PROVIDER REIMBURSEMENT REVIEW BOARD DECISION

2007-D42

PROVIDER -
Carolina Medicorp '97 Claimed Loss Disallowance Group

Provider Nos.: See Appendix I

vs.

INTERMEDIARY -
BlueCross BlueShield Association/ Cahaba Safeguard Administrators, LLC

DATE OF HEARING -
May 26-27, 2004

Cost Reporting Period Ended -
June 30, 1997

CASE NO: 00-1862G

INDEX

ISSUE:

Whether the Intermediary's adjustments disallowing the loss claimed by Medicare Providers on the disposition of assets resulting from the statutory merger of Carolina Medicorp into Presbyterian Health Services Corporation were proper.

MEDICARE STATUTORY AND REGULATORY BACKGROUND:

This is a dispute over the amount of Medicare reimbursement due a health care provider.

The Medicare program provides health insurance to the aged and disabled. 42 U.S.C. §§1395-1395cc. The Centers for Medicare & Medicaid Services (CMS), formerly the Health Care Financing Administration (HCFA), is the operating component of the Department of Health and Human Services (DHHS) charged with the program's administration. CMS' payment and audit functions under the Medicare program are contracted out to insurance companies known as fiscal intermediaries. Fiscal intermediaries determine payment amounts due providers under Medicare law and interpretative guidelines published by CMS. See, 42 U.S.C. §1395h, 42 C.F.R. §§413.20(b) and 413.24(b).

At the close of its fiscal year, a provider must submit a cost report to the fiscal intermediary showing the costs it incurred during the fiscal year and the portion of those costs to be allocated to Medicare. 42 C.F.R. §413.20. The fiscal intermediary reviews the cost report, determines the total amount of Medicare reimbursement due the provider, and issues the provider a Notice of Program Reimbursement (NPR). 42 C.F.R. §405.1803. A provider dissatisfied with the intermediary's final determination of total reimbursement may file an appeal with the Provider Reimbursement Review Board (Board) within 180 days of the NPR. 42 U.S.C. §1395oo; 42 C.F.R. §405.1835.

Medicare reimbursement is governed by 42 U.S.C §1395x(v)(1)(A) of the Social Security Act. In part, the statute provides that the "reasonable cost" of any service shall be the actual cost incurred but excluding any part of such costs found to be unnecessary in the efficient delivery of needed health services. The implementing regulation at 42 C.F.R §413.9 provides that reasonable cost includes all "necessary and proper" costs incurred in furnishing healthcare services.

Under the Medicare statute, a provider is entitled to claim as a reimbursable cost the depreciation (i.e., the loss of value over time) of property, plant and equipment used to provide health care to Medicare patients. An asset's depreciable value is set initially at its "historical cost," generally equal to the purchase price. 42 C.F.R. §413.134(a)(2)(b)(1). To determine annual depreciation, the historical cost is prorated over the asset's estimated useful life in accordance with one of several methods. 42 C.F.R. §413.134(a)(3). Providers are then reimbursed on an annual basis for a percentage of the yearly depreciation equal to the percentage of the asset used for the care of Medicare patients.

The calculated annual depreciation is only an estimate of the asset's declining value. If an

asset is ultimately sold by the provider for less than the depreciated basis calculated under Medicare (equivalent to the "net book value" and equal to the historical cost minus the depreciation previously paid, see 42 C.F.R. §413.134(b)(9)), then a "loss" has occurred, since the sales price was less than the estimated remaining value. In that event, the Secretary of DHHS (Secretary) assumes that more depreciation has occurred than was originally estimated and, accordingly, provides additional reimbursement to the provider. Conversely, if the asset is sold for more than its depreciated basis, then a "gain" has occurred, and the Secretary takes back or "recaptures" previously paid reimbursement. 42 C.F.R. §413.134(f)(1).

Where a provider sells several assets for a lump sum sales price, the regulation at 42 C.F.R. §413.134(f)(2)(iv) requires the determination of the gain or loss (depreciation adjustment) for each depreciable asset by allocating the lump sum sales price among all of the assets sold in accordance with the fair market value of each asset as it was used by the provider at the time of sale. An appropriate part of the purchase price is allocated to "all of the assets sold" regardless of whether they are depreciable (and thus Medicare-reimbursable) or non-depreciable. The allocation of the lump sum sales price to non-depreciable assets results in a smaller amount being allocated to the Medicare - reimbursable assets and, thus, a higher loss.

The regulation providing for gains or losses originally dealt with the disposition of assets through sale, scrapping, trade-in, exchange, donation, demolition, abandonment, condemnation, fire, theft or other casualty. In 1979 CMS extended the depreciation adjustment to "complex financial transactions" not previously addressed in subsection 42 C.F.R. § 413.134(f) by including mergers and consolidations. A statutory merger between unrelated parties was treated as a disposition of assets that would trigger: (1) the revaluation of assets in accordance with 42 C.F.R. §413.134(g), and (2) the realization of gains and losses under the provisions of 42 C.F.R. §413.134(f). However, a statutory merger between related parties would not trigger a gain or loss computation. Likewise, a consolidation between two or more corporations that were unrelated resulted in a depreciation adjustment. No revaluation was allowed if related corporations consolidated. 42 C.F.R. §413.134(l)(3).

STATEMENT OF THE CASE AND PROCEDURAL HISTORY:

Forsyth Memorial Hospital, Medical Park Hospital, Carolina Medical Enterprises (d/b/a The Oaks at Forsyth) and Edwin H. Martin Comprehensive Outpatient Rehabilitation Center (Providers) were all non-profit Medicare certified facilities that were components of a chain organization. Carolina Medicorp, Inc. was the home office for the chain organization and owned the buildings, land, and fixed equipment which it furnished for the Providers' use under written lease agreements. On June 30, 1997 Carolina Medicorp, Inc. merged into Presbyterian Health Services Corporation (Presbyterian), which then became Novant Health, Inc. Prior to the merger, both home offices operated as non-profit corporations with separate boards. There is no dispute that the transaction was a merger under North Carolina law; that Carolina Medicorp ceased to exist; that Presbyterian assumed Carolina Medicorp's liabilities; and that Presbyterian obtained all

of Carolina Medicorp's assets. Legal title to the assets previously owned by Carolina Medicorp was transferred to Presbyterian, as were Carolina Medicorp's leases with the Providers. Control of the Providers passed to Novant, but the Providers remained intact and there was no change in the ownership of their assets. Control over Carolina Medicorp's assets passed to Novant which was then controlled by its own governing board. Providers claimed a loss on the transaction related to land improvements, buildings and fixed equipment owned by Carolina Medicorp. Because the leased assets were owned by a related party, the Providers had received Medicare depreciation reimbursement under Medicare related party principles.[1] The Providers did not claim losses on the movable equipment that they owned individually because the ownership of these assets did not change. In October 1997 the North Carolina Department of Health and Human Services (NCDHHS) determined that the individual Providers had not undergone a change in ownership (CHOW) due to the merger of Carolina Medicorp, Inc. into Presbyterian to form Novant.[2] The NCDHHS also noted that each of the Providers maintained its same Medicare number after the transaction and filed its individual cost report under its respective provider number. Based upon the NCDHHS determination, the Intermediary denied the Providers' claims for losses on the transaction that related to land improvements, buildings and fixed equipment.

The Providers appealed the Intermediary's disallowances to the Board and met the jurisdictional requirements of 42 C.F.R. §§405.1835-405.1841. The estimated amount of Medicare reimbursement in controversy is $11,069,753.[3]

The Providers were represented by Robert E. Mazer, Esquire, of Ober, Kaler, Grimes & Shriver. The Intermediary was representated by Bernard M. Talbert, Esquire, Associate Counsel, Blue Cross Blue Shield Association.

BACKGROUND OF THE MERGER:

Carolina Medicorp was created in 1993 to receive title to the assets of Forsyth Memorial Hospital as a part of the hospital's conversion of ownership to a private non-profit entity. Prior to that time, Forsyth County owned the hospital's assets. As a part of the conversion, the Forsyth County Board of Commissioners (Commissioners) retained ultimate control over the Forsyth Memorial Hospital facility and, as a condition of the transaction, appointed 12 of the Carolina Medicorp's 19-member board of trustees. The deed transferring the hospital's assets from Forsyth County to Carolina Medicorp included restrictions on their use that required that the property be maintained as a community general hospital open to the public, that Carolina Medicorp supply services to county residents regardless of their ability to pay, and that Carolina Medicorp not encumber the property with a mortgage or deed of trust without the County's approval. If Carolina Medicorp failed to meet these conditions, ownership in the assets would revert to Forsyth County.

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[1] 42 C.F.R. §413.17.
[2] See, Provider's Final Position Paper and Exhibits. Exhibit P-11, pg. 2.
[3] Provider's Post-Hearing Brief at p.5.

Carolina Medicorp subsequently acquired Medical Park Hospital, developed The Oaks at Forsyth and created the Edwin H. Martin Comprehensive Outpatient Rehabilitation Center, so that by the mid 1990's it was the parent of a number of subsidiaries that comprised an integrated health system. Carolina Medicorp owned the land, buildings and fixed equipment that was used by each Provider in the provision of patient care services pursuant to a lease arrangement. However, movable equipment and other assets, such as supplies and inventory, were separately owned by each provider. Carolina Medicorp and each of the Providers were subject to the control of the Commissioners.

The Medicare program considered Carolina Medicorp and the entities under its control a "chain organization" for which Carolina Medicorp was the "home office." For Medicare reimbursement purposes the Intermediary therefore applied the related organization principles at 42 C.F.R. §413.17. It reimbursed each Provider for claimed ownership costs incurred by Carolina Medicorp related to the assets used by the particular Provider to furnish patient care services, including depreciation on buildings, land improvements and fixed equipment owned by Carolina Medicorp

Prior to the merger, Presbyterian served as the parent corporation for a health care delivery system that included the Presbyterian Hospital, Presbyterian Medical Care Corporation, a specialty hospital and a long-term care facility.

In 1996 Presbyterian and Carolina Medicorp began negotiations to merge the two health systems, and both parties agreed that a merger was in the best interest of their respective organizations. However, Presbyterian would not entertain an arrangement under which the Commissioners would hold substantial control over the system. Since the Commissioners held control over Carolina Medicorp, their consent was required to approve any transaction that diminished or relinquished their control. The Commissioners gave their approval conditioned upon the agreement that the Commissioners be allowed to select one member of the newly merged entity's governing board from among its own members. Additionally, the Commissioners retained the right to approve a majority of the governing board of Forsyth Memorial Hospital which, in turn, would be required to continue to abide by the restrictions that had been initially imposed when Carolina Medicorp was established. Also, at the suggestion of the Commissioners, Carolina Medicorp agreed to contribute $10 million for the Commissioners' use to enhance health care in the county.

PARTIES' CONTENTIONS:

The Intermediary argues that the merger did not produce a change of ownership among the Providers for Medicare certification or reimbursement purposes. The NCDHHS conducted the initial development of the facts for Medicare certification of the merged entities. The NCDHHS considered the transaction to have been a merger of the two home office corporations that did not affect the operation of the Providers and, therefore, it did not constitute a change of ownership for these Providers. Based upon the Commitment Agreements entered into by Carolina Medicorp,[4] the Intermediary contends

[4] See, Provider Exhibits P-77, P-78 and P-79.

that the subject merger is a related party transaction pursuant to 42 C.F.R. §413.17. The Intermediary argues that Carolina Medicorp had negotiated sufficient continuity through Presbyterian into Novant (including a right to participate on Novant's governing board and a continuing reversionary interest in the assets of Forsyth Memorial Hospital to Forsyth County) to preclude any characterization of the transaction as a bargained for exchange of assets for consideration.[5] Accordingly, the Intermediary contends that any change of ownership rights of the hospital's depreciable assets was between related parties. 42 C.F.R. §413.134 precludes providers from claiming losses upon mergers of related parties, and the Intermediary concludes that no losses may be claimed in this transaction.

The Intermediary also contends that the loss claimed by the Provider is not allowable for program reimbursement because the merger with Presbyterian was not a bona fide sale. The Intermediary explains that pursuant to 42 C.F.R. §413.134(l)(2)(i), mergers between two or more unrelated corporations, where a merged corporation is a provider, are subject to the provisions of 42 C.F.R. §413.134(f). This rule, entitled Gains and losses on disposal of assets, addresses different ways in which a gain or loss determination may be generated from the disposal of assets. The Intermediary asserts that the "way" applicable to a merger is via a "bona fide" sale. Moreover, the Intermediary argues that the subject merger was not a bona fide sale, as the Providers did not put their assets into the open marketplace to see what they were worth, and there was no good faith, arms-length bargaining between the parties to establish the fair market value of the Providers' assets to evaluate the adequacy of the consideration given.[6]

The Providers contend that pursuant to 42 C.F.R. §413.134(l)(2)(i), a statutory merger between unrelated corporations occurs if the parties are unrelated prior to the transaction, as in the instant case. The Provider asserts its position is supported by section 4502.6 of Medicare's Part A Intermediary Manual (HCFA Pub. 13-4). In part, the manual provides an example of merging entities, unrelated through common ownership or control prior to the merger, that results in a gain or loss calculation to the seller.

The Providers contend that even if the Intermediary's continuity of control argument were valid (i.e., the Intermediary's reliance upon HCFA Pub. 15-1 §1004.1), it does not exist in the instant case. According to 42 C.F.R. §413.17(b), related party principles apply where there is "common ownership or control," and "control" exists where an individual or organization has the power to significantly influence or direct the actions or policies of an organization or institution. Here, no single individual or organization previously associated with the Providers has any significant power to influence the operations of Novant.

The Providers also disagree with the Intermediary's argument that the merger does not meet the requirements of a bona fide sale because reasonable compensation was not given for the Providers' assets. The Providers argue that the transaction was a statutory

[5] See Intermediary's Post-Hearing Summary at 11.
[6] 42 C.F.R. §413.134(b)(2).

merger under state law and was not a purchase of assets. The Intermediary relies upon 42 C.F.R. §413.134(l)(2)(i), which subjects mergers involving providers to the requirements of 42 C.F.R. §413.134(f). However, there is nothing in section (f) that requires mergers to specifically comply with section (f)(2) regarding bona fide sales.

FINDINGS OF FACT, CONCLUSIONS OF LAW AND DISCUSSION:

After consideration of the Medicare law and guidelines, the parties' contentions and the evidence presented, the Board finds and concludes that the Providers and Presbyterian were unrelated parties as that term is defined and applied under the regulatory provisions of 42 C.F.R. §413.17 and 42 C.F.R. §413.134. Accordingly, a revaluation of assets and recognition of the loss incurred as a result of the merger is required under the specific and plain meaning of 42 C.F.R. §413.134(l)(2)(i).

The parties agree that the transaction at issue was a statutory merger under North Carolina law, and that 42 C.F.R. §413.134, entitled Depreciation: Allowance for depreciation based on asset costs, is applicable. Section 413.134(l)(2) defines a statutory merger as "a combination of two or more corporations under the corporation laws of the State, with one of the corporations surviving." It is undisputed that in June of 1996, Carolina Medicorp merged into Presbyterian Health Services Corporation (Presbyterian), which then became known as Novant Health, Inc., with the Carolina Medicorp entity ceasing to exist. Under the terms of the transaction, Presbyterian acquired all of the assets and assumed all of the liabilities associated with the operations of Carolina Medicorp.

The Medicare regulation at 42 C.F.R. §413.134(l)(2) provides for the reimbursement effect of a statutory merger as follows:

> (i) *Statutory merger between unrelated parties*. If the statutory merger is between two or more corporations that are unrelated (as specified in §413.17), the assets of the merged corporation(s) acquired by the surviving corporation may be revalued in accordance with paragraph (g) of this section. If the merged corporation was a provider before the merger, then it is subject to the provisions of paragraphs (d)(3) and (f) of this section concerning recovery of accelerated depreciation and realization of gains and losses . . . .
>
> (ii) *Statutory merger between related parties*. If the statutory merger is between two or more related corporations (as specified in §413.17), no revaluation of assets is permitted for those assets acquired by the surviving corporation.

Accordingly, the initial question to be decided by the Board is whether the subject merger was between related or unrelated parties. While it is undisputed that the Providers and Presbyterian were unrelated prior to the merger, the Intermediary argues that the phrase

"between related parties" requires that the merger transaction be examined for relationships after the transaction as well. The Intermediary refers to the related party regulation at 42 C.F.R. §413.17, which states in pertinent part:

> (b) *Definitions.* (1) *Related to the provider*. Related to the provider means that the provider to a significant extent is associated or affiliated with or has control of or is controlled by the organization furnishing the services, facilities, or supplies.
>
> (2) *Common Ownership*. Common ownership exists if an individual or individuals possess significant ownership or equity in the provider and the institution or organization serving the provider.
>
> (3) *Control*. Control exists if an individual or an organization has the power, directly or indirectly, significantly to influence or direct the actions or policies of an organization or institution.

In particular, the Intermediary relies on the tests for common ownership or control that are provided in HCFA Pub. 15-1 §1004.1. The section states, in pertinent part:

> A determination as to whether an individual (or individuals) or organization possesses significant ownership or equity in the provider organization and the supplying organization, so as to consider the organizations related by common ownership, will be made on the basis of the facts and circumstances in each case. This rule applies whether the provider organization or supplying organization is a sole proprietorship, partnership, corporation, trust or estate, or any other form of business organization, propriety or nonprofit. In the case of a nonprofit organization, ownership or equity interest will be determined by reference to the interest in the assets of the organization (e.g., a reversionary interest provided for in the articles of incorporation of a nonprofit organization).

The Intermediary asserts that such reversionary interest exists in the Articles of Incorporation of Novant and, therefore, there is a "continuity of ownership" that results in the parties being related. The Intermediary contends that this relationship between the old and new entities disqualifies the merger transaction from a revaluation of assets. In support of its position, the Intermediary cites section 1011.1 of Medicare's Provider Reimbursement Manual, Part I (HCFA Pub. 15-1), which states:

> [i]f a provider and a supplying organization are not related before the execution of a contract, but common ownership or control is created at the time of execution by any means, the supply contract will be treated as having been made between related organizations.

The Board finds the plain language of the merger regulation dispositive of the Intermediary's argument. The meaning of the text at 42 C.F.R. §413.134(l)(2)(i) which states: "[i]f the statutory merger is between two or more corporations that are unrelated . . . ." is crystal clear - the related party concept will be applied to the entities that are merging as they existed prior to the transaction.

The Board, therefore, concludes that the plain language of the regulation bars the application of the related party principle to the merging parties' relationship to the surviving entity. The construction of the regulation mandates a determination that only the relationship of the parties participating in the merger before it was completed is relevant to whether the assets would be revalued and a gain or loss recognized. The Board's conclusion is further buttressed by the Secretary's interpretive guidelines published in section 4502.6 of Medicare's Intermediary Manual (HCFA Pub. 13-4), which states in part: "Medicare program policy permits a revaluation of assets acquired in a statutory merger between unrelated parties, when the surviving corporation is a provider."

The Board finds that the transaction that resulted in the merger of Carolina Medicorp into Presbyterian was a bona fide transaction under North Carolina corporation law. The completed transaction merged one independent chain organization (Carolina Medicorp) into another such entity (Presbyterian), with the merged entity ceasing to exist. Contrary to the Intermediary's "continuity of control" assertions, the Board finds that such an interpretation of the related party regulation is not only inconsistent with the regulation governing statutory mergers, but it also flies in the face of reality with respect to corporate mergers. The very nature of a statutory merger being a combination of entities would likely result in some overlap of membership on the boards of trustees of the merging corporations and the surviving entity, as well as a continuation of other operations and personnel of the merging organizations. The fact that this occurs does not disqualify a statutory merger from revaluation of assets and recognition of any gain or loss under 42 C.F.R §413.134(l).

With respect to the Intermediary's argument that the relationship between Carolina Medicorp and Novant does not meet the traditional test of "bona fide" and "arm's-length" bargaining, the Board finds that the application of such criteria also fails to consider the distinctive features of a statutory merger transaction. By definition, Novant Health, Inc., (formerly known as Presbyterian Health Services Corporation) is nothing more than a combination of Presbyterian with Carolina Medicorp. That concept simply forecloses the type of bargaining between the pre- and post-transaction entities the Intermediary contends is necessary. Requiring "bargaining" between the merging and surviving entity to be "arm's-length" would effectively nullify the regulation's directive to permit revaluation of assets and recognition of gains or losses where unrelated parties merge. The Intermediary's imposition of additional requirements is not supported by the plain meaning of the statutory merger regulation and the Agency's own previous interpretation set forth in the manual instructions and informal written advice.

The Board also finds that the Providers ultimately agreed that the loss calculation should be based upon the proportionate share methodology prescribed by 42 C.F.R. §413.134(f)(2)(iv). Pursuant to this methodology, the consideration at issue is allocated among all the assets acquired based upon the relationship of each individual asset's fair market value to the total fair market value of all of the assets in aggregate.

DECISION AND ORDER:

The Intermediary's adjustment disallowing the Providers' claimed losses on disposal of assets due to a change of ownership resulting from a statutory merger was contrary to the regulatory requirements of 42 C.F.R. §413.134(l)(2)(i) and is reversed. The matter is hereby remanded to the Intermediary for the proper calculation of the loss pursuant to the governing regulations. In addition, Intermediary is instructed to ensure that all intercompany transactions are eliminated and that no consideration be allocated to land, a non-depreciable asset.

BOARD MEMBERS PARTICIPATING:

Suzanne Cochran, Esq.
Gary B. Blodgett, D.D.S.
Elaine Crews Powell, C.P.A.
Yvette C. Hayes

FOR THE BOARD:

Date: June 15, 2007

Suzanne Cochran, Esq.
Chairman

Carolina Medicorp
Group Appeal
Case Number 00-1862G

Appendix 1

Schedule of Providers Participating in Group

Provider Name	Provider Numbers
1. Forsyth Memorial Hospital	34-0014 34-S014 34-T014 34-5476 34-7005
2. Medical Park Hospital	34-0148
3. Edwin H. Martinat Comprehensive Outpatient Rehabilitation Center	34-4504
4. The Oaks at Forsyth	34-5284