HUDSON MANOR SKILLED NURSING FACILITY,
Petitioner,
v.
DIVISION OF MEDICAL ASSISTANCE
AND HEALTH SERVICES,
Respondent.

Initial Decision: August 11, 1983
Final Agency Decision: September 23, 1983

Approved for Publication by the Division of Medical Assistance
and Health Services: May 6, 1985

SYNOPSIS

Petitioner contests the nonrecognition of the full costs of its related
party lease by the Division of Medical Assistance and Health Services
in computing petitioner's rate of Medicaid reimbursement for the
years 1982 and 1983.

The administrative law judge assigned to the case found that peti-
tioner is an approved provider of Medicaid services and is the tenant
operating company which leases the facility's physical plant from the
landlord company; both companies have identical shareholders. In
March 1982, the Division rejected the lease for the physical plant in
computing the 1982-83 reimbursement rate on the grounds of a
changed internal agency policy which was later adopted into regu-
lation in March 1983.

The judge concluded that such action could not be sustained under
the agency's adjudicative powers, since by this change the agency was
implementing a broad policy change which would require compliance
with the rule-making requirements of the Administrative Procedure
Act. The judge concluded that the agency could, in an adjudicative
process, review the lease to determine its validity and fairness on a
factual basis, but in the absence of a finding that the lease was inflated
by reason of party relatedness, the agency must honor the lease in
the same way it would any nonparty lease.

Upon review, the Division rejected this initial decision. The
Division concluded that the judge had failed to give sufficient weight
to the concept of administrative flexibility and the agency's need to
implement a legislative scheme even while policy is in the developmen-
tal stage. The Division found that a clear legislative intent existed on
both the federal and state levels supporting the principle of cost
containment. The agency's policy regarding related party leases as
being suspect was founded upon the belief that there is significant likelihood that charges incurred by providers in transactions with entities related by common ownership are unreasonable. Accordingly, the agency concluded that the leasing cost was unreasonable.

Allan P. Browne, Esq., for petitioner (Breitenstein & Browne, attorneys)
Karen Suter, Deputy Attorney General, for respondent (Irwin I. Kimmelman, Attorney General of New Jersey, attorney)

Initial Decision

KLEIN, ALJ:

The petitioner is contesting the nonrecognition of the full costs of its related party lease by the Division of Medical Assistance and Health Services when computing petitioner’s rate of reimbursement for 1982-83.

On October 19, 1982, pursuant to N.J.S.A. 52:14F-1 et seq., the matter was transmitted as a contested case to the Office of Administrative Law. The parties jointly waived the necessity for a hearing and requested a summary decision to be rendered upon jointly submitted stipulation of facts and written argument. The record was closed on July 20, 1983 after receipt of these papers and after counter arguments were received from both parties.

Background

In accordance with the provisions of N.J.S.A. 30:4D-1 et seq., the State of New Jersey participates in the Medical Assistance Program (Medicaid) established by Title XIX of the Social Security Act. The Program in New Jersey is administered by the Division of Medical Assistance and Health Services (DMAHS) in accordance with a State plan submitted to and approved by the Secretary of Health and Human Services and in accordance with federal guidelines and requirements. The New Jersey Department of Health is responsible under the Cost Accounting and Rate Evaluation (CARE) guidelines for the computation and initial processing of rates to be paid to long term care facilities (LTCFs) such as Hudson Manor for the care and treatment of eligible Medicaid patients. The authority to establish reasonable rates of reimbursement lies with DMAHS.
Medicaid Reimbursement:

Rates are established prospectively on the basis of cost reports of facilities for the annual base period beginning 18 months prior to the effective date of the rates. The rates are calculated on the basis of (1) historical costs which are the facilities' own actual costs for the base period and (2) screened cost, whichever is lower.

The matter before me concerns the treatment of property costs as a component of the rate. For this component, under the care guidelines, the Division may apply either: (1) the historical costs or (2) the Capital Facilities Allowance (CFA). The CFA system, which replaced other methods for screening property costs and which is applicable only to the screened rate, uses comparisons of facilities to determine the median value of a given item of property cost particularly in regard to reasonable square footage and reasonable appraised value. Both of these are based upon an appraisal of all facilities which was made by the New Jersey Department of Transportation in 1977.

On February 24, 1983, effective March 21, 1983, the DMAHS adopted duly promulgated regulations which had been published in the New Jersey Register on July 19, 1982. These regulations specifically provide that:

All lease costs incurred as a result of related party transactions will be excluded for reimbursement purposes. N.J.A.C. 10:63-3.2(e)

The issue in this matter is whether prior to the adoption of this regulation, the DMAHS had the authority to reject petitioner's related party lease as a component of petitioner's cost.

Petitioner is appealing the reimbursement rate applicable from March 1, 1982 through April 30, 1983. Since rates are set prospectively based upon cost reports for the base year commencing 18 months prior to the reimbursement year, the lease signed on June 10, 1981 would have no bearing upon rates set prior to the 1982-83 reimbursement period. Also, petitioner is not questioning the authority of respondent to exclude from consideration for reimbursement the related party lease for periods subsequent to the adoption effective March 21, 1983 of N.J.A.C. 10:63-3.2(c).

THE FACTS

The following jointly stipulated facts are adopted as facts in this matter:

1. Wall Street on Hudson Corporation (hereinafter, Wall Street, Inc., a corporation of the State of Delaware) is, at all times relevant, the owner of the land and building upon which a skilled nursing facility known as Hudson Manor Skilled Nurs-
ing Facility (hereinafter, the Facility) has been operated since the Facility was opened in 1970. At some time during the year 1981, a determination was made by the stockholders of Wall Street, Inc. to form a new corporation under the name of Hudson Manor Skilled Nursing Facility, Inc., (hereinafter, Hudson Manor, Inc.) for the sole business purpose of operating the Facility while leaving the ownership of the land and building, as well as the equipment used in the operation of the Facility, in the name of the original corporation, Wall Street, Inc.

2. Hudson Manor, Inc., was formed on March 21, 1981 and has the same shareholders as Wall Street, Inc. The percentage interests of the various shareholders are identical in each of the corporations, i.e., for each ten shares of stock owned in Wall Street, Inc., one share of stock is owned in Hudson Manor, Inc. An application for a Certificate of Need was submitted which requested permission to transfer the operation of the business of the Facility to Hudson Manor, Inc. This application was granted by the New Jersey Department of Health on or about April 29, 1981.

3. On June 10, 1981, Hudson Manor, Inc., and Wall Street, Inc., entered into the following leases:
   1. a personal property lease, and
   2. a land and building lease.

   These leases became effective on July 1, 1981. Pursuant to the personal property lease, Hudson Manor, Inc., agreed to pay $62,440 per year to Wall Street, Inc., for the right to use all of the equipment, fixtures and furniture located at the facility, 9020 Wall Street, North Bergen, Hudson County, New Jersey. Pursuant to the land and building lease, Hudson Manor, Inc., agreed to pay $702,100 per year to Wall Street, Inc., for the right to use all the land and buildings located at 9020 Wall Street, North Bergen, Hudson County, New Jersey.

4. On July 13, 1977, the New Jersey Department of Transpor- tation conducted an appraisal of the nursing facility known as Hudson Manor Extended Care Facility (the Facility) on behalf of the New Jersey Department of Health. The purpose of this appraisal was to "... estimate the current depreciated value of the improvements and the market value of the land to be used as a basis for computation of the property cost portion of the
New Jersey Medicaid reimbursement program for participating in nursing homes."

5. Hudson Manor, Inc., did submit a cost study for the year end August 31, 1981 to the New Jersey Department of Health (hereinafter, Health Department), on November 30, 1981.

6. On December 30, 1981, Michael A. Cordisco, Analyst II at the Health Department, requested additional information from Hudson Manor, Inc. Specifically, the additional information requested was the amount of depreciation and interest on the mortgage for both Wall Street, Inc., and Hudson Manor, Inc. In response to this request, Form E-1 was submitted by the Facility. This form reported the depreciation as $128,724 and the interest on the mortgage as $184,573 for the reporting period September 1, 1980 through August 31, 1981.

7. By letter dated March 18, 1982, the Health Department denied reimbursement based upon the related lease expense as reported by the Facility, on Schedule A, line 18 of its cost study and replaced the same by the amount set forth on Schedule E-1 for depreciation and interest on the mortgage. Specifically, the amount of $764,500 was eliminated and the amounts of $128,724 and $184,573 were added.

8. Between March 18, 1982, the date of the desk review by the Health Department, and June 9, 1982, various correspondence was exchanged between the Health Department, DMAHS and the Facility. Additionally, a memo from the Department of Health, James R. Hub, Director, Health Economics Services, to administrators/owners of LTCFs regarding per diem reimbursement rates effective March 1, 1982, was issued and received by the Facility.

9. The Facility appealed the disallowance of its lease expense to the Health Department. A Level I appeal was conducted by telephone and through the exchange of correspondence. By letter dated September 16, 1982 from Michael Cordisco, analyst II, to Harold Herskovitz, administrator of the Facility, the Facility was advised of the result of the Level I appeal. With regard to lease expense issue, the Facility was advised that the disallowance of these expenses was upheld. As a result of the Level I appeal, the Facility was issued revised rates effective March 1, 1982.

10. By letter dated September 30, 1982, the Facility requested an administrative hearing "... with regard to the portion of the
Level I decision concerning the related party lease.”

11. Petitioner, Hudson Manor, Inc., stipulates that it is a related party as defined by the CARE Guidelines on pages B-30 and B-31. Specifically, Hudson Manor, Inc., is a corporation which is related by ownership to Wall Street, Inc., because the shareholders of both corporations are identical.

12. From January 1982 until the present, it has been DMAHS’s policy to disallow as a cost for Medicaid rate setting purposes, lease expenses reported by related parties and to replace said lease expense by mortgage interest, depreciation and property taxes or any other expenses of ownership attributable to the leased facility, all of which are reported by the facility on its cost study or supplemental schedules. Prior to January 1982, such lease expenses were not disallowed by DMAHS.

13. Prior to March 21, 1983, there was no specific regulation adopted which disallowed related party lease expenses. On July 19, 1982 a proposed regulation was published in the New Jersey Register concerning related party lease expenses. This regulation was adopted on February 24, 1983, effective on March 21, 1983. See, N.J.A.C. 10:63-3.2(c). Petitioner agrees that subsequent to March 21, 1983, related party lease expenses, such as are included in this appeal, are, in accordance with said regulation, not allowable costs for Medicaid reimbursement purposes. Therefore, petitioner is not seeking reimbursement in this appeal for any of said expenses after March 21, 1983.

14. Petitioner agrees that if the total amount of its related party lease expense were allowed as a cost for Medicaid reimbursement purposes for the reporting period September 1, 1980 through August 31, 1981, its per diem reimbursement rate based upon actual historical costs would be greater than its per diem reimbursement rate based upon the screened rate for rates effective March 1, 1982. If the lease expense reported by the Facility on its cost study is disallowed and replaced by mortgage interest and depreciation, the Facility’s per diem reimbursement rate based on actual historical costs is lower than the per diem reimbursement rate based upon the screened rate for rates effective March 1, 1982.

15. During the reporting period September 1, 1979 through August 31, 1980 for rates effective March 1, 1981 (which rates have not been appealed), the Facility reported $125,586 for depreciation and $201,972 for interest on the mortgage. For rates
effective March 1, 1981 this Facility's per diem rate was based upon the "historical cost rate."

I FIND it to be a fact that in March 1982 when respondent rejected the lease as a basis for computing the 1982-83 rate, it did so on the grounds of a changed internal policy which was later adopted into regulation effective March 1983. There is no evidence, nor is it alleged, that the lease was examined and evaluated for reasonableness, that it was compared to similar but nonrelated party leases or evaluated in terms of fair market value.

THE DISPUTE

It is petitioner's position that a change in administrative policy, in order to be effective must first be promulgated in accordance with the Administrative Procedure Act L. 1968, c. 410 §1 (N.J.A.C. 52:14B-1 et seq.). Prior to March 1983, related party leases were treated in the regulations no differently than other leases and prior to respondent's adoption of a new internal policy in January 1982 such related party leases were accepted as part of the cost reports of Long Term Care Facilities and subject to the same treatment as other leases. Therefore, the lease between Hudson Manor, Inc., the lessee, and Wall Street, Inc., the lessor was a valid lease between two distinct and separate corporations which under then existing law and regulation was subject only to treatment no different from any other lease.

Respondent's position is that agencies have the authority to regulate through adjudication of individual cases as well as through the adoption of duly promulgated and adopted regulations and that the agency was not precluded from adopting policy and applying it prior to the actual adoption of the regulations.

CONCLUSIONS OF LAW

Both positions are thoroughly articulated and carefully documented in the excellent briefs and responses from both parties. I CONCLUDE that it is a clearly established principle of law that agencies have the responsibility and authority to administer and carry out their duties through a dual process of promulgation of regulation and individual adjudication, a position most recently expressed by the New Jersey Supreme Court in In re Uniform Administrative Procedure Rules, 90 N.J. 85, 93 (1982).

Furthermore, it has been held by both the United States Supreme Court and the New Jersey Supreme Court that "the choice made between proceeding by general rule or by individual, ad hoc litigation is one that lies primarily in the informed discretion of the adminis-

As explained in the Rules decision, 90 N.J. at 93,

...[A]n agency engages in ad hoc rulemaking everytime it decides a contested case. The agency can use the adjudicative process to set certain policies, to define the contours of its regulatory jurisdiction, to give specific content to general regulations, and to handle specialized problems that arise. Thus, the agency's decisional authority over contested cases is directly and integrally related to its regulatory function.

See also, Chenery Corp., 332 U.S. at 202.

This form of regulatory power exercised by administrative agencies is characterized as "quasi-judicial" as opposed to "judicial" since it "is not simply a neutral forum whose function is solely to decide the controversy presented to it." City of Hackensack v. Winner, 82 N.J. 1, 28 (1980). Rather, the agencies, as part of the executive branch of the government, are also charged with administering laws in accordance with delegated statutory duties. Rules, 90 N.J. at 93.

The distinction between adjudication and rulemaking was enunciated in Bally Mfg. Corp. v. N.J. Casino Control Comm'n, 85 N.J. 325, 337-346 (1981) (Handler, J., concurring). Under the Administrative Procedures Act (APA), an "adjudication" is a "final determination, decision or order rendered in a contested case." N.J.S.A. 52:14B-2(c). "Contested case" is described as:

... a proceeding ... in which the legal rights, duties, obligations, privileges, benefits or other legal relations of specific parties are required by constitutional right or by statute to be determined by an agency by decisions, determinations, or orders, addressed to them or disposing of their interests, after opportunity for an agency hearing. N.J.S.A. 52:14B-2(b).

A "rule," however,

... is an agency statement of general applicability and continuing effect that implements or interprets law or policy, or describes the organization procedure or practice requirements of any agency. N.J.S.A. 52:14B-2(e).

Generally, therefore, adjudicatory proceedings usually determine the legal rights and relations of specific individuals, involve disputed factual issues, and require evidence and cross-examination in an adversarial proceeding. Texter, at 384 (1982). Rulemaking, on the other hand, typically involves broader policy judgments and is not governed by strict procedural requirements or subject to conventional rules of evidence. Bally, at 340.

The DMAHS disallows the cost of related party lease expenses for Medicaid reimbursement purposes because such leases allow the op-
portunity for excessive reimbursement. Medicare regulation 42 C.F.R. 405.427 (1981) provides that costs resulting from related party transactions "must not exceed the price of comparable services, facilities, or supplies that could be purchased elsewhere."

The regulation adopted by the Division of Medical Assistance and Health Services which disallows related party leases in effect establishes an irrebuttable presumption that related party leases not only provide the opportunity for excessive reimbursement but that such leases can be presumed to be excessive and not worthy of consideration. It eliminates the necessity to examine such leases to determine whether they exceed the fair market price and are inflated.

This presumption was not established in regulation prior to March 1983 and I CONCLUDE that the application of such a presumption in 1982 does not conform to any reasonable definition or description of an adjudicative process in which a determination is rendered in an individual matter based upon an examination of the facts. No regulation existed which permitted the agency to exclude a class of contractual agreements between two legally constituted entities. Property costs as reported, including the costs of rent, were accepted subject to certain screens. Such costs are still accepted subject to the screens where leases are between unrelated parties. The CFA was developed in order to obviate the need to examine, among other things, the ingredients of a lease. Whether the lessor received a return on his investment, was paid an amount which exceeded the actual costs of interest, taxes and depreciation was not and is not a subject of agency interest or analysis.

It is obvious that the establishment of a separate corporation, Hudson Manor, Inc., provided petitioner with the opportunity to collect rent in excess of the actual cost of taxes, depreciation and interest, to include for instance amortization and a return on investment. Such opportunity is available to property owners who lease to a tenant provider. These tenants then submit their expenses of leasing as part of their cost report and are reimbursed subject to the CFA screen. The act of establishing such a separate corporation and entering into a party-related lease violates no law and prior to January 1982 it was the policy of DMAHS to treat such leases identically with leases between unrelated parties.

In 1982, there was no regulatory change in this policy. DMAHS was, in effect, asked to consider the 1981 lease as part of the cost report of Hudson Manor in setting its prospective rate. The new lease included a marked increase in cost over the former capital cost sub-
mission which was limited to actual payment for taxes, interest and
depreciation paid by the owner/provider Hudson Manor. The new
cost was higher than the CFA rate. Petitioner contends that the
Division then had no choice but to use the actual costs or the CFA
which ever was lower. Respondent argues that DMAHS had the
authority to exclude the lease under a new changed policy, not yet
promulgated and adopted, to treat related party leases as excluded
from consideration.

Neither of these positions is supportable. DMAHS clearly has the
right and the obligation to examine cost submissions and the right
to question and exclude any unreasonable costs, consistent with
N.J.S.A. 30:4D-1 et seq. All rates established pursuant to the CARE
guidelines are subject to on-site audit verification of costs reported
by LTCFs (See N.J.A.C. 10:63-3 Foreword.) The guidelines specifi-
cally state at N.J.A.C. 10:63.3.9(b):

1. The departments should not concern themselves with the
   method and attendant costs with which individual LTCFs are
   financed and constructed or the arrangements under which
   they are acquired or leased.

2. While not concerning themselves about the costs, financing
   and so forth, of individual LTCFs the departments mandate
   with respect to the reasonableness of cost requires it to de-
   velop this rate component (property-capital costs) upon the
   presumption of reasonable facility costs and prudent financ-
   ing or leasing arrangements.

I CONCLUDE that the DMAHS had the right and the obligation
to examine the leasing arrangement between Wall Street, Inc., and
Hudson Manor, Inc., to hear the facts, to pierce the corporate veil,
and to determine whether the lease was reasonable in terms of fair
market value and comparability to other leases. In other words, the
agency has the power to adjudicate the reasonableness of this indi-
vidual lease regardless of its party relatedness and regardless of whether
or not the facility’s costs were above, equal to, or below the CFA.
DMAHS had the right to determine whether the costs of this lease
were unduly inflated because of the relationship between the corpo-
rations and to accept or reject the lease based upon the facts in the
matter. The decision to reject the lease, however, was not based upon
such a factual finding and adjudication. The lease was rejected solely
upon the basis of an internal policy, not yet promulgated, that the
agency would not consider a related party lease. This would appear
to be an undue extension of the powers of adjudication.

Looked at another way, if the Division were to discover in 1984
that it had inadvertently been using cost reports of a facility which
had a related party lease dating back to 1980, and if the Division undertook corrective action in 1984 to reassess the rates, excluding the related party lease, could the Division take such action retroactive to January 1982? Unquestionably, the effective date of the regulation in March 1983 would set the time limit for such retroactivity.

If the court were to find that the agency's action in this matter was permissible and within the adjudicatory procedures and authority of administrative function, that it could apply a broad policy change such as this in the absence of any regulatory change, such a finding would render meaningless the Administrative Procedures Act P.L. 1968. That law requires that changes in policy which are initiated or administered by agencies will take place under a process which includes prior announcement of intention to adopt regulations, participation and comment by the public and publication of adoption. Exceptions to such procedures are rare and specially circumscribed. While it is clear that the enactment of the Administrative Procedures Act of 1968 does not deprive administrative agencies of their power to administer also through the adjudicative process, that process cannot be construed to be a substitute for the regulatory requirements but rather an adjunct to it. DMAHS was not required to wait a year in order to implement a new policy through regulation. If the agency viewed this as a matter of important public interest requiring emergency adoption of rules, the agency could have adopted such regulations effective immediately under the procedures in the Administrative Procedures Act for emergency adoption of rules. The agency did not do that. DMAHS was not prevented either, in the absence of a regulation, from adjudicating and rendering an individual decision on the validity of petitioner's lease based upon a finding of fact. It did not do that. What it did do was implement a broad policy change without following the required regulatory process. I CONCLUDE that such action cannot be sustained under the umbrella of adjudicative powers.

The decision is to REVERSE the action of the agency in excluding from consideration petitioner's lease on the sole basis that it is a related party lease for the purposes of calculating the 1982-83 reimbursement rate. This does not preclude the agency from now reviewing that lease through an adjudicative process to determine its validity and reasonableness on a factual basis. In the absence of a factual finding that the lease is inflated by reason of party relatedness, the agency must honor the lease in the same way it would any nonparty related lease and is ordered to adjust the 1982-83 rate accordingly.
FINAL DECISION BY THE DIRECTOR OF THE DIVISION OF MEDICAL ASSISTANCE AND HEALTH SERVICES, THOMAS M. RUSSO:

The Director, Division of Medical Assistance and Health Services, has reviewed and considered the entire record in this matter, including the initial decision of the Honorable Ann Klein, ALJ, the exceptions thereto filed on behalf of the agency by Deputy Attorney General Karen L. Suter, and the replies to the agency's exceptions filed on behalf of the petitioner by Allan P. Browne, Esq.

Having reviewed in detail the record in this matter and having considered the arguments advanced by both parties, the Director REVERSES the recommended decision of the administrative law judge.

The basis for the Director's reversal is that the administrative law judge did not give sufficient weight or consideration to the principle of administrative flexibility which recognizes the dynamic nature of administrative and regulatory conduct and the necessity for agency action to implement a legislative scheme even while policy is in the developmental stages.

Both federal and New Jersey courts have recognized this principle of administrative law by liberally construing the authority of an administrative agency to effectuate the statutory scheme it is charged to enforce through individual adjudication or by official rule making.

A review of the legislative scheme concerning the administrative and operation of Medicaid programs reveals that section 1396a(a)(13)(A) of the Social Security Act requires that Medicaid providers be reimbursed for expenses that:

... are reasonable and adequate to meet the costs which must be incurred by efficiently and economically operated facilities in order to provide care and services in conformity with applicable State and Federal laws, regulations, and quality and safety standards....

Similarly section 1396a(a)(30) also requires that state Medical Assistance plans must:

... provide such methods and procedures relating to the utilization of, and the payment for, care and services available under the plan ... as may be necessary to safeguard against unnecessary utilization of such care and services and to assure that payments (including payments for any drugs provided under the plan) are not in excess of reasonable charges consistent with efficiency, economy and quality of care....

The intent of the New Jersey Legislature is similar, as evidenced by N.J.S.A. 30:4D-2 which mandates the state Medicaid agency to:

... provide medical assistance insofar as practicable, on behalf of persons whose resources are determined to be inadequate to enable them to secure quality medical care at their own expense, and to enable the State, within
the limits of funds available for any fiscal year for such purposes, to obtain all benefits for medical assistance provided by the Federal Social Security Act as it now reads or as it may hereafter be amended, or by any other Federal act now in effect or which may hereafter be enacted.

The State Legislature further charged the Commissioner of the Department of Human Services with the responsibility to adopt rules, regulations and fee schedules consistent with fiscal responsibility and to determine that payments for services rendered are reasonable (N.J.S.A. 30:4D-7 and 30:4D-7(b)).

As a result it is clear that the intent of both the federal and state Medicaid legislation includes the goal of cost containment.

In order to implement the legislative scheme of a reasonable and adequate reimbursement system and to achieve the goal of cost containment, the Department of Human Services and the Department of Health jointly developed the CARE reimbursement system. N.J.A.C. 10:63-3 et seq.

Under the CARE methodology long-term care facilities are reimbursed for services rendered to Medicaid patients in accordance with prospectively established reasonable cost related per diem rates.

As stated in the foreword to the CARE Guidelines the long-term care facility reimbursement formula was developed to meet the following overall goals:
1. To comply with federal requirements for a “reasonable cost related” formula;
2. To provide sufficient reimbursement to assure adequate levels of patient care;
3. To provide sufficient incentive to attract long-term care facility investment thereby reducing the reported Medicaid, bed shortage; and
4. To end opportunites for excessive properly cost reimbursement. (N.J.A.C. 10:63-3).

Hence, the CARE Guidelines, by screening out excessive or unreasonable costs, attempts to ensure that the state Medicaid agency only reimburses providers for the reasonable cost of services related to patient care.

However, the implementation of the CARE reimbursement methodology to achieve the above-stated goals has developed into a battle between the providers of nursing home services who seek to maximize their rate of reimbursement and the state agencies which attempts to limit reimbursement to reasonable costs related to patient care.

In order to repulse the raids on the public fisc initiated by providers, it is essential that the state agency has the flexibility to regulate
through individual adjudication as well as through rule making.

In this particular case the record clearly indicates that Hudson Manor Skilled Nursing Facility, Inc., the tenant operating company, leases its physical plant from Wall Street on Hudson Corporation, the landlord company.

The record further indicates that both the landlord and tenant corporations have identical stockholders and are related parties as defined by the CARE Guidelines.

It is also undisputed that from rate year 1981 to rate year 1982 the facility’s property capital expense rose from $327,588 to $764,500 per year.

In the previous rate year (1981) the facility reported its costs as an owner, not as a lessee, and was reimbursed for its capital property costs which included $125,586 for depreciation and $201,972 for interest for a total property capital expense of $327,558.

However, with the inception of the related party lease, the facility’s total property capital expense for rate year 1982 increased from $327,558 to $764,500.

Thus, in the course of one year, the facility’s property capital expense increased by $436,942 or 233% over the reported costs in the previous rate year.

This is precisely the type of opportunity for excessive property cost reimbursement that the statutes and CARE Guidelines are intended to prevent.

Similarly the agency’s policy regarding related party leases is founded in the belief that there is a significant likelihood that charges incurred by providers in their transactions with entities related to them by common ownership will artificially inflate costs due to the absence of bona fide arms-length bargaining, thereby rendering such costs unreasonable. The policy is thus designed to prevent seemingly separate entities from generating intra-company profits which accrue solely to the benefit of the stockholders at the expense of the Medicaid Program.

This type of self-dealing results in the generation of excessive costs and violates one of the primary tenets of the Medicaid Program which holds that payments authorized by federal and state legislation are intended primarily for the benefit of Medicaid recipients, and not for providers of services, N.J. Federation of Physicians and Dentists v. Klein, 144 N.J. Super. 466, 472 (App. Div. 1976); accord N.J. Pharmaceutical Association v. Klein, 140 N.J. Super. 16, 25 (App. Div. 1976).

Thus, based on the foregoing reasons, the Director makes the following:
FINDINGS OF FACT

1. Hudson Manor Skilled Nursing Facility, Inc. is an approved provider of Medicaid services.

2. Hudson Manor Skilled Nursing Facility, Inc. is the tenant operating company which leases the facility's physical plant from the landlord company Wall Street on Hudson Corp., Inc.

3. The landlord and tenant companies have identical stockholders.

4. The companies are related parties by common ownership as defined by the CARE Guidelines.

5. From rate year 1981 to rate year 1982 Hudson Manor's property capital expense rose from $327,558 to $764,500 per year.

6. The legislative intent of both federal and state statutory schemes is to ensure economically responsible reimbursement of Medicaid providers for the reasonable costs of service related to patient care.

7. One of the purposes of the CARE Guideline is to end opportunities for excessive property cost reimbursement by screening out unreasonable costs in order to comply with the legislative cost containment mandate that limits reimbursement to reasonable costs.

8. The $436,942 increase in the facility's property capital expense which would result from the recognition of the related party lease is an unreasonable expense and was properly disallowed.

9. The Department of Health on behalf of the Medicaid Program acted properly in replacing the artificially inflated property capital expense with depreciation of $128,724 and $184,573 in interest on the mortgage for purposes of establishing a Medicaid rate of reimbursement. These amounts reflect the actual cost of ownership for the facility, which costs had been included in reimbursement rates prior to the execution of the related party lease. As a result, the facility had its per diem rate for the period in question calculated in the same manner, giving consideration to its actual costs, as has been done for all prior periods under the CARE reimbursement system.

Further, the Director concludes that the statutory requirement of N.J.S.A. 30:4D-12(b) mandating the Division of Medical Assistance and Health Services to "Assure that payments . . . are not in excess of reasonable charges . . . consistent with efficiency, economy and quality of care" and the regulatory scheme set forth in the CARE Guidelines at N.J.A.C. 10:63-3 and N.J.A.C. 10:63-3.9(b)(2) provides ample authority for the agency to set aside related party lease expenses on a case by case basis.
Specifically *N.J.A.C.* 10:63-3.9(b)(2) under the heading "Property-capital costs" states that:

While not concerning themselves about the costs, financing and so forth, of individual LTCFs, the departments mandate with respect to the reasonableness of cost requires it to develop this rate component upon the presumption of reasonable facility costs and prudent financing or leasing arrangements.

Given the situation wherein a lease between two related corporations with common ownership increases the capital property costs by 233% in the course of one year, the presumption of a prudent leasing arrangement does not exist.

Moreover, it is an accepted principle of law in this State that "Administrative Agencies necessarily possess great flexibility and discretion in selecting the form of proceeding best suited to achieving their regulatory aims." *In re Uniform Administrative Procedural Rules, 90 N.J. 85* (1982).

As the New Jersey Supreme Court further explained:

The agency can use the adjudicative process to set certain policies, to define the contours of its regulatory jurisdiction to give specific content to general regulations, and to handle specialized problems that arise. *In re Uniform Administrative Procedural Rules, supra.* at 93.

The Director further concludes that the acceptance of the administrative law judge's recommended decision would severely undercut the ability of the agency to implement its mandate to contain costs because the agency would be limited to disallowing unreasonable costs only on a prospective basis through the rule-making process.

Such a result is contrary to both the established principles of Medicaid reimbursement and the body of administrative law case authorities followed in this State.

**THEREFORE,** it is on this 23rd day of September, 1983, ORDERED:

That the recommended decision of the administrative law judge is hereby REVERSED; and

**IT IS FURTHER ORDERED:**

That the disallowance of certain related party lease expenses submitted for the calculation of the petitioner's Medicaid per diem rate of reimbursement for the period from March 1, 1982 through April 30, 1983 is hereby AFFIRMED; and

**IT IS FURTHER ORDERED:**

That the use of the actual costs of ownership in the amount of $128,724 for depreciation and $184,573 in interest on the mortgage for the purposes of establishing a Medicaid rate of reimbursement is hereby AFFIRMED; and
IT IS FURTHER ORDERED:

That the findings, conclusions and recommendations of the administrative law judge are modified to the extent that they conflict with the holding in this decision.

You must check the New Jersey Citation Tracker in the companion looseleaf volume to determine the history of this case in the New Jersey Courts.