PROVIDER REIMBURSEMENT REVIEW BOARD
HEARING DECISION

2002-D11

PROVIDER -
Augustana Lutheran Home
Brooklyn, NY

Provider No. 33-5521

vs.

INTERMEDIARY -
Blue Cross and Blue Shield Association/
Empire Medicare Services

DATE OF HEARING-
February 13, 2001

Cost Reporting Period Ended -
December 31, 1995

CASE NO. 98-1968

INDEX

ISSUE:[1]

Was the Intermediary's adjustment to unpaid interest expense proper?

STATEMENT OF THE CASE AND PROCEDURAL HISTORY:

Augustana Lutheran Home ("Provider") is a 240-bed, voluntary, skilled nursing facility located in Brooklyn, New York. For the fiscal year ended December 31, 1995, Empire Medicare Services ("Intermediary") made an audit adjustment disallowing interest expense in the amount of $238,187 that had been claimed by the Provider on its Medicare cost report.[2] The interest expense at issue pertains to a loan from the Lutheran Medical Center ("LMC") which was used to finance unanticipated costs associated with the construction of the Provider's replacement facility. The loan is documented by a note dated June 24, 1992, wherein LMC committed $4,707,050.26 to the Provider at an interest rate of eight and one-quarter percent (8.25%) to be due and payable on or before December 31, 2005.[3] The Provider appealed the Intermediary's determination to the Provider Reimbursement Review Board ("Board") pursuant to 42 C.F.R. §§405.1835-.1841 and has met the jurisdictional requirements of those regulations. The amount of Medicare reimbursement in controversy is approximately $43,000.

The Provider was represented by Mel Feder, CPA, of Loeb & Troper. The Intermediary's representative was Eileen Bradley, Esquire, of the Blue Cross and Blue Shield Association.

PROVIDER'S CONTENTIONS:

The Provider contends that the interest expense incurred on its loan with LMC should be fully allowed as necessary and proper costs based on the facts presented and the governing provisions of the Provider Reimbursement Manual ("HCFA Pub. 15-1"). The provisions of HCFA Pub. 15-1 § 202.1 state that:

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1 All other issues appealed by the Provider have been administratively resolved or withdrawn from this appeal.

2 See Intermediary Exhibit I-54.

3 See Provider Exhibit P-4.

> To be allowable under the Medicare program, interest must be: (1) supported by evidence of an agreement that funds were borrowed and that payment of interest and repayment of the funds are required; (2) identifiable in the provider's accounting records; (3) related to the reporting period in which the costs are incurred; and (4) necessary and proper for the operation, maintenance or acquisition of the provider's facilities.
> To support the existence of a loan, the provider should have available a signed copy of the loan contract which should contain the pertinent terms of the loan such as amount, rate of interest, method of payment, due date, etc. Where the lender does not customarily furnish a copy of the loan contract, correspondence from the lender stating the pertinent terms of the loan such as amount, rate of interest, method of payment, due date, etc., will be acceptable.

HCFA Pub 15-1 § 202.1

With respect to interest on loans from lenders related to a provider, HCFA Pub. 15-1 § 218 states the following:

> One of the elements required for interest to be "proper" is that the interest be paid to a lender not related through control, ownership, or personal relationship to the borrowing organization. (See Chapter 10 for the definition of control and ownership.) Presence of any of these factors could affect the "bargaining" process that usually accompanies the making of a loan, and could thus be suggestive of an agreement for higher rates of interest or for unnecessary loans. This provision is intended to assure that loans are legitimate and needed, and that the interest rate is reasonable.

HCFA Pub. 15-1 § 218

The determination of common ownership or control is set forth in Chapter 10 of HCFA Pub. 15-1 as follows:

> In determining whether a provider organization is related to a supplying organization, the tests of common ownership and control are to be applied separately. If the elements of common ownership or control are not present in both organizations, the organizations are deemed not to be related to each other.

HCFA Pub. 15-1 § 1004

> Common Ownership Rule
> A determination as to whether an individual (or individuals) 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, proprietary or non-profit. In the case of a non-profit organization, ownership or equity interest will be determined by reference to the interest in the assets of the organization.

HCFA Pub. 15-1 § 1004.1

> Control Rule
> The term "control" includes any kind of control, whether or not it is legally enforceable and however it is exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise.
>
> The facts and circumstances in each case must be examined to ascertain whether legal or effective control does, in fact, exist. Since a determination reached in a specific case represents a conclusion based on the entire body of facts and circumstances involved, such determination should not be used as a precedent in other cases unless the facts and circumstances are substantially the same.

HCFA Pub. 15-1 § 1004.3

As to the necessity of the indebtedness, the Provider states that the purpose and necessity of the loan made by LMC was to finance unanticipated increased costs for the construction of its new nursing facility. The total project costs increased to $25.6 million, which was approximately $4.8 million greater than the funding obtained through an insured mortgage with the Department of Housing and Urban Development ("HUD") and other existing equity. The Provider asserts that it could not finance these additional costs from its own reserves because of minimal or negative working capital during the construction period.

The Provider further contends that it could not obtain a loan from a commercial lender for two reasons: (1) the facility's poor financial position precluded a loan based solely on the credit worthiness of the organization; and (2) a lien on the new replacement facility could not be furnished because such a lien had already been granted to mortgagee under the HUD-insured loan of $17.9 million. Accordingly, the Provider insists that it would not have been able to proceed with the project without the loan granted by LMC.

With respect to evidentiary documentation of the loan, the Provider contends that a formal signed loan agreement was entered into with LMC on June 24, 1992.[4] Pursuant to the requirements of HCFA Pub. 15-1 §202.1, the loan agreement contains the requisite evidence that the payment of interest and repayment of the funds borrowed are required. Specifically, the loan agreement states that interest accrues " at the rate of eight and one-quarter percent (8.25%) per annum [and that] said principal ($4,707,050.26) and interest [are] to be due and payable on or before December 31, 2005." The Provider further contends that the 1995 interest expense of $238,187.26 was identified in the accounting records under the general ledger account number 0988-823 (Loan Interest Expense). A copy of the detailed analysis of this general ledger account for the fiscal year ended December 31, 1995 was furnished to the Intermediary and is presented as Intermediary Exhibit I-56.

In support of the reasonability of the interest rate, the Provider points out that the threshold financial indicator used by the lenders for loan-making purposes is the prime interest rate. A premium on the prime rate is customarily charged by lenders based on the creditworthiness of the borrower and associated risks involved. The Provider advises that the prime rate at the time of the LMC loan on June 24, 1992 was 6.5 percent.[5] Since the interest rate on the LMC loan was 8.25 percent, the interest rate paid by the Provider was a mere 1.75 basis points above the prime rate. Given the financial condition of the Provider at that time, this clearly was a reasonable premium. By contrast, the interest rate on the HUD-insured mortgage of $17.9 million was 9 percent during 1995. On the mortgage closing date, October 13, 1993, the prime interest rate was 6 percent or 3 basis points below the HUD loan interest rate. Using the prime rate as the barometer to measure reasonableness, the interest rate on the LMC loan was actually 1.25 basis points lower than the premium that was charged on the HUD -insured mortgage. Accordingly, the LMC loan had a lower absolute rate and a lower premium charge than the HUD-insured mortgage, which the Intermediary accepted as fully reasonable.

The Provider notes that the propriety of interest expense is discussed in HCFA Pub. 15-1 §218, which states that the bargaining process that accompanies the 'making' of a loan is deemed to be affected if the lender and provider are related parties. Therefore, the Provider insists that the operative time frame for determining whether the parties are related is the date when the loan

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4 See Provider Exhibit P-4.

5 See Provider Exhibit P-18.

transaction is made. In support of this position, the Provider refers to the Board's decision in Visiting Health Services of New Jersey v. Blue Cross and Blue Shield Association/ Blue Cross and Blue Shield of Wisconsin, PRRB Dec. No. 93-D102, September 29,1993, Medicare and Medicaid Guide (CCH) ¶41,765.[6] In that decision, the provider's contentions included the following:

> The Provider argues that "control" requires that an entity "have the power, directly or indirectly, significantly to influence or direct the actions or policies" of another entity. The control relationship must exist at the time of the transaction in question, not merely as a result of the transaction. . . . The Intermediary witness conceded that if control did not exist at the time of the transaction the related party principle would not be a problem.

Id. (emphasis added).

Accordingly, the Provider contends that the time frame to determine whether it was related to LMC is the period prior to the date of the loan (i.e., June 24, 1992), and not any subsequent time frame. Prior to that date, the Provider maintained a multimillion dollar nursing facility operation which was governed by a Board of Directors. Throughout this prior time frame, the Provider's sole business and purpose for existence was the operation of its 90-bed nursing facility under all rules and regulations of federal, state and local governments and generating in excess of $4 million in annual revenues. During this same time frame, the Provider was involved in: (1) a real estate venture with LMC which originally involved leasing and ultimately acquiring the site for its replacement facility; and (2) the establishment process for construction of its new facility.

The Provider argues that any determination of "relationship" between itself and LMC must focus on two key factors:

> (1) Whether LMC was "to a significant extent associated with or affiliated with" or had "significant control or ownership of" the Provider's nursing home operation; and
> (2) Whether this "relationship" existed at, or prior to, June 24, 1992.

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6 See Provider Exhibit P-8.

The Provider believes that it has demonstrated through the evidence presented and the testimony of its witnesses at the Board hearing that it was not related to LMC on or before June 24, 1992. Based on the testimony of its witness who served as a member of the Provider's Board of Directors, the Provider lists the following to substantiate its contention:[7]

- LMC did not hire the CEO, COO or any other key personnel of the Provider, nor did LMC influence the Provider's hiring practices for those key employees;

- LMC did not have a management contract with the Provider;

- LMC neither appointed nor nominated members to the Provider's Board of Directors;

- Only four out of a total of 15 members of the Provider's Board of Directors were common to LMC's Board, and that commonality was due to a limited pool of local Lutheran clergy and lay personnel available to serve on these Boards;

- The Provider did not give up any control of its operations to LMC, nor did LMC exercise any control over the operations of the Provider; and

- The Provider and LMC were totally independent organizations.

[7] Tr. at 124-142.

The Provider insists that its related-party relationship with LMC actually occurred subsequent to June 24, 1992. This relationship occurred on November 22, 1993 when the Provider's Corporate By-Laws were amended and the "Principles of Affiliation" with LMC were adopted.[8] It was at that time that the following controls were transferred over to LMC:

- The Provider's Board members were now elected by LMC's Board of Directors;

- The Provider's Administrator now reported to LMC's CEO;

- The Provider could not make financial commitments without LMC's approval; and

- LMC now approved the Provider's budget.

Finally, the Provider points out that the Intermediary's original basis for disallowing the interest expense claimed for the cost reporting period ended December 31, 1995 was that the claimed amount of $238,187 had not been paid by the Provider in accordance with Medicare policy. The Provider argues that, pursuant to the provisions of HCFA Pub. 15-1 § 2305,[9] a short term liability must be liquidated within one year after the end of the cost reporting period in which the liability is incurred. Where liquidation is made by check, the payment must be redeemed through an actual transfer of the provider's assets within the same time limitation. The Provider asserts that all of the 1995 interest expense related to the LMC loan was liquidated in 1996 in conformity with the manual provision.

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8 See Provider Exhibit P-13.

9 See Provider Exhibit P-3.

As of December 31, 1995, the principal balance on the LMC loan was $4,746,619, and the total accrued interest expense was $790,239 (inclusive of the 1995 interest amount of $238,187).[10] In addition, the interest amount due on the LMC loan for the 1996 year was approximately $391,596 ($4,746, 619 x 8.25 percent), and the required principal payments on the loan for 1996 were $318,905.[11] Accordingly, the total required payments due in 1996 to LMC were $1,500,740 as follows:

Accrued Interest as of December 31, 1995	$790,239
Interest Expense for 1996	391,596
Principal Payments for 1996	318,905
Total	$1,500,740

The Provider contends that, if its 1996 payments to LMC were at least $1,500,740, then the full balance of the December 31, 1995 accrued interest expense would be considered paid within the one-year allowable time frame. The Provider asserts that in 1996 it made payments to LMC in the amount of $1,575,000, or $74,260 greater than the required amount. In support of such payments, the Provider presented copies of the canceled checks as Exhibit B to its original position paper listed as follows:

Date	Check No	Amount
7/3/96	15041	$ 500,000
7/3/96	15042	50,000
7/3/96	15043	100,000
9/9/96	15493	100,000
10/21/96	15722	75,000
11/29/96	15927	750,000
	Total	$1,575,000

Accordingly, the Provider concludes that it fully complied with the provisions of HCFA Pub. 15-1 § 2305 when it fully liquidated the December 31, 1995 accrued interest expense liability in calendar year 1996.

INTERMEDIARY'S CONTENTIONS:

The Intermediary contends that it properly disallowed the interest expense claimed by the Provider on a note executed by LMC based on the proper application of Medicare policy as set forth in the regulations and HCFA Pub. 15-1. The regulations at 42 C.F.R. §413.153 provide for

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10 See Note 4 of the Provider's audited financial statements as of December 31, 1995 presented in Intermediary Exhibit I-59.

11 Id.

the reimbursement of cost incurred on borrowed funds where the interest expense is:

- Supported by evidence of an agreement that funds were borrowed and that payment of the interest and repayment of the funds are required;
- Specifically identified in the provider's accounting records;
- Related to the cost reporting period in which the costs are incurred; and
- Necessary and proper for the operation, maintenance or acquisition of the facility.

In defining the term "proper," the regulation at 42 C.F.R. § 413.153(b)(3) requires that interest be: (i) Incurred at a rate not in excess of what a prudent borrower would have to pay in the money market existing at the time the loan was made; and

(ii) Paid to a lender not related through control or ownership, or personal relationship to the borrowing organization . . . .

42 C.F.R. § 413.153(b)(3).

The Intermediary advises that the related-party restriction arises from the concern that related lenders and borrowers might not engage in the arms length transaction contemplated for borrowing money when funds are really needed and at reasonable interest rates. The related organizations' regulation at 42 C.F.R. § 413.17 defines "related to the provider" to mean that "the provider to a significant extent is associated with or affiliated with or has control or is controlled by the organization furnishing the services, facilities or supplies." The regulation further states that " 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." The term "control," which the Intermediary believes applies in the instant case, is further defined in HCFA Pub. 15-1 § 1004.3 as "any kind of control, whether or not it is exercisable or exercised." The Intermediary further points out that neither the form nor mode of its exercise is dispositive of whether legal or effective control in fact exists; each case must be examined on its merits and particular facts.

The Intermediary argues that under any reasonable construction of the applicable rules, the Provider and LMC were related parties as early as 1982, and certainly no later than the time when the Provider filed its Certificate of Need ("CON") application sometime between 1982 and 1984.[12] The record includes evidence that as early as 1982 the Provider and LMC were mapping out a joint venture whereby the Provider would relocate to land owned by LMC. The land was

12 See Intermediary Exhibits I-8, I-9 and I-69.

adjacent to LMC's facility, which would expand LMC's options with regard to existing services and also enable the Provider to continue providing nursing home services to the same patient care community. The CON application demonstrated a commitment to use the LMC site and is premised, in part, on the expectation that the property would be transferred at no cost to the Provider.

Since the State's CON process requires that an application specify where it intends to locate its replacement facility, the Intermediary insists that the Provider was committed to relocating next door to LMC's facility.[13] In addition to the construction of a new nursing home facility, the project also included the construction of a parking garage to be shared with LMC and a skyway connecting the Provider with LMC. Moreover, the language of the CON application reveals a close partnership between the two parties as follows:

> Although Augustana and LMC will remain two separately distinct and independent institutions, we feel that the common bond which ties them together is the strong commitment to providing quality care to the sick, the elderly. . . This commitment has clearly been evident throughout the planning process for the project which has enhanced our relationship with LMC and demonstrated the success which can be achieved when the resources of two institutions are pooled.

Intermediary Exhibit I-9, p.5.

The Intermediary contends that the pattern of behavioral interaction and financial transactions carried out by the Provider and LMC over an extended period of time clearly satisfies the "control" prong of the related party rules. The record shows that LMC took a leadership role in the fundraising activities for the Provider's construction project which included: (1) holding the raised funds in trust for the Provider; (2) disbursing the funds on an as needed basis; and (3) guiding and directing the overall project. On April 15, 1985, the Herman Goldman Foundation pledged a $300,000 grant to LMC to support the relocation of the Provider's nursing home facility to the property adjacent to LMC.[14] In addition, the Morgan Bank's Charitable Trust

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[13] See Intermediary Exhibit I-10.

[14] See Intermediary Exhibit I-64.

awarded a grant of $50,000 to LMC for the same project.[15] For each of these grants, the money was paid over to LMC and not the Provider.

15 See Intermediary Exhibit I-72.

The Intermediary argues that the minutes of the Provider's Board of Directors meetings present some of the clearest evidence of the true relationship between the Provider and LMC.[16] All of the Provider's Board minutes produced in discovery show that officers and Board members from LMC routinely attended the Provider's Board meetings, and that their attendance preceded any loan agreement between LMC and the Provider. At a meeting held on February 10, 1992, the Provider's Board unanimously passed a resolution to accept LMC's offer of investment funds to commence construction of its new facility. The Intermediary believes that such a commitment was instrumental in bringing in outside lenders, inasmuch as the Provider could not have qualified for a bank loan on its own. Thus, the combination of LMC's offer and the Provider's acceptance deepened the working relationship between the parties. In the face of the Provider's precarious financial status, the Intermediary believes LMC's financial commitment made the Provider dependent on LMC's largesse for its survival. Such a relationship suggests the "control" or the potential for the "control" contemplated by the related party rules.

The Intermediary notes two other meetings of the Provider's Board of Directors which preceded the loan agreement with LMC. At the Provider's Board meeting on April 9, 1992, the Provider disclosed that it might lose its real estate tax exemption and become liable for a significant amount of taxes which it would be unable to pay. LMC agreed to sign an agreement to pay such taxes, if necessary, as long as the Provider would sign a statement promising to turn over its assets to LMC if the Provider could not continue to operate as a non-profit entity. At a special meeting of the Provider's Board held on June 8, 1992, a resolution was proposed that the Provider seek a "formal relationship" with LMC to overcome the mounting impediments to the construction project. It was also noted at that meeting that LMC Board members also served on the Provider's Board of Directors. The Intermediary argues that the minutes of these meetings suggest the continuing and strengthening emergence of a relationship that is best described as "related parties."

The Intermediary points out that the Provider and LMC entered into a financial arrangement on June 24, 1992 wherein LMC agreed to make \$4.7 million available to the Provider at a fixed interest rate of 8.25 percent. The agreement was signed by the Provider's Treasurer, who testified at the hearing before the Board that he had not been part of any of the negotiations, and that he had not questioned the interest rate which was 1 and 1/4 points above the prime rate. He further testified that the rate ensured a reasonably profitable rate of return for LMC.[17] The Intermediary subscribes that it is not unreasonable to conclude that LMC's influence and potential to exercise the "control" described in the manual instructions had become even more entrenched.

The Provider and LMC agreed to a set of "Principles of Affiliation" (dated September 11,

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16 See Intermediary Exhibit I-65.

17 Tr. at 144-149.

1992)[18] which included the following propose resolutions:

- The Provider would submit an annual budget to the LMC Board;
- LMC's CEO would serve as the Vice-Chairperson of the Provider's Board;
- The Provider's Administrator would report directly to LMC's CEO; and
- The Provider's Board could not change its mission or make financial commitments without approval by LMC's Board.

[18] See Intermediary Exhibit I-65.

The "Principles of Affiliation" were unanimously adopted by the Provider's Board of Directors on September 21, 1992. Although the Provider contends that these Principles were agreed to in contemplation of a future formalized relationship, the Intermediary believes the record clearly shows that the Principles characterized how the Provider and LMC effectively interacted both before and after the date the Provider's Board approved them. The Intermediary notes that when the Provider's Articles of Incorporation were amended on November 4, 1991, one of the authorizing signatories was a member of LMC's Board as well as the Provider's Board.[19] On November 22, 1993, the Provider's Corporate By-Laws were amended to make LMC the sole corporate member of the Provider, thus memorializing what had been in place for some time.

In summary, the Intermediary contends that the Provider's construction project for its replacement facility would not have materialized absent the following factors:

- LMC's and the Provider's joint effort and commitment to locate a skilled nursing facility adjacent to an acute care facility, which led to the Provider's submission of the CON application;
- LMC's joint fund raising, and then controlling the dispersal of the funds as to purpose and time;
- LMC's pledge to be the guarantor for any tax defaults on the part of the Provider to help secure other lenders' commitments;
- LMC's "loan" of $4.7 million to help finance the project;
- LMC's commitment to collateralize an additional $1.4 million to support the project; and
- LMC's dispersal of funds to meet not just the construction costs but the Provider's operating costs.

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[19] See Intermediary Exhibit I-75.

The Intermediary insists that the facts set forth above squarely show that the Provider was to a significant and long-term extent associated with LMC. As a result of LMC's financial weight and available land, it had the power which it later exercised to influence the policies of the Provider. The various resolutions passed by the Provider's Board, which allowed even further LMC encroachment on its decision-making authority, were apparently driven by the Provider's desire to survive and operate the nursing facility planned for the site adjacent to LMC. The Intermediary finds the Provider's narrow reading of the "control" standard to be inconsistent with HCFA's rules and polices. In further support of its related-party determination, the Intermediary cites the decision rendered by the U.S. Court of Appeals for the Eighth Circuit in Medical Center of Independence v. Harris, 628 F.2d 1113 (8th Cir. 1980).[20]

The Intermediary alternatively argues that if the Board were to find that the Provider and LMC were not related at the time the loan was made, the provisions of HCFA Pub. 15-1 § 1011.1 should be applied to this case. Under this manual provision, if the parties are not related before the execution of a contract but control is created at the tine of execution by any means, "the supply contract will be treated as having been made between related organizations." Accordingly, if the Provider paid any interest to LMC in 1995, it did so as part of the implementation of an executory contract. The Provider's execution of any loan repayment with interest in 1995 occurred when the parties were indisputably related and, thus, the interest should be disallowed.

As to the original basis for disallowing the interest expense claimed by the Provider on its 1995 cost report, the Intermediary maintains that the Provider has yet to produce the requisite documentation which shows that interest payments were actually made to LMC for the 1995 cost reporting period. The regulations at 42 C.F.R. § 413.20 require providers to maintain sufficient financial records and statistical data for proper determination of costs payable under the Medicare program. If a provider is unable to produce the requisite documentation to support its claims, the intermediary must deny the claim. The Intermediary contends that nothing the Provider has submitted since the audit or testified to at the Board hearing has shed further light on whether any interest payments have been made to LMC for the 1995 cost reporting period.

The Intermediary argues that no loan agreement was made available to its auditors at the time of the audit. The June 24, 1992 note proferred by the Provider, and the method by which LMC implemented its commitments, do not suggest a loan of monies in the conventional sense. Rather, they merely reflect the opening of a line of credit that the Provider could draw upon with LMC's approval as to the needs for the funds. The canceled checks presented by the Provider do not break out the interest portion which is allegedly being paid on the principal portion of the liability. The Intermediary suggests that the monies transferred by LMC to the Provider appear

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[20] See Intermediary Exhibit I-94.

to be for operating purposes and not capital costs. Although the liquidation of liability rules vary between the two types of loans, no auditable records exist to make the requisite distinctions.

The Intermediary further notes that, although apparent modifications were made in the "loan" or similar transactions over several years leading up to 1995, the Provider failed to disclose or furnish any of the relevant documents or information to the Intermediary as required by Medicare policy. The available general ledgers indicate that the financial situation between the Provider and LMC was extremely fluid with funds moving in and out between the parties. While it is not clear from the record, the Intermediary believes it is certainly plausible that LMC made additional financial commitments or dispersals to the Provider throughout the period from 1985 through fiscal year 1995. Likewise, the Provider's financial statements (to the extent they are reliable based on some of the testimony at the Board hearing), are simply inadequate to sort out the overall financial picture that surrounded this enterprise. In the absence of reliable and creditable documentary evidence to support the interest payments, the Intermediary contends that this is sufficient reason in itself to justify the disallowance of interest expense claimed by the Provider on its Medicare cost report for the fiscal year ended December 31, 1995.

Based on the above contentions, the Intermediary recommends that the Board affirm its audit adjustment on both of the grounds asserted: the requisite documentation was nonexistent; and even if it were available, the Provider and LMC were related parties and thus no interest expense can be recognized.

CITATION OF LAW, REGULATIONS AND PROGRAM INSTRUCTIONS:

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

§§ 405.1835-.1841	-	Board Jurisdiction
§ 413.17et seq.	-	Cost to Related Organizations
§ 413.20	-	Financial Data and Reports
§ 413.153 et seq.	-	Interest Expense

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

§ 202.1	-	Definition -- Interest
§ 218	-	Interest on Loans from Lenders Related to the Provider

§ 1004	-	Determination of Common Ownership or Control in the Provider Organization and Supplying Organization
§ 1004.1	-	Common Ownership Rule
§ 1004.3	-	Control Rule
§ 1011.1	-	Special Applications - Contracts Creating Relationship
§ 2305	-	Liquidation of Liabilities

3. Case Law:

Medical Center of Independence v. Harris, 628 F.2d 1113 (8th Cir. 1980).

Visiting Health Services of New Jersey v. Blue Cross and Blue Shield Association/Blue Cross and Blue Shield of Wisconsin, PRRB Dec. No. 93-D102, September 29, 1993, Medicare and Medicaid Guide (CCH) ¶ 41,765.

FINDINGS OF FACTS, CONCLUSIONS OF LAW AND DISCUSSION:

The Board, after consideration of the facts, parties' contentions, evidence presented, testimony elicited at the hearing, and post-hearing briefs, finds and concludes that the Intermediary properly disallowed the interest expense claimed by the Provider in conformance with the governing regulations and manual instructions.

The Board finds that there is substantial evidence in the record to demonstrate that the Provider and LMC were related parties when the loan transaction was entered into on June 24, 1992. In making this determination, the Board relies on the related organization principles set forth in 42 C.F.R. § 413.17 and HCFA Pub. 15-1 §1004 which specifically apply to the facts and circumstances in this case. Pursuant to these governing principles, organizations are deemed to be related under the Medicare program where they meet the test of either being related by common ownership or control. In this case, the Board finds that the control test has been met through LMC's ability to control or influence the actions of the Provider with respect to the construction and financing of its replacement facility and ongoing operations.

The regulation at 42 C.F.R. § 413.17 (b)(3) states that "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." The manual provisions at HCFA Pub. 15-1

§ 1004.3 further define the control rule, stating that "[t]he term "control" includes any kind of control, whether or not it is legally enforceable and however it is exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. The facts and circumstances in each case must be examined to ascertain whether legal or effective control does, in fact, exist." In viewing the aspect of control, the Board finds that a chronological tracking of events and actions taken, both before and after the loan transaction, unequivocally demonstrates that LMC was in a position and had the ability to control or significantly influence the transaction entered into with the Provider. While it is difficult to quantify the degree of control or identify a specific action which denotes LMC's control over the Provider, the Board believes that the extensive interaction between the Provider and LMC in planning and financing the replacement facility over an extended number of years provides clear evidence of the relationship which existed between the two entities at issue.
The record shows that the Provider filed a CON application with New York State's Department of Health sometime between 1982 and 1984 in which it specifically stated that the planned replacement facility would be located on land owned by LMC and adjacent to its hospital facility.[21] Although LMC offered the Provider free use of the land forever, intervention by HUD later required a payment of $150,000 to LMC by the Provider. The CON application further describes the close relationship between the Provider and LMC, stating that the two entities have a "common bond which ties them together," and that "this commitment has clearly been evident throughout the planning process for the project which has enhanced our relationship and demonstrated the success which can be achieved when the resources of two institutions are pooled." In addition to the construction of a new nursing home facility, the project identified in the CON also included the construction of a parking garage to be shared with LMC and a skyway connecting the Provider with LMC.

Further evidence of LMC's control is demonstrated by its leadership role in controlling the fundraising activities for the Provider's construction project.[22] In this regard, LMC directly received large grants which were specifically pledged for the Provider's construction project. LMC held these funds in trust for the Provider and controlled the disbursement of the funds on an as needed basis. In addition to guiding and directing the Provider's fundraising activity, the minutes of the Provider's Board of Directors meetings show that high ranking officials and Board members from LMC routinely attended the Provider's Board meetings prior to the loan agreement between LMC and the Provider.[23] A review of these Board minutes revealed the following:

(1) On February 10, 1992, the Provider's Board unanimously passed a resolution to accept LMC's offer of investment funds to commence

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[21] See Intermediary Exhibits I-8, I-9 and I-69.

[22] See Intermediary Exhibits I-64 and I-72.

[23] See Intermediary Exhibit I-65.

construction of its replacement facility;

(2) The Provider disclosed at a Board meeting on April 9, 1992 that it might lose its real estate tax exemption which would result in a significant liability that it could not meet. LMC agreed to sign an agreement to pay such potential taxes if the Provider agreed to turn over its assets to LMC should the Provider lose its non-profit entity; and

(3) At a special meeting held on June 8, 1992, the Provider's Board proposed that a "formal relationship" be sought with LMC to overcome the mounting impediments to the construction project.

The record further shows that in 1992, five of the 16 members of the Provider's Board of Directors also served on LMC's Board.[24] Such a proportion of commonality may not in itself manifest a direct relationship between the parties. However, the Board finds LMC's representation on the Provider's Board of Directors to be an important factor, given the substantial evidence in the record that LMC played a significant and vital role in the construction and relocation of the Provider's replacement facility. Under the related organization principles, it is the ability to exercise control that is important, not necessarily a finding that control has been exercised. Both parties benefitted from the joint venture which resulted in the construction of a new skilled nursing facility adjacent to an acute care hospital facility. Based on the facts presented in this case, it is evident that the entities have common interests strengthened by their respective business direction.

It is the Provider's contention that its related-party relationship with LMC did not occur until November 22, 1993 when: (1) its Corporate By-Laws were amended making LMC the sole corporate member of the Provider; and (2) the "Principles of Affiliation" with LMC were adopted.[25] The Board finds it noteworthy that the "Principles of Affiliation" are dated September 11, 1992 and were unanimously adopted by the Provider's Board of Directors on September 21, 1992.[26] The fact that such action was taken less than three months after the Provider and LMC entered into the loan transaction at issue further amplifies the close relationship of the parties prior to the formal approval of their affiliation. The Board concurs with the Intermediary's belief that the "Principles" merely characterized how the Provider and LMC effectively interacted both before and after the date the Provider's Board approved them.

With respect to the documentation of the loan transaction, the Board finds that the record is void of any credible evidence which would substantiate the amount of interest and principal actually

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[24] See Intermediary Exhibit I-74.

[25] See Provider Exhibits P-12 and P-13.

[26] See Intermediary Exhibit I-65.

paid for the period in contention. The record shows that funds flowed freely between the Provider and LMC, and that the funds transferred by LMC to the Provider consisted of both capital loans related to the construction project and working capital loans used for operational purposes.[27] Due to the intermingling of capital and working capital loans, and the amalgamation of principal and interest payments relating to multiple years, the Board is unable to ascertain the amount of allowable interest expense which might have been reimbursable for the fiscal year ended December 31,1995. The Board finds the transitory nature of the Provider's accounting records with respect to funds flowing to and from LMC further illustrates the close relationship which existed between the Provider and LMC and provides additional affirmation for the application of the related organization principles.

Based on the above finding that the Provider and LMC are related organizations, the Board concludes that the Provider is not entitled to reimbursement for interest expense incurred on the funds borrowed from LMC in accordance with the regulatory provisions of 42 C.F.R. § 413.153 and HCFA Pub. 15-1 § 218. The regulation at 42 C.F.R. § 413.153 (c)(1) states in part ". . . to be allowable, interest expense must be incurred on indebtedness established with lenders or lending organizations not related through control, ownership, or personal relationship to the borrower...." The Board has considered the Provider's arguments that the loan was legitimate and needed, and that the interest rate was reasonable. However, the Board is bound by the regulations which require the application of the related organization principles in determining the allowability of interest expense.

[27] See Intermediary Exhibits I-56 and I-57.

<u>DECISION AND ORDER</u>:

The Intermediary's adjustment to unpaid interest expense was proper and is affirmed by the Board.

<u>Board Members Participating</u>:

Irvin W. Kues
Henry C. Wessman, Esquire
Stanley J. Sokolove
Gary B. Blodgett, D.D.S

<u>Date of Decision</u>: March 05, 2002

<u>FOR THE BOARD:</u>

Irvin W. Kues
Chairman