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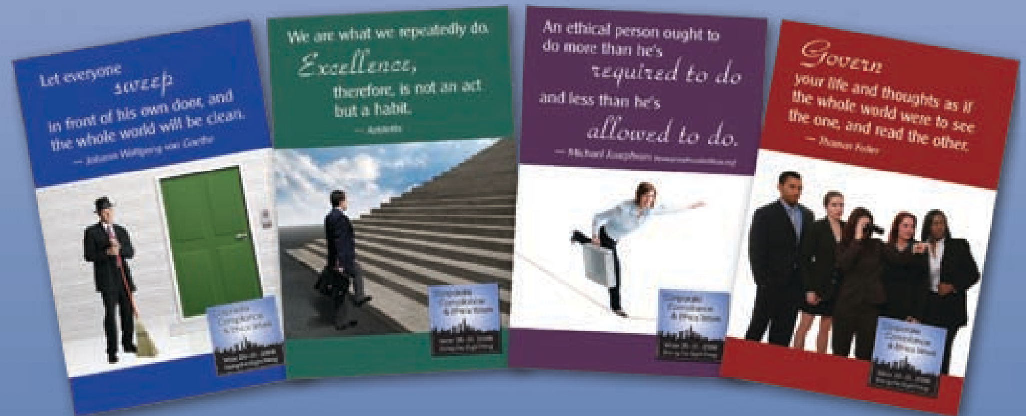
SEE PAGE 65



Meet

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PAGE 14

Earn CEU credit

SEE INSERT

Ten tips for leveraging your compliance committee

PAGE 5

Also:

Unallowable costs under the False Claims Act

PAGE 29

Feature Focus:

New CMS Interpretive Guidelines for Hospital CoP

PAGE 38

Unallowable costs under the False Claims Act: When to hold and when to fold

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The unallowable cost provisions have been a mainstay of fraud and false claims litigation judgments and settlement agreements. Medicare providers have long recognized the inevitable additional penalty of segregating and allocating out unallowable costs in *qui tam* litigation under the False Claims Act. The process of segregating and allocating the unallowable costs to a separate cost center in *qui tam* litigation is an arduous, time consuming, and costly task. It is a painstaking process to look back, review, and amend cost reports to identify and eliminate costs which are unallowable in *qui tam* litigation. It is a further administrative burden to track unallowable costs when a judgment and settlement agreement requires application of the unallowable cost provisions. However, the unallowable cost provisions are not applicable in every case.

The Federal Acquisition Regulations (FAR) were enacted over 20 years ago and apply to Medicare and Medicaid providers under Titles XVIII and XIX of the Social Security Act [42 U.S.C. §§ 1395-1395ggg and 1396 – 1396v]. FAR provides the roadmap for determining and accounting for unallowable costs in legal and other fraud proceedings, but that roadmap is hazy at best. Medicare providers have bright–line tests in determining unallowable costs for Medicare cost reporting purposes, but the task is not as clear cut in *qui tam* litigation.

In government contract matters, there is a Government Contract Guide which sets forth the principles and case law regarding cost allowability and the principles for determining and accounting for unallowable costs.[1] Comparable general guidance has not been forthcoming from the Department of Justice or Department of Health and Human Services, Office of Inspector General in Medicare fraud and False Claims Act litigation.

The unallowable cost provisions apply both in criminal and civil proceedings. In the criminal arena, not only a conviction, but pleas of guilty and *nolo contendere* trigger the unallowability provisions.[2] This is consistent with the Medicare grounds for exclusion under 42 USC 1320a-7 [See also, 42 CFR §1001.2]. The definition of "convicted" not only means a plea of guilty or plea of *nolo contendere*, but includes "An individual or entity [who] has entered into participation in a first offender, deferred adjudication, or other program or arrangement where judgment of conviction has been withheld" [42 CFR §1001.2(d)].

The FAR also provide that the unallowable cost provisions apply when there is liability in a fraud or similar misconduct proceeding or an assessment of civil money penalties. In either instance, the proceeding must be brought by a federal, state, local, or foreign government, or involve a *qui tam* action under the False Claims Act brought by a *qui tam* relator.[3] An action brought by a *qui tam* relator is considered an action "brought by the government" and triggers the unallowable costs provisions.

A civil action under the False Claims Act [31 USC §§3729-3733] constitutes a fraud action within the meaning of the Contract Clause, and makes costs of defending a fraud action, in most cases, unallowable.[4] The FAR contain provisions defining fraud as "(1) Acts of fraud or corruption or attempts to defraud the Government or to corrupt its agents;… and (3) Acts which violate the False Claims Act [31 USC, sections 3729-3731 or the Anti-Kickback Act, 41 USC, sections 51 and 54].[5] Clearly, Medicare False Claims Act proceedings fall within this definition.

Lastly, the unallowable cost provisions apply if a provider is suspended or debarred or Medicare/Medicaid participation is terminated. The FAR regulations are broader and apply to all government contractors who are "(1) suspended or debarred, (2) the contract is rescinded or voided, or (3) the contract is terminated for default as a result of a violation of law or regulation."[6]

The term "proceedings" under the FAR unallowable cost regulations includes not just judicial proceedings, but administrative proceedings and the investigation thereof.[7] This has been interpreted to include the internal investigation of the allegation, remedial or corrective action, compliance activities related to the proceedings, employee salaries, internal and outside counsel, and consultant costs and defense costs associated with the proceedings.

The regulations provide exceptions where the unallowable cost provisions do not apply, thus allowing for negotiation of the unallowable cost

Continued on page 30

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 ...continued from page 29

provisions in certain matters with the government and under the False Claims Act. The exceptions are limited in scope, but they are worthy of negotiation given the time, cost, and labor in identifying, segregating, allocating, and calculating unallowable costs for Medicare and Medicaid purposes.

The exceptions fall under the following general categories:

- There is no criminal conviction.
- The case, criminal or civil, is dismissed.
- In a *qui tam* matter where the government does not intervene and the matter is settled for nuisance value, in other words it is determined that "there was very little likelihood that the third party [*qui tam* relator under the False Claims Act] would have been successful on the merits." Costs may also be determined to be allowable if a court finds the *qui tam* relator's claim is clearly frivolous, clearly vexatious, or brought primarily for the purpose of harassment.[8]
- In an action commenced by the government and resolved by consent or compromise, the government specifically provides in the agreement for the allowability of the costs.[9]

Careful attention to the characterization and resolution of a proceeding is critical in any settlement negotiations. For example, in *Rumsfeld v. General Dynamics Corp*. [365 F.3d 1380 (Fed. Cir. 2004)], a contractor settled multiple fraud claims in a single proceeding. One of the claims had been dismissed before the settlement and the contractor sought to allocate and recover the legal defense costs associated with the dismissed claim. However, the settlement was silent as to the dismissed claim and did not provide for the allowability of any legal defense costs. The Court found that there was only one "proceeding," albeit multiple claims, and because the settlement did not allocate as allowable any of the costs associated with the proceeding, none were allowed. Had the settlement allocated the dismissed claim as allowable, the Court may have reached a different result.

Likewise, where a contractor assumed the legal defense of an employee and the employee was convicted of wrongdoing, the costs were held to be unallowable even though the contractor was not found liable and was not legally bound to pay them [See *Brownlee v. DynCorp*, 349 F.3d 1343 (Fed. Cir. 2003)].

Oftentimes, when the government does not intervene in *qui tam* litigation, it is because it believes the claim has no merit. Nonetheless, it is permitted to share in any settlement proceeds of the case and often negotiates to include the unallowability provisions in the settlement agreement, even if an exception applies. Preliminary negotiations with the government and the *qui tam* relator and some concessions regarding the merits may assist in a successful resolution of the unallowability issue. It is clear a strong defense and settlement posture is critical, and knowing when to hold and when to

fold is key when negotiating the unallowability provisions in fraud and False Claims Act litigation and settlement with the government.

The actual analysis of the allowability and allocation of costs in "legal and other proceedings" is beyond the scope of this article, but some general principles borne out by regulations, guidance, and case law are worthy of note. The unallowability provisions in "legal and other proceedings" may be found at 48 CFR §31.205-47. There is a distinction between allowability and allocation of costs. The concept of cost "allowability" is based on whether the cost can be recovered in whole or in part from the government [See *Boeing North American, Inc. v. Roche*, 298 F.3d 1274, 1280 (Fed. Cir. 2002) and 48 CFR §31.204].

Allowability is governed by the FAR. For Medicare and Medicaid purposes, it is also governed by the Medicare and Medicare laws and regulations. Allowability also requires a determination of "reasonableness; allocability standards promulgated by the Cost Accounting Standards (CAS) Board, if applicable; otherwise, generally accepted accounting principles and practices appropriate to the particular circumstances; terms of the contract; and, any other limitations [included in the regulations]" [See FAR CFR §31.201-2; 31.201-3]. The determination of allowability is based on principles and standards set forth in the regulations and the treatment of similar or related selected items [See 48 CFR §31.204(d)]. The cost allowability provisions are not all inclusive, but instead provide a framework for determining allowable cost [See 48 CFR §31.204(c)]. Although a cost may be allocable to a contract or the Medicare program, the cost is not necessarily allowable [See *Boeing*, Id. at 1280]. Costs may be assignable and allocable under CAS, but not allowable under FAR, [See *United States v. Boeing Co.*, 802 F. 2d 1390, 1394 (Fed. Cir. 1986)]. There are three types of unallowable costs: "expressly unallowable, mutually agreed to be unallowable, and those designated by a contracting officer or the government to be unallowable."[10] Two other types of costs fall in the unallowable category: "(1) costs that are not contractually authorized or for Medicare purposes, cost that are not allowed under Medicare/Medicaid rules; and (2) directly associated costs".[11] Directly associated costs are treated differently than other types of unallowable costs which are unallowable irrespective of the dollar amount. Directly associated costs are unallowable only if they are material in amount. "Materiality" is determined by "(1) the actual dollar amount, (2) the cumulative effect of all directly associated costs in a cost pool; and (3) the ultimate effect on the cost of Government contracts" [See 48 CFR § 31.201-6(e)(1)]. The directly associated costs, if material in amount, must be purged from the cost report.

In contrast, when determining the unallowability of employee salary expenses, a different standard applies. Some salary expenses are unallowable regardless of materiality. Some salary expenses are treated as directly associated costs and determined unallowable under the "materiality standard" if the time spent on the proscribed activity is material, even if the costs would not otherwise satisfy the definitions of directly associated costs.

"Salary expenses of employees who participate in activities that generate unallowable costs, are to be treated as 'directly associated costs' to the extent of the time spent on the proscribed activity, provided the costs are material in accordance with subparagraph (e)(1) above [9] except when such salary expenses are, themselves, unallowable). The time spent in proscribed activities should be compared to total time spent on activities that determine if the costs are material. Time spent by employees outside of the normal working hours should not be considered except when it is evident that the employee engages so frequently in company activities during periods outside normal working hours as to indicate that such activities are part of the employee's regular duties".[12]

The FAR Councils declined to provide a bright–line percentage rule for "materiality," instead opting for a case-by-case determination of the "materiality" based on actual dollar amount, cumulative effect of all directly associated costs in the cost pool, and the ultimate effect on cost to the government [See preamble comments to Proposed Rules 69 Fed. Reg. 58014 - 58015 (Sept. 28, 2004)].

In "legal and other proceedings," all costs that have a "direct bearing on the proceedings" are unallowable and both the in-house and outside counsel and consultant fees in those proceedings are unallowable [See, 48 CFR §31.205-47(a)].

The concept of allocability is based on whether there is a "sufficient nexus between the cost and a government contract and whether a particular item of cost should be recoverable as a matter of public policy".[13] The allocability of cost is governed by the CAS promulgated by the CAS Board [See 48 CFR §9904.405-20].

Costs that are either totally or partly unallowable under the "legal and other proceedings" cost principle must be segregated from other costs and accounted for separately. This will require a provider to identify and segregate the costs incurred during the pre-proceeding phase and throughout the course of the proceeding. Even where allowability depends on the outcome of the proceedings, the unallowable costs must be segregated from other costs and excluded from the cost report. While

Continued on page 63

Unallowable costs under the False Claims Act

...continued from page 31

31.205-47(g) contemplates that the government may initially reimburse a provider for potentially unallowable costs before a matter is resolved, segregation in all phases pending the outcome is preferred. The unallowable provisions in standard government settlement agreements require that the provider, within a 60-day time period, look back and carve out any unallowable costs from the cost report. Once the matter is resolved, a provider is required to separately identify, segregate to a separate cost center, and exclude from the cost report any unallowable costs incurred in the implementation of the settlement agreement or judgment and all attendant post resolution compliance activities. A compliance officer, and/or and Independent Review Organization (IRO), if one is appointed under a Corporate Integrity Agreement, will audit the unallowable cost allocation. A compliance officer must certify compliance and appropriate exclusion of unallowable costs is an appropriate area of inquiry for compliance. An IRO will often audit the time records of legal counsel, using those records as a roadmap to determine appropriate allocation of unallowable costs during Fraud and False Claims Act proceedings. Providers are cautioned to carefully review each phase of the proceedings to determine the allocation of internal and external resources for an unallowable cost determination.

1 Steven W. Feldman, Government Contract Guidebook (4th Ed 2008).
2 48 C.F.R. §31-205-47(b)(1).
3 48 C.F.R. §31.205-47(b)(2).
4 The Boeing Co., Successor-In-Interest of Rockwell Int'l Corp., CBCA Nos. 337,338,339 (July 9, 2007).
5 48 C.F.R. §31.205-47 (a)(1) and (3).
6 48 C.F.R. §31-205-47(b)(3).
7 See, Carl L. Vacketta, Donna Lee Yesner and Mary Ita Snyder, "Recovery of Legal Costs", Briefing Papers No. 93-12 (Nov. 1993). See also 48 C.F.R. §31-205-47(a).
8 48 C.F.R. §31.205-47(c)(2).
9 48 C.F.R. §31.205-47(c)(1).
10 Karen L. Manos, Government Contract Costs & Pricing, updated April 2007, available at Westlaw 1 GC-Costs 66:B. (Commenting on CAS 405, Accounting for Unallowable Costs).
11 See, Government Contract Costs and Pricing Part III. Cost Accounting Standards Chapter 66. CAS 405, Accounting for Unallowable Costs by Karen L. Manos (2007). B. Fundamental Requirements and Techniques for Applications; See, also 48 C.F.R. §9904.405-40
12 See, 48 C.F.R. § 31.201-6(e)(2).
13. [See *Boeing* at 1281 citing *Lockheed Aircraft Corp. v. United States*, 375 F.2d 786,794 (1967) and *Rice v. Martin Marietta Corp.*, 13 F.3d 1563,1569 (Fed. Cir. 1993)]