PROVIDER REIMBURSEMENT REVIEW BOARD DECISION

2007-D54

PROVIDER -
UPMC-Braddock Hospital
Braddock, PA

Provider No.: 39-0128

vs.

INTERMEDIARY -
BlueCross BlueShield Association/
Veritus Medicare Services (n/k/a
Highmark Medicare Services)

DATE OF HEARING -
March 20, 2006

Cost Reporting Period Ended -
November 30, 1996

CASE NO.: 00-1411

INDEX

ISSUE:

Whether the Intermediary properly disallowed the Provider's loss on disposal of depreciable assets as a result of the merger with UPMC Braddock, a subsidiary of the University of Pittsburgh Medical Center (UPMC).

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 issuance of the NPR. 42 U.S.C. §1395oo(a); 42 C.F.R. §405.1835.

Section 42 U.S.C. §1395x(v)(1)(A) of the Social Security Act (the Act) provides that the "reasonable cost" of any service shall be the actual cost incurred 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 states that reasonable cost includes all "necessary and proper" costs incurred in furnishing (healthcare) services, subject to principles relating to specific items of revenue and cost.

Under the Act, 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 initially set at its "historical cost," generally equal to the purchase price. 42 C.F.R. §413.134(b)(1). To determine annual depreciation, the historical cost is then prorated over the asset's estimated useful life in accordance with an acceptable depreciation method. 42 C.F.R. §413.134(a)(3).

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 its undepreciated basis calculated

under Medicare (equivalent to the "net book value" and equal to the historical cost minus the depreciation recognized and claimed as allowable costs under the Medicare program, 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, it is assumed that the asset had depreciated more than was originally estimated and, accordingly, the Program provides additional reimbursement to the provider. Conversely, if the asset is sold for more than its undepreciated 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 the assets sold" regardless of whether they are depreciable or not.

The regulation providing for the recognition of gains and losses was originally implemented to address 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 sale 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 is not a basis for revaluation that would trigger a gain or loss.

STATEMENT OF THE CASE AND PROCEDURAL HISTORY:

UPMC Braddock (Provider) is a general short-term hospital located in Braddock, Pennsylvania. On November 30, 1996 Braddock Medical Center (BMC) merged with the Provider. The following is a summary of pertinent facts:

- Prior to the effective date of the statutory merger, November 30, 1996, BMC was a Pennsylvania non-profit corporation operating in Pittsburgh, Allegheny County, Pennsylvania and a duly licensed acute care general hospital under Pennsylvania law.[1]

- Prior to the merger date, Heritage Health System (Heritage) was BMC's sole corporate member, and BMC's governance and control pre-merger was vested solely in its board of directors and in its sole corporate member, respectively.

- Heritage Health Foundation (Foundation) was both prior to the merger date and thereafter, a Pennsylvania non-profit corporation, and its charitable purpose pre-

[1] See, Hearing Exhibit P-16, ¶ 4 (Affidavit of Thomas E. Boyle, Esquire).

merger was to provide support of a charitable nature to BMC through fundraising and other similar activities.[2] The Foundation, although party to the Agreement, did not merge into the new entity.[3]

- Prior to the merger date, UPMC Braddock was a Pennsylvania non-profit corporation incorporated on October 17, 1996 under Pennsylvania law for the purpose of effectuating the merger that was being negotiated. The University of Pittsburgh Medical Center System (UPMCS) was its sole corporate member.[4] UPMC Braddock was organized for the purpose of carrying out the proposed merger and was inactive and non-operational as a functioning entity until the merger date.[5]

- Prior to the merger date, UPMCS was a Pennsylvania non-profit corporation in Pittsburgh, Pennsylvania. It was the parent and corporate member of a major academic medical center and integrated health care system headquartered in Pittsburgh, Pennsylvania.[6] As the sole corporate member of UPMC Braddock, UPMCS retained certain reserved powers over UPMC Braddock, including the legal authority to amend, adopt or repeal the by-laws of UPMC Braddock, approve the appointment of all individuals to the UPMC Braddock board of directors, establish and approve capital and operating budgets of UPMC Braddock, and to operate UPMC Braddock for the benefit of the UPMCS system of hospitals as a whole.[7]

- Prior to the merger date, there was no corporate governance, operational or system relationship or affiliation between BMC/Heritage/Foundation on the one hand and UPMCS on the other hand, nor did any of their related entities have any type of influence over another.[8]

- Prior to the merger date, BMC/Heritage/Foundation each had its own separate board of directors and operational officers, none of whom sat on any of the boards of or served in any officer position at or for UPMCS and/or any of its affiliated entities.[9]

- On October 28, 1996, the parties, as part of their on-going negotiations, executed an "Agreement to Merge and to Affiliate" (Agreement). The Agreement contemplated the statutory merger of BMC into UPMC Braddock.

---

[2] See, Hearing Exhibit P-16, ¶ 6 (Affidavit of Thomas E. Boyle, Esquire).
[3] See, Hearing Exhibit P-2, pg. 037.
[4] See, Hearing P-16, ¶ 24.
[5] Id.
[6] See, Hearing Exhibit P-16, ¶ 7.
[7] See, Hearing Exhibit P-16, ¶ 32 and 33 and Hearing Exhibit P-2, Pages 076 to 077.
[8] See, Hearing Exhibit P-16, ¶ 8.
[9] See, Hearing Exhibit P-16, ¶s 9 and 10.

- Following the closing on the merger date, UPMC Braddock assumed all rights and obligations of BMC under the Non-Profit Corporation Law of Pennsylvania, and pursuant to Pennsylvania law, BMC as such no longer existed for Medicare reimbursement purposes.[10]

- On the merger date, the assets, liabilities, reserves and accounts of BMC were taken up on the books of UPMC Braddock at the amounts they were being carried on the books of BMC immediately prior to the closing, subject to any adjustments which were required in accordance with generally accepted accounting principles giving effect to the merger date.[11]

- In order to discharge their respective fiduciary duties, the boards of directors of the contracting parties used separate legal counsel and separate accounting and financial advisors to represent their respective interests in the negotiation of the transaction.[12]

- All officers and directors of the newly created entity would, under Pennsylvania law, owe their fiduciary duties solely to the new entity, UPMC Braddock.[13]

- The Board of Directors of UPMC Braddock consisted in part of certain directors who had been members of either the BMC, Heritage or Foundation board of directors, with the Foundation initially having the right to appoint one-third (1/3) of the directors and UPMCS initially having the right to appoint two-thirds (2/3) of the directors.[14]

- In connection with the transaction, BMC engaged Valuation Counselors Group (Valuation Counselors), an independent appraisal firm, to perform an appraisal of the fair market value of the Provider's assets in accordance with Medicare regulations.[15]

The Provider appealed the Intermediary's denial of its claimed loss of approximately $3,000,000 to the Board and met the jurisdictional requirements of 42 C.F.R. §§405.1835-405.1841. The Provider was represented by Samuel W. Braver, Esquire, of Buchanan Ingersoll PC. The Intermediary was represented by Bernard M. Talbert, Esquire, of Blue Cross Blue Shield Association.

PARTIES' CONTENTIONS:

The Intermediary contends that the merger was a related party transaction pursuant to 42 C.F.R. §413.17, because the Provider has the power to significantly influence or direct

[10] See, Hearing Exhibit P-16, ¶s 31 and 37; see also, 15 Pa. C.S. §5929.
[11] See, Hearing Exhibit P-16, ¶ 34.
[12] See, Hearing Exhibit P-16, ¶s 15 and 23.
[13] See, Hearing Exhibit P-16, ¶ 35.
[14] See, Hearing Exhibit P-2, pg. 018.
[15] See, Hearing Exhibit P-20.

the actions and policies of UPMC Braddock, the surviving corporation. The Intermediary also cites Program Memo A-00-76 to support its position that the parties are related.

The Intermediary contends that the loss claimed by the Provider is non-allowable for program reimbursement because the merger 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 the merged corporation was a provider, are subject to 42 C.F.R. §413.134(f). This section, entitled *Gains and losses on disposal of assets,* addresses the treatment of the gain or loss as a result of the manner of disposition of depreciable assets. The Intermediary asserts that in order for a merger to qualify for a gain or loss determination, it must be a "bona fide" sale.

The Intermediary further contends that the parties to the merger did not negotiate at arm's length in order to determine the fair market value of the assets. The transaction did not evidence the fair market value of the assets through the behavior of the parties because they were not trying to ascertain it. They had a different agenda, and it had nothing to do with determining whether the assets were significantly under depreciated from the point when they were put in service until the moment of the merger.[16] Absent the type of arm's length bargaining anticipated by 42 C.F.R. §413.134(f)(2), the Intermediary maintains that the transaction was not a bona fide sale, and no loss on disposal can be allowed.

The Intermediary also argues that the statutory merger between Braddock Medical Center and UPMCS was a transaction between related parties as a result of the structure of the new governing board. The governing board of the Provider would consist of a total of 18 members, 6 members from the pre-merger board and 12 members from UPMCS. The Intermediary further contends that according to Program Memorandum, Transmittal A-00-76 dated October 19, 2000, the fact that the parties are unrelated before the transaction does not bar a related organization finding as a result of the transaction. It is appropriate to compare the governing board composition before the transaction with the governing board composition after the transaction even though there was no contemporaneous co-existence of those boards.

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

The Provider contends that the Intermediary's "continuity of control" argument in accordance with HCFA Pub. 15-1 §1011.1 is irrelevant, and even if it were valid, it does not exist in the instant case.[17] 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

[16] Tr. at 40-43.
[17] Exhibit P-1, pg. 019 through -023.

individual or organization has the power to significantly influence the actions or policies of an organization or institution. In this merger, no single individual previously associated with the Provider had the power to significantly influence the operations of UPMC Braddock.

FINDINGS OF FACT, CONCLUSIONS OF LAW AND DISCUSSION:

After considering the Medicare laws and guidelines, the evidence presented, and the parties' contentions, the Board finds and concludes that the Provider and BMC 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 the assets and a 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 Pennsylvania law, and that 42 C.F.R. §413.134, *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 BMC merged into UPMC Braddock and ceased to exist. Under the terms of the transaction, UPMC Braddock (the surviving corporation) acquired all the assets and assumed all the liabilities associated with the operations of BMC.

Under regulations set forth at 42 C.F.R. §413.134(l)(2), the effect of a statutory merger upon Medicare reimbursement is 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 the 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 UPMC Braddock and BMC 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.

The Board finds the plain language of the statutory merger regulation dispositive of the Intermediary's argument. The text at 42 C.F.R. §413.134(l)(2)(i), which states, "if the statutory merger is between two or more corporations that are unrelated . . ." is unambiguous in its meaning that 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 (CMS 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 transaction that resulted in a statutory merger of BMC into UPMC Braddock under Pennsylvania corporation law, merged one independent hospital corporation, BMC, into another hospital corporation, UPMC Braddock, 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 is in direct opposition to the purpose of corporate mergers. The very nature of a statutory merger as a combination of entities would likely result in some overlap of membership on the board of directors of the merging corporation and the surviving entity, as well as a continuation of other operations and personnel of the merging organization. The fact that this occurs does not

disqualify a statutory merger from revaluation and recognition of any gain or loss under 42 C.F.R §413.134(l).

The Board finds that because there is a specific regulation that controls the recognition of a loss on the merger transaction at issue in this case, 42 C.F.R. §413.134(l), the merger is not required to meet the bona fides of sales transactions addressed in 42 C.F.R. §413.134(f)(2). However, the Board observes that while it is aware that the regulation on mergers may be interpreted as applying only to stock transactions, CMS has interpreted the regulation to apply to non-profit transactions as well. CMS' Director of the Division of Payment and Reporting Policy, Office of Reimbursement Policy, stated in a 1987 letter that the regulation applied to non-profits. In addition, the October 2000 "Clarification of the Application of the Regulations at 42 C.F.R. §413.134(1) to Mergers and Consolidations Involving Non-profit Providers," CMS Program Memorandum, Transmittal A-00-76, states that the regulation applies to non-profits; however, it asserts that "special considerations" apply.

The Provider and Intermediary agreed that if the Board allowed the loss, the loss calculation should be based upon the proportionate allocation 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 the aggregate.

The Board finds that the "Booth pro-rata method," as revised by the Provider, needs to be reviewed and audited by the Intermediary. The Board, therefore, remands this case to the Intermediary to perform the necessary audit procedures to ensure accuracy and appropriateness. Finally, the Board noted that in its review of the merger agreements that a significant amount of consideration was omitted from the loss on disposition calculation. Specifically, Heritage Health Foundation was a party to the Merger and Affiliation Agreement,[18] and through a separate assignment agreement with the University of Pittsburgh Medical Center System, the Foundation committed $3 million to the Provider.[19] The Board finds that a commitment of these funds was an inducement to UPMCS to enter into the merger transaction with BMC. Therefore the $3 million represents additional consideration that must be included in the computation of the loss.

DECISION AND ORDER:

The Provider's claimed loss on disposal of depreciable assets as a result of the merger is allowable under 42 C.F.R. §413.134(l)(2)(i) subject to: (1) inclusion of $3,000,000 of consideration from HHC, and (2) review and audit of the Provider's "Booth method" allocation of consideration relating to the merger. The Intermediary's denial of the loss resulting from the merger is reversed.

[18] See, Provider's Exhibit P-2 at 001.
[19] See, Provider Hearing Exhibit P-2, p. 121.

BOARD MEMBERS PARTICIPATING:

Suzanne Cochran, Esquire
Gary B. Blodgett, D.D.S.
Elaine Crews Powell, CPA
Anjali Mulchandani-West
Yvette C. Hayes

DATE: July 31, 2007

FOR THE BOARD:

Suzanne Cochran
Chairperson