Bonds and the Provider's available funded depreciation monies. It was determined that the Provider had incurred unnecessary borrowing related to the issuance of the 1989 Bonds in the amount of $1,089,189.[1] The Provider accepted the resolution of the unnecessary borrowing issue as developed by the Intermediary and a revised Notice of Program Reimbursement (ANPR@) was issued accordingly.

In addition to the unnecessary borrowing determination related to the 1989 Bonds, the Intermediary also determined $3,755,885 of the borrowing was to repay the general operating fund, and therefore, was considered as a borrowing for operating purposes versus a borrowing for capital since these equipment purchases were made six to twelve months prior to September 1, 1988. The Intermediary considered bond funds as necessary borrowing and treated the interest as a capital cost only to the extent that the funds were used to repay the Provider for capital assets purchased within six months prior to borrowing. Therefore, the Intermediary treated the interest expense on $7,519,337 of assets purchased within six months of the borrowing as capital. It treated the interest expense on the $3,755,885 of assets purchased six to twelve months before the bond issuance as an operating expense.[2] This resulted in a reduction in Medicare reimbursement of approximately $150,000 in fiscal year ended September 30, 1990 (AFY 90").

The Provider appealed this determination to the Provider Reimbursement Review Board (ABoard@). The Provider=s filing meets the jurisdictional determination of 42 C.F.R. '' 405.1835-.1841. The Provider is represented by Sanford E. Pitler, Esquire, of Bennett, Bigelow

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1 See Intermediary Exhibit 1-2.

2 See Exhibit P-18 (BCT=s revised workpaper.

and Leedom, P.S. The Intermediary is represented by Bernard M. Talbert, Esquire, of Blue Cross and Blue Shield Association.

PROVIDER=S CONTENTIONS:

The Provider contends that the Board should order the Intermediary to reimburse the Provider for capital interest expense incurred in borrowing funds to repay itself for capital assets purchased between six and twelve months of the1989 Bond issuance. The Provider also requests that the Intermediary make the related adjustments to the interest income offset and the amortization of bond interest costs. In making its determination to allow as capital only a portion of the borrowing to repay prior capital expenditures, the Intermediary unlawfully denied necessary borrowing and capital treatment to funds borrowed by the Provider to repay recent capital expenditures. In making it determination regarding this portion of the borrowing, the Intermediary ignored the criteria established by the Board in Santa Maria Hospital Cambridge, Mass. v. Blue Cross and Blue Shield Association, Blue Cross of Massachusetts, PRRB Dec. No. 91-D81, September 20, 1991, Medicare & Medicaid Guide (CCH), & 39,697 (ASanta Maria@). Under the Board's own test, borrowing to repay past expenditures is appropriate, and the interest thereon is allowable as a capital expense when certain criteria are met. These criteria are present in the Santa Maria case. The Intermediary does not dispute that. Further, the Intermediary does not dispute that it is the Provider's common practice to borrow funds to repay itself for capital acquisitions over the prior year, and that the Intermediary has allowed it. In its position paper, the Intermediary concedes that no regulation or manual provision expressly authorizes a six-month cut-off. The Intermediary has no basis to arbitrarily limit the allowability of interest to six months.

The Provider contends that it meets all the criteria necessary for the Intermediary to allow interest on all of the funds used to reimburse the Provider for prior expenditures. In Santa Maria, the Board set forth the type of documentation a provider must produce to meet the criteria for establishing that a borrowing to replenish operating funds used to acquire capital assets was, in fact, capital-related and the interest expense allowable as capital related interest. This documentation includes: (1) minutes of a meeting of a provider's board documenting the borrowing for capital acquisitions; (2) loan documents referencing the capital assets that were purchased previously out of operating funds; (3) a list created prior to the borrowing showing total capital assets previously purchased and equivalent funds to be borrowed; (4) correspondence at the time of the borrowing indicating no improper purpose for the borrowed funds; (5) financial statements and notes thereto referencing the borrowing as capital related; and (6) documents indicating that it was common practice for the provider to purchase capital assets with operating funds, then to replenish working capital funds through borrowing.

The Provider contends that the minutes of the Board of Trustees clearly document the borrowing for capital acquisitions. On January 25, 1989, the Provider's Board of Trustees met and approved $45,000,000 of borrowing.[3] As evidenced by the minutes, the Board specifically approved the use of

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[3] See Provider Exhibit P-8 (Meeting Minutes)

approximately $12,000,000 of the borrowing to reimburse past capital expenditures. The Provider had seriously depleted its operating fund to pay for necessary capital acquisitions in the year prior to the borrowing and needed to replenish its working capital. The Provider had $7,153,396 cash on hand and in bank accounts in September, 1988. By March 1, 1989, the cash balance was only $802,655.[4] On March 22, 1989 the Provider issued $45,000,000 in Variable Rate Demand Revenue Bonds.[5] As directed by the Board of Trustees, the Provider used $12,548,676 of this issuance to reimburse its general fund for operating funds used to acquire capital assets in the year prior to the borrowing. The Provider had to pay $716,900 of the funds for underwriting discounts, bank financing fees and other costs associated with the issuance of the bonds. The remainder $31,734,424 was allocated for construction of the "South Tower". The Board of Trustees specifically directed that the borrowing be used for prior capital acquisitions.

The Provider contends that the loan documents expressly reference the previously purchased capital assets. Subsequent to the Board of Trustees' meeting, the Provider and National Australia Bank Limited, the lender, executed a letter of credit reimbursement agreement relating to the Bonds.[6] Pursuant to the letter of credit, on March 22, 1989, the Provider executed Requisition Certificate #1 to The First National Bank of San Antonio and National Australia Bank Limited to draw $12,964,470 of 1989 bond funds.[7] The Certificate expressly references the capital assets previously purchased out of operating funds. As stated in Schedule A to the Certificate, the purpose of $12,548,676 of the draw was to reimburse the Provider for capital expenditures incurred in the year prior to the date of the Certificate. Itemizations of those capital expenditures are attached to Schedule A.

The Provider notes that it has correspondence establishing the purpose of the borrowing. Requisition Certificate #1 clearly identifies the purpose of the borrowing, and that it was for capital and other proper purposes.[8] The financial statements reference the borrowing as capital-related. In its audited financial statement for FY 90, on page 13, the Provider clearly describes the purpose of the 1989 borrowing as "constructing and equipping the new South Tower, and <u>reimbursing</u> <u>the Hospital for certain previous capital expenditures</u>." (Emphasis added.)[9] Further, the Provider's documents establish its common practice of purchasing capital assets with operating funds and then replenishing working

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[4] <u>See</u> Provider Exhibit P-13 (Cash Summary Chart).

[5] <u>See</u> Provider Exhibit P-10 and P-11.

[6] <u>See</u> Provider Exhibit P-9 (Letter of Credit dated as of March 1, 1989).

[7] <u>See</u> Provider Exhibit P-11.

[8] <u>See</u> Provider Exhibit P-11.

[9] <u>See</u> Provider Exhibit P-l4, p.13.

capital funds through borrowing. Evidence of this common practice exists in the Provider's documents relating to 1984, 1985 and 1991 bond issuances. For example, the Officer's Certificate requesting disbursement of the 1985 bond funds indicate that the borrowing was used to reimburse the Provider for the prior years' capital expenses.[10] Further, the Intermediary has historically allowed this common practice.[11]

The Provider points out that other Board cases finding that the criteria in Santa Maria are not met, are distinguishable from this case. For example, in Riverside Hospital (Toledo, Ohio) v. Blue Cross and Blue Shield Association Community Mutual Blue Cross and Blue Shield, PRRB Dec. No. 94-D17, March 11, 1992, Medicare & Medicaid Guide (CCH), **&** 42,220 (ARiverside@), the Board held that the provider's borrowing to refinance purchases out of operating funds was not capital-related. In Riverside, however, the provider did not present documentation like that present in this case concerning the purpose of the repayment. Here, the Provider has overwhelming documentation that the provider and its lenders recognized that a chief purpose of the borrowing was to repay past capital purchases. Moreover, in Riverside, the Board was influenced by the provider's very weak working capital position, which to the Board, demonstrated the need to borrow for current operating funds.

The Provider notes that in Wuesthoff Memorial Hospital (Rockledge, FL). v. Blue Cross and Blue Shield Association/Blue Cross and Blue Shield of Florida, PRRB Dec. No. 96-D30, May 9, 1996, Medicare & Medicaid Guide (CCH), **&** 44,189, and in Little Company of Mary Hospital v. Blue Cross and Blue Shield Association/Blue Cross and Blue Shield of Illinois, PRRB Dec. 98-D1, October 21, 1997, Medicare & Medicaid Guide (CCH), **&** 45,739, aff=d by HCFA Administrator, Dec. 22, 1997, Medicare & Medicaid Guide (CCH), **&** 46,053, the Board held and the Administrator affirmed that the providers in those cases did not present sufficient documentation of the purpose of their borrowings to refinance prior capital expenditures. Here, the Intermediary does not claim that the documentation is not sufficient. Further, the Intermediary acted arbitrarily and capriciously in imposing a 6-month limit. An intermediary acts arbitrarily and capriciously if it applies a rule that is unsupported by regulations and manual provisions and conflicts with reasonable practice. See e.g., McCurry's Home Health v. Blue Cross Blue Shield. Association, PRRB Decision No. 98-D38, April 3, 1998, Medicare & Medicaid Guide (CCH), **&** 46,222 (AMcCurry=s @). In McCurry's, the intermediary disallowed an allowable educational seminar expense only because the seminar took place on a cruise ship. The provider pointed out that no regulation specifically limits allowable educational workshops or prohibits seminars held on cruise ships. The provider claimed that the intermediary's reliance on the location of the seminar to disallow cost was without foundation. The Board ruled for the provider, finding that the expense was not precluded by regulation, that the costs were reasonable, and that such educational expenses were common practice. Here, as in McCurry=s the Intermediary in this case has provided no pertinent

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[10] See, e.g., Provider Exhibit P-15.

[11] Id.

authority for limiting allowability of this borrowing based on date. It randomly arrived at a six-month cut-off which has no basis in fact or law. The Intermediary admitted that it has no legal basis to apply a six-month limitation. In response to the Provider's discovery request in Southwest Texas Methodist Hospital, PRRB No. 95-0154, FYE 9/30/91, a case addressing the same issue addressed here, the Intermediary wrote that it:

> [k]now[s] of no specific regulations or manual references which address treating equipment purchases six month[s] prior to the issuance of bonds as capital related versus operating expense, we believe our application of this methodology to be a reasonable interpretation of 42 C.F.R. ' 413.153 and HCFA Pub. 15-1, Section 202.

April 27, 1998 letter from Ms. Kathy Prickett, Blue Cross and Blue Shield of Texas, Inc. to Thomas L. Weinberg.[12]

The Provider notes that the regulation cited by the Intermediary does not directly or indirectly support its six-month rule. Regulation 42 C.F.R. ' 413.153 requires that costs be "necessary" and "proper." Costs do not automatically become unnecessary and improper within six months. The Intermediary seeks to arbitrarily cut off capital treatment at six months for no logical reason. In addition to being arbitrary, the six-month cut-off conflicts with the Board's guidelines as set forth in Santa Maria.

The Provider observes that the Intermediary seeks to rationalize its six-month rule, but none of the Intermediary's stated reasons make sense. The Intermediary claims its six-month rule was based on discussions with other providers. The Intermediary does not explain how the circumstances of other providers apply to this case. Further, the Intermediary does not dispute that the borrowed funds used to repay the Provider for assets purchased within the six months prior to the borrowing should be treated as capital. The Intermediary presents no pertinent facts to support cutting off capital treatment at six months. The Intermediary also claims that it generally takes providers six months to issue bonds. Again, the Intermediary presents irrelevant arguments. It is undisputed that the Provider issued a bond to reimburse itself for capital assets purchased over the prior twelve months. The Provider produced supporting documentation as required by the Board in Santa Maria, clearly establishing that the $12,548,676 was borrowed to replenish working funds used for capital expenditures incurred in the year prior to the borrowing. The Intermediary does not dispute those pertinent facts. The length of time to issue bonds has no significance. Finally, the Intermediary states that the Provider had over $10,000,000 in its operating fund at the end of fiscal period 1988, and, therefore, did not need to borrow funds. The Intermediary makes this argument after already deeming the borrowing as necessary. In any event, the Intermediary does not dispute that the Provider spent the $10,000,00 to purchase capital assets, and that the expenditure decreased the Provider's funded depreciation by that amount. It

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12 See Provider Exhibit P-16.

does not matter that the funds used to purchase the capital assets had at one time been in the operating fund. The Intermediary's point is irrelevant.

INTERMEDIARY=S CONTENTIONS:

The Intermediary contends that it developed the six-month period based on discussions with other providers with the same issue. Originally the Intermediary treated this type of borrowing as not being supported by a financial need. After additional review, and in order to administratively resolve the issue, the Intermediary agreed with the providers who presented the argument that capital expenditures made in the six months prior to the issuance of bonds would have been considered as part of the total amount to be borrowed. This approach was based on the time period it generally took these providers to determine that bonds should be issued, and the actual issuance date for the bonds. While no Medicare regulation or manual instruction specifically addresses this issue, the Intermediary applies this six month time period as a reasonable interpretation of 42 C.F.R. ' 413.153 and the determination of necessary interest. The reimbursement of operating funds for expenditures prior to six months before the issuance of debt would be considered as a working capital borrowing. However, in a case where it is obvious the Provider had sufficient working capital funds at the time of the borrowing, the total borrowing to reimburse operating funds should be considered as an unnecessary borrowing since the provider would not have shown a financial need for working capital. This point is illustrated on the Provider's 1988 audited financial statement cash flow analysis.[13] It is noted that the Provider had sufficient funds to pay $10,964,555 for property, plant and equipment purchased during that fiscal year (which encompasses the six-month time period in dispute) without suffering a negative cash flow. This affirms the Intermediary's contention that there was no financial need to borrow additional monies to repay operating funds for purchases made six to twelve months prior to the borrowing. Additionally, the Provider has not identified the equipment items, which were purchased a year or six-months prior to the issuance of the 1989 bonds for which repayment of the general fund was warranted. Adequate documentation to support this equipment is necessary in order for the Intermediary to ascertain whether or not these items are related to patient care.

CITATION OF LAW, REGULATIONS AND PROGRAM INSTRUCTIONS:

Regulation - 42 C.F.R.:

'' 405.1835-.1851 - Board Jurisdiction

' 413.153 - Interest Expense

Cases

[13] See Intermediary Exhibit 1-3.

Santa Maria Hospital Cambridge, Mass. v. Blue Cross and Blue Shield Association, Blue Cross of Massachusetts, PRRB Dec. No. 91-D81, September 20, 1991, Medicare & Medicaid Guide (CCH), & 39,697.

Riverside Hospital (Toledo, Ohio) v. Blue Cross and Blue Shield Association Community Mutual Blue Cross and Blue Shield, PRRB Dec. No. 94-D17, March 11, 1992, Medicare & Medicaid Guide (CCH), & 42,220.

Wuesthoff Memorial Hospital (Rockledge, FL) v. Blue Cross and Blue Shield Association/ Blue Cross and Blue Shield of Florida, PRRB Dec. No. 96-D30, May 9, 1996, Medicare & Medicaid Guide (CCH) & 44,189.

Little Company of Mary Hospital v. Blue Cross and Blue Shield Association/Blue Cross and Blue Shield of Illinois, PRRB Dec. 98-D1, October 21, 1997, Medicare & Medicaid Guide (CCH), &45,739, aff=d by HCFA Administrator, Dec. 22, 1997, Medicare & Medicaid Guide (CCH), & 46,053.

McCurry=s Home Health v. Blue Cross Blue Shield Association, PRRB Decision 98-D38, April 3, 1998, Medicare & Medicaid Guide (CCH) &46,222.

FINDINGS OF FACT, CONCLUSIONS OF LAW AND DISCUSSION:

The majority of the Board, after considering the law, regulations, program instructions, facts, parties contentions and evidence submitted finds and concludes that the Intermediary=s disallowance of capital interest expense on capital purchases six to twelve months prior to the borrowing was reasonable. The Intermediary did not permit this allowance based on regulations or program instructions. It based the disallowance on general intermediary practices. The majority finds that the Provider=s variable rate demand revenue bonds were issued in March 1989. The primary purpose of the bonds were to finance the South Tower Building. The majority also finds that according to its financial statement the Provider had over $24 million in its funded depreciation account (AFDA@) as of the date of borrowing. The Intermediary=s calculation of funded depreciation as of the date of borrowing was $10,519,000.[14] The Intermediary did allow interest on the above borrowing that related to capital purchases made from operations up to six months prior to the borrowing.

Based on the above, the majority of the Board finds that what the Intermediary did was reasonable. The six month Acutoff@ by the Intermediary appears reasonable in light of the facts. It is reasonable to assume that assets related to the financing could have been purchased with operating funds up to six

[14] See Provider Exhibit 18.

months before the borrowing occurred. This often happens because the financing process can take a considerable amount of time to take place. In the meantime, various capital purchases are necessary to complete the project related to the borrowing.

The majority of the Board considered giving relief to the Provider. The six month period limit appears arbitrary. However, there is no authoritative source to allow such relief. There is nothing in Medicare regulations or program instructions to support such relief. Further, based on the record, the Board majority finds that approximately $14 million of funded depreciation available as of the date of the borrowing that the Provider has not accounted for. The $14 million represents the difference between the financial statement balance sheet amount of $24 million and the $10 million accounted for by the Intermediary in its analysis of the project. If the $14 million were available, it should have been used to purchase assets. Financing for such assets were inappropriate when funded depreciation funds were available. Thus, based on the above, the Board majority concludes that the interest on borrowing related to assets purchased six to twelve months before the bond issuance is unnecessary and is disallowed.

DECISION AND ORDER:

The interest expense on borrowings related to assets purchased six to twelve months before the bond issuance is not allowable. The Intermediary=s adjustment is affirmed.

BOARD MEMBERS PARTICIPATING

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

Date of Decision: January 25, 2001

For The Board:

Irvin W. Kues
Chairman

Dissenting Opinion of Henry C. Wessman

I dissent.

I take note of the fact that this Hearing, and the resultant Decision, was AOn-The-Record@. By definition, the Board can use only the Position Papers and attached Exhibits as presented by each party prior to the Hearing date.

The documentation, as presented to the PRRB, clearly demonstrates that the Provider had ample Afunded depreciation@ (Provider Exhibit P-13, unnumbered page 3) at the time it borrowed funds ostensibly for capital expenditure, but apparently for replenishment of operating capital. In my humble opinion, such borrowing does not meet the definition of Anecessary borrowing@ as detailed in 42 C.F.R. ' 413.153, and is thus not a Medicare-allowable expense. The Board, restricted to the information on-the-record, can not conclude otherwise.

The issue of a Asix month@ allowable interest-deduct time frame, as espoused by the Intermediary, is, at best, arbitrary. There is no supporting statute, regulation, nor rule that would lend credence to this red herring. Based on the record as presented to us, and bolstered by 42 C.F.R. ' 413.24(2)(c), I would modify the Intermediary=s determination to deny any and all interest expense relating to the 1989 Bond float for the Fiscal Year in question, based upon the apparent adequacy of the Provider=s Afunded depreciation@ to cover the purchases, and the lack of Provider documentation presented to indicate otherwise.

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Henry C. Wessman, Esq.