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COMMONWEALTH OF KENTUCKY
SUPREME COURT
2006-SC-000348

COMMONWEALTH OF KENTUCKY,
CABINET FOR HEALTH AND
FAMILY SERVICES — APPELLANT

v.

APPEAL FROM ANDERSON CIRCUIT COURT
ACTION NO. 04-CI-00101
COURT OF APPEALS NO. 2005-CA-000274-MR

EPI CORPORATION — APPELLEE

BRIEF FOR APPELLEE EPI CORPORATION

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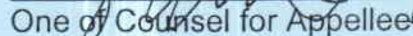
CERTIFICATE OF SERVICE

The undersigned hereby certifies that true and correct copies of this Brief for Appellee have been served upon the following, by U.S. mail, postage prepaid, on this the 23rd day of July, 2007: Samuel Givens, Jr., Clerk, Kentucky Court of Appeals, 360 Democrat Dr., Frankfort, Kentucky 40601; Honorable Charles R. Hickman, Judge, Anderson Circuit Court, 15 Courthouse, 501 Main St., Lawrenceburg, Kentucky 40065; Johann F. Herklotz, General Counsel, Cabinet for Health and Family Services, Office of Legal Services, 275 East Main Street 5W-B, Frankfort, Kentucky 40621.



One of Counsel for Appellee

May It Please The Court:

INTRODUCTION

"[I]t is axiomatic that failure of an administrative agency to follow its own rule or regulation generally is *per se* arbitrary and capricious."[1] The Cabinet's regulations here compelled it to accomplish recoupment of alleged Medicaid overpayments within a maximum twenty-one month period. *See* 907 KAR 1:110(3). Despite this mandatory requirement, the Cabinet asserted recoupment of alleged overpayments from EPI in 2004, for cost-years as far back as 1988 through 1996, contending (until now) that it was immune from **any** statute of limitations. Its "failure to follow its own rule" may be as unprecedented as it is astonishing.

Even without the Cabinet's own unavoidable deadline, KRS 413.120(2) bars any recoupment more than five years after the Cabinet learns of alleged overpayments. The Cabinet concedes notice of alleged overpayments at the time of its audits for EPI's cost-years, all of which occurred well more than five years before 2004. Audits on cost-years 1988 through 1995, for example, were completed by July 1996, **eight years** before the Cabinet sought recoupment. And, it **never** based any recoupment right on its contract with EPI. Either under its own promulgated rules or KRS 413.120(2), recoupment is barred. We respectfully ask this Court to affirm the unanimous Court of Appeals' decision.

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[1] *Com., Transportation Cabinet v. Weinberg*, 150 S.W.3d 75, 77 (Ky. App. 2004).

COUNTERSTATEMENT CONCERNING ORAL ARGUMENT

If oral argument would assist the Court, we welcome it.

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Counterstatement of the Case

As the Court of Appeals observes, there is "a long history of disagreement between the parties spanning nearly three decades".[2] The issue before the Court of Appeals only concerned, however, the Cabinet's[3] right to revise EPI's Medicaid rates and recoup alleged overpayments for cost years 1988 through 1996. It held that the Cabinet's regulations barred it from pursuing recoupment nearly a decade after the audits for cost-years 1988 to 1995. Because the Cabinet changed its rules in 1996 and eliminated the regulatory statute of repose, the Court held that it had the right to seek recoupment for cost-year 1996 as long as it took action to do so within five years of the filing of the cost report (Opinion at 16). EPI continues to dispute the amount of overpayment for 1996, but has **not** appealed the Court of Appeals' reasoning that the Cabinet had the ability, under its revised regulations, to assert a claim for 1996 to the monies it had already recouped within five years of the filing of the relevant cost report. This appeal therefore only involves whether the Cabinet must comply with its own regulations in effect for cost-years 1988 to 1995.

The Cabinet's Brief before this Court tries to reshape what this dispute has always concerned: The Cabinet's regulations. It told the Court of Appeals that the "gist of the argument on appeal" concerns its "right to recoup overpayments"

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[2] *Commonwealth v. EPI Corp.*, Court of Appeals No. 2005-CA-000274-MR (Ky. App. 2006) Opinion (hereinafter "Opinion") at 2).

[3] Appellant, the Cabinet for Health and Family Services (the "Cabinet"), is the state agency charged with administering the Medicaid program ("Kentucky Medical Assistance Program" or "KMAP") in Kentucky.

and, in its own words, **the answer to the question lies "in the audit and recoupment process detailed in the State's Medicaid regulations as they existed during the relevant time period"**.[4] To that end, just as it does for this Court, the Cabinet included all the applicable regulations in its hefty appendix.

Despite the Cabinet's consistent reliance on its regulations to demand recoupment, the Cabinet tells this Court that the issue is the statute of limitations applicable to recoupment of "overpayments made pursuant to a contractual Medicaid provider agreement".[5] If this Court reviews the voluminous record, however, as the Court of Appeals did, it also will realize that this has never been a contract action. Rather, "the Cabinet consistently primarily relied upon violations of either federal or state Medicaid and Medicare regulations in seeking to recoup alleged Medicaid overpayment" (Opinion at 12). The Cabinet wants to escape its regulations that forbid the sort of inaction and delay that took place here.

Regulations Governing 1988 to 1995

As a Medicaid provider that owned and operated skilled nursing facilities, EPI was required to submit year-end cost reports that showed its prior year costs.[6] 907 KAR 1:036E, Section 13 (1988). The Cabinet then established Medicaid reimbursement rates prospectively, based on the allowable costs in the

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[4] Cabinet's Brief for Appellants filed with the Court of Appeals on May 31, 2005 (hereinafter "Cabinet's Court of Appeals Brief").

[5] Cabinet's Brief for Appellant (hereinafter "Brief"), Introduction.

[6] EPI has since sold its skilled nursing facilities and is no longer a Medicaid provider.

previous year's cost reports. The Cabinet concedes that EPI filed its cost reports in a timely fashion "at the close of the facilities' fiscal year" (Cabinet Court of Appeals Brief at 2).

For each cost reporting period, the Cabinet had the right to conduct audits "annually or at less frequent intervals." 907 KAR 1:036E, Section 14 (1988). The audit told the Cabinet whether a provider had possibly been overpaid.[7] From 1988 to 1995, if a Medicaid participant provider disputed the audit results, the Cabinet's regulations on "Reimbursement Review and Appeal" contemplated two levels of review. First, the provider requested reevaluation of an audited cost report in writing to the Director, Division of Reimbursement, within forty-five days of receiving notice of the audit adjustments. The Director then had twenty days to respond. Second, the provider could then seek review, in writing, by a "standing review panel" within twenty days of the Director's decision. The review panel had twenty days from the provider's request to convene a hearing and thirty days thereafter to issue a binding decision.[8]

These strict deadlines were necessary because, during the relevant time, regulations implementing the federal Boren Amendment, 42 U.S.C.

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[7] Beginning July 1, 1997, the Cabinet changed its rate-setting methodologies and that rate year and subsequent rate years have never been at issue.

[8] 907 KAR 1:036E, Section 5 (1988); 907 KAR 1:036E, Section 6 (1989); 907 KAR 1:036E, Section 6 (1990); 907 KAR 1:025, Section 6 (1991); 907 KAR 1:025, Section 6 (1992); 907 KAR 1:025E, Section 6 (1993); 907 KAR 1:025E, Section 6 (1994); 907 KAR 1:025, Section 6 (1995).

§1396(a)(13)(A)(1996),[9] compelled the Cabinet, and its counterpart in all other participating states, to establish an appeal procedure that gives providers, like EPI, "**prompt** administrative review." 42 CFR 447.253(e) (emphasis added). The Cabinet's regulations ensured "prompt" administrative review by imposing a statute of repose on the Cabinet's recoupment rights. For each cost-year from 1988 to 1995, 907 KAR 1:110, entitled "Recoupment of Overpayments," gave the Cabinet a period of **no more than twenty-one months** to recoup overpayments.[10]

Through strategic labeling, the Cabinet suggests that 907 KAR 1:110 is limited to "exceptional hardship circumstances." But that is only part of what the regulation addresses. It is the only regulation governing the time applicable to the Cabinet's recoupment of overpayments in 1988 to 1995, and it squarely applies to the Cabinet's dilatory inaction.

[9] The Boren Amendment was repealed by the Balanced Budget Act of 1997 for services rendered after October 1, 1997, but remains effective here for all periods prior to that date.

[10] Under federal law it was important that the Cabinet act expediently since it had to repay the federal government its share of any alleged overpayments within sixty days of discovery. *See Finnerty v. Thornton Hall, Inc.*, 593 S.E.2d 568, 573 (Va. App. 2004). The facts in *Finnerty* are amazingly close to this case. There the state Medicaid agency hired the same auditor, Clifton Gunderson, PLLC, to audit the provider's cost reports. The agency waited, however, until 2001 to conduct the required informal fact finding conferences with the provider for the 1991, 1993, 1994, 1995 and 1996 cost years. The agency was found to be time-barred from recoupment by Virginia's four-year limitations period. The statute was passed because the legislature had "determined it unjust to subject Medicaid providers to the threat of DMAS overpayment recovery, regardless of how stale the claim may be." *Smith v. Liberty Nursing Home, Inc.*, 522 S.E.2d 890, 895 (Va. App. 2000). The Cabinet's regulations here signaled both to the Legislature and the providers that recoupments would be completed within twenty-one months at the outside.

Section 1 of 907 KAR 1:110 states that the regulation applies to "all providers of medical assistant services." Section 2 provides:

> Recoupment of Overpayments.
>
> When it is determined that a provider has been overpaid, a letter shall be mailed to the provider **requesting payment in full within thirty (30) days**. If a provider demonstrates to the program within the thirty (30) day time limit that full payment would create an undue hardship, **a payment plan not to exceed six (6) months from the notification date shall be established. If the full payment or payment plan request is not received within thirty (30) days of notification**, the amount due shall be deducted from current payments until the full amount is recouped. Once the payment plan has been established and a payment is not received by the agreed to date, the amount shall be deducted from current payments (emphasis added).[11]

Thus, under Section 2, the Cabinet must begin deducting recoupment amounts within thirty days of a maximum six month period from the date when it determines that a provider has been overpaid or, in other words, within approximately seven months of the audit.

Section 3 of 907 KAR 1:110, creates one exception to the seven-month period in allowing a provider to obtain a "reasonable extension of the time period for recoupment" if it can demonstrate an "exceptional hardship." It concludes, however, with an unmistakable command: "**The time period for recoupment** shall not exceed twelve (12) months from the date the overpayment is

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[11] The mandatory language of the regulation became more emphatic changing from "will" to "shall", as quoted here, in 1993.

established, and **shall be accomplished within twenty-one (21) months from the end of the provider's cost reporting period** ..." (emphasis added).[12]

As the Court of Appeals correctly recognized,

> Based on the plain language of these regulations, **it is clear that time was of the essence for the Cabinet to seek recoupment** from providers given an overpayment of Medicaid funds. **Even in exceptional hardship circumstances, the most gracious time period for recoupment** given by the Cabinet was twelve months from the date of the overpayment and within **twenty-one months from the end of the providers cost reporting period**.

(Opinion at 10 (emphasis added)).

The statute of repose in 907 KAR 1:110 injects certainty and predictability in the system by (i) compelling the Cabinet to act promptly and responsibly, and (ii) forbidding recoupment in this century for nearly a decade of cost-years in the last century. It did not leave providers wondering whether, if ever, the Cabinet would claim recoupment. A statute of repose on government action stands entirely consistent with the obstacles placed on citizen providers, who lose rights, for example, if they fail to appeal within forty-five days. A worn cliché comes to mind: Sauce for the citizen goose is sauce for the government gander.

New Regulations for 1996

As the Court of Appeals explains, in 1996, the regulatory language no longer contained the 1988 to 1995 statute of repose (Opinion at 11). The

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[12] 907 KAR 1:110(3) [1993 Ed.]. Section 3 also provides an absolute cutoff for recoupment within twenty-one months of "the billing invoice, request for payment or similar document for providers not reimbursed on the basis of cost reports." This language of Section 3 does not apply to EPI because it is reimbursed based on cost reports. The twenty-one month statute of repose therefore begins "from the end" of EPI's "cost reporting period."

Cabinet adopted a new Section 2 in 907 KAR 1:671, entitled "Methods for Recoupment of Overpayments Made By the Medicaid Program," which maintained regulatory deadlines for recoupment steps, but omitted the statute of repose. New Section 2 required providers, for the first time, to pay the audit adjustment within 60 days even if the provider appealed and the Cabinet quickly recouped the alleged overpayments for cost-year 1996.[13]

The amended regulation has no bearing on cost-years 1988 to 1995,[14] except to demonstrate that the applicable twenty-one month period imposed a mandatory statute of repose that gave the Cabinet a limited time to pursue recoupment, which the Cabinet could have amended, but chose not to do so until it promulgated new Section 2. Moreover, the Cabinet did not provide for a "stay" of recoupment until 2002 when it promulgated a regulation that tolled recoupment pending appeal. *See* 907 KAR 1:671, Section 2(10)(6)(2002). This 2002 amendment plainly reveals that no tolling provision for delay was possible in the

[13] EPI continues to dispute the validity of the Cabinet's audit adjustments for cost-year 1996, as it also does for 1988 through 1995, but not the timeliness of the 1996 recoupments completed within five years. The substantive issues and EPI's objections to the Hearing Officer's substantive rulings have not yet been addressed by any court since the statute of limitations issue is preclusive.

[14] The Cabinet concedes that the regulations in existence in 1988 through 1996 apply to those cost years [Cabinet Court of Appeals Appellees' Brief at 4]. Although the recoupment rules changed after 2000, those regulations are inapplicable to prior years. KRS 446.080(3) provides: "No statute shall be construed to be retroactive, unless expressly so declared." This rule has been applied to regulations. *E.g., United Sign, Ltd. v. Com.*, 44 S.W.3d 794 (Ky. App. 2000); *Kerr v. Kentucky State Board of Registration for Professional Engineers & Land Surveyors*, 797 S.W.2d 714 (Ky. App. 1990); Com. *Transportation Cabinet v. Woodall*, 735 S.W.2d 335 (Ky. App. 1987). Only the regulation that is in effect at the time of the conduct at issue can control.

last century for cost-years 1988 to 1995. And, even the 2002 tolling rule fails to give the Cabinet the fifteen-year period it demands here.

The Cabinet's Noncompliance

The Cabinet relies on its regulations when demanding money from EPI but ignores those regulations entirely when it comes to its own actions. The Cabinet has no choice but to insist on a fifteen-year period for recoupment because it failed to meet any regulatory deadline. It is undisputed that EPI timely filed its cost reports at the end of each cost-year for 1988 to 1995. It is also undisputed that the Cabinet took years even to complete its audits. It finalized its audit for 1990, 1991, and 1992 on April 9, 1996. The audits for 1988 and 1989 are not dated, but the Cabinet has never disputed that the audits for these years occurred before 1996. It finalized its audit for cost-year 1993 on June 20, 1996, cost-year 1994 on June 26, 1995, and cost-year 1995 on June 20, 1996.

Likewise, it is undisputed that the Cabinet learned from its audits that the State's "reimbursement to EPI's facilities for 1988 through 1996 exceeded the actual cost of services ... for these years" (Cabinet Court of Appeals Brief at 2). In the Cabinet's own words, on the dates of the audits, it "was authorized by regulation to seek recoupment." Under 907 KAR 1:110, the express regulation governing recoupment for cost-years 1988 to 1995 required the Cabinet to complete recoupment by the end of 1990 for cost year 1988, and by the end of 1997 for cost-year 1995. With the lone possible exception of 1988, the Cabinet failed even to complete its audits within twenty-one months of the cost reporting

period. And, it did not demand recoupment until May 26, 2004.[15] It says it notified EPI of its "intent to recoup" on February 5, 2002. That notice was well outside the twenty-one month time period for recoupment under 907 KAR 1:110. Moreover, the mere "intent" to recoup is not a recoupment, as the Cabinet's May 26, 2004, demand proves. The regulation compels the Cabinet to **accomplish** recoupment within twenty-one months, not simply to "intend" to accomplish it.

In a footnote, the Cabinet suggests that the reasons for its delay "are not relevant" to its current appeal. Perhaps so. But the fact remains that the Cabinet promulgates regulations governing its conduct. The Cabinet controls the entire reimbursement, administrative appeal and recoupment process. The Cabinet elected unilaterally to lump all the cost years from 1988 through 1996 together, and then, in January 2003, provide EPI an evidentiary hearing.

Consistent with the Cabinet's dilatory conduct, the Hearing Officer issued his decision more than eight months after submission of the case in violation of the deadlines in KRS 133.110 (Opinion at 17-18). And, when he finally issued it, he adopted nearly verbatim the Cabinet's 81-page proposed findings, including its reliance on the fifteen-year statute of limitations applicable to contracts. As the Court of Appeals noted, "it is inappropriate for administrative hearing officers to delegate such an important part of his authority to a party in a matter before him" (Opinion at 18).

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[15] Appendix 1, hereto contains the Cabinet's demand letters sent to EPI on May 26, 2004, after EPI filed an appeal with the Anderson Circuit Court from the Secretary's Final Order adopting the Hearing Officer's Recommended Decision upholding the Cabinet's audit adjustments.

Proceedings Below

EPI appealed to the Anderson Circuit Court on April 2, 2004. On May 26, 2004, nearly fifteen years after the first cost-year at issue, the Cabinet sent letters for the first time notifying EPI of the alleged amounts of overpayments and stating that it would deduct those amounts for all cost-years (Appendix 1, hereto). The Cabinet asserts that the overpayment amount exceeds $6.8 million, but that amount remains disputed by the parties, and the Cabinet never notified EPI of the amount claimed until May 2004.[16]

EPI moved for summary judgment based on the statute of limitations (TR 287). KRS 413.120(2) imposes a five-year limitation for "[a]n action upon a liability created by statute, when no other time is fixed by the statute creating the liability." EPI's alleged liability for Medicaid reimbursement rests on statutes empowering the Cabinet to impose regulations on recoupment. *See* 907 KAR 1:110 (1988 – 1995), appended to the Cabinet's Brief. The Cabinet relies on the

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16 The $6.8 million the Cabinet refers to in its Brief is actually the amount of audit adjustments the Cabinet made to EPI's cost reports. The total amount of the claimed overpayments is much smaller at $3,034,557. Among other things, this is because the rate setting methodology in effect at the time employed different ceilings or cut-offs. Thus, for example, if a facility's costs exceeded the relevant peer group maximum then the facility's rate was set at the peer group maximum. In that instance, an audit adjustment increasing those costs further was a purely academic exercise since the peer group maximum would still determine the rate. This case is so old that the Cabinet has forgotten how the now ancient methodologies it used to employ worked. The amount of any alleged overpayment cannot be determined without detailed referenced to the rate setting regulations. As noted earlier EPI's substantive challenges to the audit adjustments allowed by the Hearing Officer remain to be decided if this Court should find the Cabinet is not time-barred here. In addition, EPI has never had the opportunity to question how the Cabinet calculated the $3,034,557 in claimed overpayments.

contract between EPI and the Cabinet, but even that contract is governed by "applicable federal and state laws and regulations," and EPI agrees to abide by the same regulations that govern the Cabinet (See Selected Provider Agreements Appended to Cabinet's Brief). The Circuit Court reversed the Hearing Officer's findings and granted EPI's motion as a matter of law: The Cabinet "is barred from recouping any payments from EPI ..." (TR 437).

The Cabinet then appealed. Consistent with its administrative position, it contended that it was immune from any statute of limitations. But its lead argument, for the first time, insisted that the five-year statute of limitations was tolled, an argument never presented to the Anderson Circuit Court or the Hearing Officer. In its words, "[w]hile the administrative appeal was pending, the recoupment was stayed; thus, the right accrued once the audit was completed but was tolled until a final administrative agency determination in 2004" (Cabinet Court of Appeals Brief at 14).

This contention is directly contrary to mandatory regulatory deadlines and the statute of repose. As previously noted, the Cabinet never allowed tolling until it promulgated a new regulation in 2002, which has no application to the 1988 through 1995 cost years. Faced with this new, unfounded argument, and the Cabinet's square reliance on its "regulatory" right to recoupment, EPI pointed out that the Cabinet's own regulations – the ones cited in the Cabinet's Brief, specifically 907 KAR 1:110 – imposed a statute of repose that made "tolling" impossible. EPI also asserted that, even without this regulatory limitation, the five-year statute in KRS 413.120(2) barred recoupment. The Cabinet admitted

that recoupment was barred if KRS 413.120(2) applied (absent its new tolling position).

The Court of Appeals affirmed the Circuit Court for cost-years 1988 to 1995 based on 907 KAR 1:110. Consistent with its reliance on the Cabinet's own regulations, the Court reversed on cost-year 1996 based on the new regulation. "According to the record, the Cabinet enforced its new regulation and required EPI to promptly pay back alleged overpayments for cost-year 1996. This occurred shortly after EPI was notified of the audit adjustments, which was within five years of EPI's submission of its cost report for cost-year 1996" (Opinion at 16). Because the Cabinet complied with its new regulations for cost-year 1996 and completed recoupment within five years, the Court found it was not time-barred. But if the recoupment had been "past the five-year limit, we may have reached a different result" (Opinion at 17).

On appeal to this Court, the Cabinet abandons both its argument for immunity and its tolling attempt before the Court of Appeals to escape the five-year bar. The Cabinet falls back on a demand for the fifteen-year period applicable to contract claims. Its only strategy for avoiding the rules that it promulgated to govern itself, and other Medicaid participants, is to say EPI did not preserve the right to rely on the very regulations that give the Cabinet the right to recoupment. The law is clear that EPI adequately raised and preserved its statute of limitations defenses. Moreover, conceding the Cabinet's position would mean that an agency of government can cavalierly disregard the rules it adopts both for itself and the citizens with no legislative or judicial oversight.

ARGUMENT

I. THE CABINET'S OWN REGULATIONS BAR RECOUPMENT FOR COST-YEARS 1988 TO 1995.

The regulation governing "Recoupment of Overpayments" from 1988 through 1995, 907 KAR 1:110, imposes an unambiguous statute of repose that gives the Cabinet a maximum of twenty-one months to accomplish recoupment. Without doubt, if this regulation applies, recoupment is barred. The Cabinet does not contend otherwise.

A. An Agency Is Bound By Its Rules.

KRS 13A.130(1) prohibits an administrative body from modifying, limiting or expanding a regulation by internal policy or other action. "An agency must be bound by the regulation it promulgates .... Further, the regulations adopted by an agency have the force and effect of law." *Hagan v. Farris*, 807 S.W.2d 488, 490 (Ky. 1991); *See also Linkous v. Darch*, 323 S.W.2d 850 (Ky. 1959); *Shearer v. Dailey*, 226 S.W.2d 955 (Ky. 1950).

The enforcement of a regulation is subject to the same rules that govern statutory interpretation. *See Revenue Cabinet, Com. V. Gaba,* 885 S.W.2d 706, 708 (Ky. App. 1994) ("the same rules apply that would be applicable to statutory construction and interpretation."). *See also Revenue Cabinet v. Joy Technologies, Inc.*, 838 S.W.2d 406, 409 (Ky. App. 1992) (In construing regulations, the court is "governed by the same rules which would apply in construing statutes in the same field."). All rules of interpretation demand strict application of unambiguous laws. "When the words of the statute are clear and unambiguous and express the legislative intent, there is no room for construction

or interpretation and the statute must be given its effect as written." *McCracken County Fiscal Court v. Graves*, 885 S.W.2d 307, 309 (Ky. 1994) (citing *Lincoln County Fiscal Court v. Department of Public Advocacy*, 794 S.W.2d 162, 163 (Ky. 1990)).

While the Cabinet demands "deference," an agency cannot interpret its own regulations in a way that is contrary to the language of the regulations. *See J. B. Blanton Co. v. Lowe*, 415 S.W.2d 376, 378 (Ky. 1967). Agencies are bound to enforce regulations as they are written. "An agency's interpretation of a regulation is valid . . . only if the interpretation complies with the actual language of the regulation." *Hagan v. Farris*, 807 S.W.2d 488, 490 (Ky. 1991). When, as here, a court is reviewing an administrative decision, "questions of law are for the ultimate determination of the court, and the court may substitute its judgment for the agency's if the ruling was based on an erroneous interpretation of the law." *City of Frankfort v. Davenport*, 2006 WL 2380792, at *2 (Ky. App. 2006) (citing *Mill Street Church of Christ v. Hogan,* 785 S.W.2d 263 (Ky. App. 1990)). *See also Flaget Fuels, Inc. v. Com., Environmental and Public Protection Cabinet*, 2005 WL 2574148, at *3 (Ky. App. 2005) ("While we will give some deference to an agency interpretation of the regulations and the law underlying them, the courts have the ultimate responsibility in matters of statutory construction.") (citing *Delta Air Lines, Inc. v. Com., Revenue Cabinet,* 689 S.W.2d 14, 20 (Ky. 1985)).

B. <u>The Statute of Repose Means What It Says.</u>

No deference is deserved in this case because the words of 907 KAR 1:110(3) could not be more self-explanatory: "The time period for recoupment

shall not exceed twelve (12) months from the date the overpayment is established, and **shall be accomplished within twenty-one (21) months from the end of the provider's cost reporting period** ...." (emphasis added). "Shall" is mandatory. *Alexander v. S&M Motors, Inc.*, 28 S.W.3d 303, 305 (Ky. 2000); KRS 446.010(20); *Plaut v. Spendthrift Farm, Inc.*, 1 F.3d 1487, 1490 (6th Cir. 1993), aff'd., 514 U.S. 211 (1995) (No stronger words convey intent that the specified action is mandatory).

"Accomplish" is also a word of ordinary meaning. The first definition in Webster's Third New International Dictionary defines "accomplish" as "1: **to execute fully**: Perform, Achieve, Fulfill" (emphasis added). It says the synonym for "accomplish" is to "complete." The Cabinet unquestionably failed here to "execute fully, perform, achieve or fulfill" recoupment within twenty-one months of the last cost reporting period, 1996.

The Cabinet insists that its interpretation of regulations "is accorded a certain degree of deference" (Brief at 18). But, as explained, it has long been settled that an agency's "interpretation" is valid **only** if the interpretation complies with the language of the regulation. *Hagan*, 807 S.W.2d 490. It is hardly a matter of mere "interpretation" to contend that twenty-one months means fifteen years.

The Cabinet says it could have "introduced evidence to contest or refute" what 907 KAR 1:110(3) plainly states. But it never suggests what that "evidence" could possibly be, and any such "evidence" would necessarily relate to an "interpretation" that contravenes the unambiguous words of the regulation. An

agency is hardly denied due process, as the Cabinet claims, when courts force it to adhere to the rules it promulgates.

To the contrary, the Cabinet's reliance on "due process" to support arbitrary and capricious conduct, turns due process on its head. If due process has any involvement in this dispute, it supports EPI's right to be free of capricious agency action in disregard of every regulatory deadline governing recoupment, and what can only be viewed as a classic kangaroo court administrative proceeding, as the Court of Appeals observed in gentler words when "commenting" on the Hearing Officer's conduct (Opinion at 18-19).

C. EPI Did Not Waive The Right To Rely On The Cabinet's Regulations.

While the Cabinet insists on a fifteen-year limitations period, it offers no argument on the merits of the regulatory statute of repose that prohibits its delay. The Cabinet cannot because the words in 907 KAR 1:110(3) are clear: a mandatory twenty-one months to "accomplish" recoupment. The Cabinet therefore contends only that EPI failed to preserve the statute of repose for appeal. This position is flawed for any number of reasons.

1. *Burton* Supports the Court's Reliance on 907 KAR 1:110(3).

The Court of Appeals cursorily dismissed the Cabinet's "preservation" argument for the right reason. "Applicable legal authority is not evidence and can be resorted to at any stage of the proceedings whether cited by the litigants or simply applied, *sua sponte*, by the adjudicator(s)" (Opinion at 11). The Court relied on *Burton v. Foster Wheeler Corporation*, 72 S.W.3d 925, 930 (Ky. 2002),

which holds: "[A]n appellate court should resolve cases on the merits, aided by but not necessarily restricted to the arguments of counsel."[17]

In *Burton*, the Supreme Court made clear that a party can point to a regulation for the first time on appeal. "[A]pplicable legal authority is not evidence and can be resorted to at any stage of the proceedings whether cited by the litigants or simply applied, *sua sponte*, by the adjudicator(s)."[18] The Court of Appeals applied this well recognized doctrine in rendering its decision and requiring the Cabinet to abide by its own promulgated rules.

The Cabinet downplays *Burton* despite, other decisions adhering to this same holding that favor decisions on the merits. In one of the leading cases, *First National Bank of Louisville v. Progressive Casualty Insurance Co.*, an attorney made off with his clients' settlement money through forging endorsements on settlement drafts.[19] The Supreme Court allowed the victims to obtain full recovery from the paying bank, without subtracting the attorney's fees agreed to in the clients' contingent fee contracts.[20] It reached this result, not based on the parties' arguments, but on a theory of law that an amicus curiae brief submitted to the court on rehearing.[21] In justifying its reliance on the amicus

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[17] *Burton v. Foster Wheeler Corp.*, 72 S.W.3d 925, 930 (Ky. 2002) (citing *First Nat'l Bank of Louisville v. Progressive Cas. Ins. Co.*, 517 S.W.2d 226, 230 (Ky. 1974)).

[18] *Id.*

[19] *See First Nat'l*, 517 S.W.2d at 227.

[20] *See id.* at 230.

[21] *See id* at 229.

brief, the Court observed: "[M]uch bad law will go into the books (more, that is, than is there already) if courts confine their analysis of cases to the theories presented in the briefs."[22]

If this Court were to reject the decision of the Court of Appeals here, it would allow exactly what the Court sought to avoid in *First National*. "Bad law" will be passed into the books, and a party not entitled to recover by its own regulations would be able to do so. In the interests of good law, the Cabinet must be obliged to follow its own rules, on what it has consistently relied in demanding reimbursement from EPI. This result remains especially just, given the fact that EPI presented 907 KAR 1:110 in rebuttal to a new theory that the Cabinet raised, for the first time, in the Court of Appeals.

The Supreme Court approved *Burton* again in *Marrs v. Kelly.*[23] There, the appellant argued that an administrative law judge's testimony was inadmissible in a motion to amend the trial court's decision. The appellant then dropped the argument and made a partial concession in the Court of Appeals.[24] The Supreme Court nevertheless allowed the appellant to renew its abandoned position on appeal, and then "set forth the law" with regards to ALJ testimony in the process.[25] It did so acknowledging: "We are loathe to order parties to trial

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[22] *Id.* at 230.

[23] *Marrs v. Kelly*, 95 S.W.3d 856 (Ky. 2003).

[24] *See id.* at 858.

[25] *Id.* at 859.

based upon a concession that requires a misapplication of the law."[26] The Supreme Court directs: "[C]ourts have a duty to properly apply the law without regard to omissions or errors by parties."[27]

The Cabinet attempts to distinguish *Burton* and consistent authority because they supposedly did not involve administrative proceedings. This "distinction" is incomprehensible because *Burton* itself began with a hearing before an administrative law judge:[28] An injured employee sought disability benefits from the Workmen's Compensation Board.[29] The Supreme Court based its decision on a regulation that it found on its own, which the appellant never even cited, not even in its Supreme Court Brief.[30]

It is well-settled that a party is not required to guess correctly, at its peril, as to which statute of limitations a court might ultimately decide is controlling. It is only necessary that the party raise the issue as a defense in the proceedings below. Thus, in *Val Decker Packing Co. v. Corn Products Sales Co.*, 411 F.2d 850 (6th Cir. 1969), where the district court granted summary judgment to the defendant based on a two-year statute of limitations, the Sixth Circuit Court of

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[26] *Id.*

[27] *Id.* at 859 n.3 (interpreting *Burton*, 72 S.W.3d 925 and *First Nat'l*, 517 S.W.2d 226).

[28] *See Burton*, 72 S.W.3d at 926.

[29] *See id.*

[30] *Id.* at 930 ("Ironically, the regulation that Appellant finally did cite in his reply to the employer's response to his petition for reconsideration, as well as in all of his appellate briefs, is not the regulation that applies to the facts proven in this case").

Appeals was free to inquire, *sua sponte*, about a four-year statute of limitations. This four-year statute had not been brought to the attention of the lower court, nor had it been argued or briefed.[31] The appellee objected contending that, because the four-year statute was not raised in the district court, it could not be considered by the appellate court. The Sixth Circuit disagreed, stating:

> No new issue has been raised. The only issue before the District Court was whether plaintiff's action was barred by a state statute of limitations. The Court was required to determine which statute was applicable. Having made that determination and dismissed the complaint, its judgment is subject to appellate review, and we have the right to consider all of the statutes and to apply the one which in our judgment is required....

Id. at 852. The Sixth Circuit continued to reverse the trial court finding the four-year statute applicable.[32] In short, the Court is the guardian of the law.

Another similarity between *Burton* and this case makes it clear the same result should apply here. Although the appellant in *Burton* never cited to the correct safety regulation, it generally referenced a safety regulation at each stage of the process. EPI likewise based its administrative and lower court theories on a statute of limitations defense without specifically citing 907 KAR 1:110, until its brief for the Court of Appeals. EPI argued vociferously that the Cabinet was

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[31] 411 F.2d at 851.

[32] *See also Lawyers Cooperative Publishing Co. v. Muething*, 603 N.E.2d 969, 971-72 (Ohio 1992) (Because statute of limitations issue was raised below, the court would consider all aspects of that argument, including the applicability of a statute raised for the first time on appeal). *Zotos v. Lindbergh School District*, 121 F.3d 356, 361-62 (8th Cir. 1997) (Defendant did not waive statute of limitations defense simply by pleading the defense based on the wrong choice of law, and the court may affirm the lower court's judgment on any basis supported on the record).

time-barred from making audit adjustments or taking any other steps towards recoupment at every step of the way, both in front of the agency and in the courts below. The bar is not a new issue. *Burton* controls and allows this Court to render justice and bind the Cabinet to the regulations that it promulgated.

2. Appellate Courts Have Wide Discretion in Looking to New Legal Authority.

"So long as an appellate court confines itself to the record, no rule of court or constitutional provision prevents it from deciding an issue not presented by the parties."[33] "[T]heir discretion is broad enough to prevent a conclusion that it has been abused."[34] As was stated in *Burton*, "applicable legal authority is not evidence" and therefore citing to a new statute or regulation is not going outside of the record. The Court of Appeals here exercised its recognized discretion in looking to the regulations that the Cabinet itself cited. The Court of Appeals simply exercised the same power that the Supreme Court endorsed in *Priestley v. Priestley*. In that case, the Court of Appeals looked to the issue of standing *sua sponte*.[35] The Supreme Court found no abuse of discretion for the same reasons the Court should affirm here.

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[33] *Priestley v. Priestley*, 949 S.W.2d 594, 596 (Ky. 1997) (citing *Montgomery v. Koch*, 251 S.W.2d 235 (Ky. 1952); *Mitchell v. Hadl*, 816 S.W.2d 183 (Ky. 1991)); *see also Elk Horn Coal Corp. v. Cheyenne Resources, Inc.*, 163 S.W.3d 408, 424 (Ky. 2005).

[34] *Id.* (citing *Young v. J.B. Hunt Transportation, Inc.,* 781 S.W.2d 503 (Ky. 1989).

[35] *See id*;

3. The Legislature Supports This Policy.

The Legislature also supports allowing courts to decide cases on the merits when the governing regulation or statute is not cited in the court below. Kentucky's "statutes on judicial notice of law were repealed upon adoption of the Kentucky Rules of Evidence and the Rules contain no provision on judicial notice of law. Drafters considered the need for such a rule and came to the following conclusion: 'The Committee rejected the rule because it believes that judges should not be restricted in any way in researching the applicable law.'"[36]

This policy has also been supported on the federal level. "[The judge] may make an independent search for persuasive data or rest content with what he has or what the parties present. ... [T]he parties do no more than to assist; they control no part of the process."[37] Because both the state and federal legislatures have approved the policy of allowing a judge to apply the proper law, this Court should affirm the Court of Appeals' decision in favor of EPI.

4. Affirmative Claims and Defenses Fall Under the *Burton* Line of Cases.

The Cabinet argues that because the statute of limitations is an "affirmative defense," the Court should ignore the Cabinet's own governing regulation. This distinction has not managed to find its way into any of the case

[36] ROBERT G. LAWSON, THE KENTUCKY EVIDENCE LAW HANDBOOK § 1.00[6] (4th ed. 2003) (citing Evidence Rules Study Committee, Kentucky Rules of Evidence—Final Draft, p. 15 (Nov. 1989).

[37] *Id.* (citing FED. R. EVID. 201, Advisory Committee's Note to Subsection (a)).

law that governs the facts here. In addition, Kentucky courts recognize a party's ability to obtain a judgment on an affirmative *claim* not made in lower court.[38] In *Wireman v. City of Greenup*, the Court of Appeals raised the issue of eminent domain in reversing a summary judgment for the city, despite the fact that the plaintiff church had brought a claim of trespass.[39] In doing so, the Court cited *O'Gara v. City of Dayton*, in which the Supreme Court also proceeded on an eminent domain theory despite all of the plaintiff's claims being grounded on theories of negligence.[40] In other words, these cases allow a "claim" to be considered, even when no party presented it.

If an affirmative claim can be raised for the first time on appeal, it only follows that an affirmative defense can be as well. This stands true, especially when EPI has asserted the statute of limitations defense at each stage of the proceedings. The record here contains everything that the Court of Appeals needed to decide the limitations issue. In short, "applicable legal authority" does not constitute part of the record, and can therefore be "resorted to at any stage of the proceedings."[41]

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[38] *See* O'Gara v. City of Dayton, 194 S.W. 380 (Ky. 1917); *Wireman v. City of Greenup*, 582 S.W.2d 48, 50 n.2 (Ky. Ct. App. 1979).

[39] *See Wireman*, 582 S.W.2d at 50 n.2 (citing *O'Gara*, 194 S.W. 380).

[40] *See O'Gara*, 194 S.W. at 381-382.

[41] *Burton v. Foster Wheeler Corp.*, 72 S.W.3d 925, 930 (Ky. 2002).

5. Ignoring The Regulation Would Constitute Manifest Injustice.

Even without all the foregoing authorities allowing the Court to compel an agency to adhere to its own rules, CR 61.02 gives this Court the opportunity to review "palpable error which affects the substantial rights of a party," "even though insufficiently raised or preserved for review" when it determines that "manifest injustice has resulted from the error."[42] "Generally, application of this exception requires that ... the result would have been different had the errors not occurred."[43] Ignoring the Cabinet's governing statute of repose, *will* result in a palpable error affecting the substantial rights of EPI. If the Court ignores the Cabinet's regulation and applies the fifteen year statute of limitations, the result of this case will be different. This outcome would represent manifest injustice because the Cabinet itself promulgated a regulation to govern the recoupment period and necessarily knew about the statute of repose all along, as shown by its attachment to the Cabinet's Brief. The Cabinet conveniently ignores its own regulatory scheme and hides beneath a "preservation of error" argument to obtain a favorable result. This strategy, if successful, would publish as much manifest injustice as a flagrant disregard of the Constitution. For this reason, this Court has reached for the just result.

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[42] Kentucky Rules of Civil Procedure. 61.02.

[43] Sheryl G. Snyder et al., *Appellate Practice*, *in* 19 KENTUCKY PRACTICE § 4:2 (2006).

In *Collins v. Hudson*, this Court allowed an argument of miscodification of a statute not raised in any of the courts below.[44] The Legislative Research Commission inadvertently left out a portion of a statute that the General Assembly enacted, which shielded the defendant from civil liability. In affirming judgment for the defendant, this Court stated "[i]n good conscience, we cannot, in the name of failure of preservation, ... return this case to a trial court, effectively directing it to apply the wrong law, thereby imposing civil liability that would not exist but for the clerical error committed by the LRC." If this Court remands this case to a lower court under any limitations period different than the Cabinet's governing regulation, it would compel the trial court to follow the wrong law and allow liability where none should exist. This consequence is exactly what this Court sought to avoid in *Collins*.

6. The Statute of Repose Is No Surprise.

The Cabinet cries surprise when presented with its own regulatory statute of repose, but EPI has consistently raised statute of limitations as a defense throughout the proceeding. The Cabinet ignores entirely the context in which EPI raised 907 KAR 1:110(3), the statute of repose. Throughout the debate over which statute of limitations applied in both the administrative proceedings and Anderson Circuit Court, all agreed that, if the five-year limitations applied, recoupment was barred. When the case reached the Court of Appeals, the Cabinet unveiled, for the first time, as its lead argument (now abandoned), that

[44] Collins v. Hudson, 48 S.W.3d 1, 4 (Ky. 2001).

the five-year statute "was tolled until a final administrative determination in 2004." In response to this new argument, EPI argued that the Cabinet failed to raise tolling in the lower court and could not raise it on appeal. EPI also relied on the regulations that the Cabinet cited to the Court of Appeals and attached to its Brief, including 907 KAR 1:110(3). The Cabinet itself opened the door to the statute of repose by presenting a new tolling argument on appeal that violated its own regulatory deadlines.

Faced with the deadline in its own promulgated regulation, the Cabinet never cried "due process" to the Court of Appeals. It never said there was "evidence" that could change the plain words in 907 KAR 1:110(3). It argued that the twenty-one month period was "absurd," but the Cabinet controls the recoupment process and delayed until 2004 to send its notice of the recoupment amount, in derogation of what any regulation required. That was solely the Cabinet's arguably faulty and voluntary decision. In addition, if 907 KAR 1:110(3) is "absurd," the Cabinet is free to amend it, just as it did in 1996, when it eliminated the statute of repose pursuant to a properly promulgated regulation.

Moreover, the Cabinet could hardly be startled by the content of the regulations that it promulgated. Again, the Cabinet attached all the regulations applicable to cost-years 1988 to 1995 in its appendix both for the Court of Appeals and this Court. EPI simply asked the Cabinet to follow its own rules. If any agency flagrantly acts outside its regulations, the whole process for promulgating administrative regulations becomes pointless.

With boundless temerity, the Cabinet asserts: "Citizens in a civilized society cannot lead orderly lives or make plans for the future unless there is some stability in the law" (Brief at 12 (citations omitted)). So true. Providers, like EPI, are entitled to rely on rules promulgated and published by a regulatory agency. Providing skilled nursing care is a business, and it depends on stability and predictability in the Medicaid reimbursement rules, which affect its operations and budgeting. Section 2 of the Kentucky Constitution protects the public from arbitrary agency action. The framers obviously recognized that it was imperative to guard against capricious conduct by governmental officials. *American Beauty Homes Corp. v. Louisville & Jefferson County Planning & Zoning Comm'n*, 379 S.W.2d 450 (Ky. 1964).

In keeping with this constitutional command, the General Assembly mandates that agencies operate **only** according to statutes or properly promulgated regulations and not according to inconsistent internal policies that are not subject to legislative oversight. *See* KRS 13A.130. When an agency promulgates a regulation, it tells the public and the Legislature how it will exercise its power – in this case, that it will "accomplish" recoupment promptly. When it then acts in a manner contrary to or outside its regulations, the agency thwarts legislative oversight. As here, the Cabinet assured the Legislature that it would act promptly and then unbeknownst to the General Assembly engaged in dilatory conduct for nearly a decade.

II. THE FIVE-YEAR STATUTE OF LIMITATIONS BARS THE CABINET'S RECOUPMENT.

The Cabinet's recoupment ability rests on its own regulations governing Medicaid reimbursement. Until 1996, those regulations mandated recoupment within twenty-one months. Even during that period and beyond, the absolute outside limit on recoupment may be found in the five-year statute of limitations, which governs "[a]n action upon a liability created by statute...." This five-year bar is obviously the most "analogous statute" because the Cabinet's rights are statutory. The Cabinet failed to recoup any amount for cost years 1988 to 1996 within five years as required.

EPI's alleged liability for Medicaid reimbursement rests on statutes empowering the Cabinet to impose regulations on recoupment. *See* 907 KAR 1:110 (1988 – 1995) and 907 KAR 1:671 (1996). Under KRS 413.120(2), the Cabinet's recoupment is time-barred. EPI's cost reports for 1988 through 1993 were filed more than **ten** years before the Cabinet's May 26, 2004 recoupment notices. All of the remaining cost reports were filed at least two years before May 1999, again more than five years before May 24, 2004. In addition, the Cabinet admits in its Court of Appeals' Brief that it "learned" of overpayments to EPI "when the 1988 through 1996 cost reports for EPI's facilities were audited" (Cabinet Court of Appeals Brief at 2). What matters is either the date of the cost period or the date on which the Cabinet discovered an "overpayment," all dates occurring more than five years before May 24, 2004.

III. THE FIFTEEN-YEAR STATUTE OF LIMITATIONS HAS NO APPLICATION.

The Cabinet relies on the statute of limitations applicable to contract claims in KRS 413.090. The Court of Appeals found, however, the Cabinet's reliance on that statute misplaced.

> Following a review of the voluminous record, the Cabinet consistently primarily relied upon violations of either federal or state Medicaid and Medicare regulations in seeking to recoup alleged Medicaid overpayments. As such, we believe this entire action does not sound in contract as urged by the Cabinet.

Opinion at 12.

The Cabinet cannot pursue the advantage of a fifteen-year statute of limitations when its own regulations impose specific time periods for accomplishing recoupment. Even assuming it had a contract with EPI that incorporated the law, the law in effect in 1988 through 1995 required the Cabinet to complete recoupment within defined regulatory periods. The contracts likewise incorporate the governing regulations. Furthermore, in the absence of the regulation, the fifteen-year contract statute of limitations still does not apply. As the Court of Appeals determined, citing to *Million v. Raymer*, 139 S.W.3d 914, 918 (Ky. 2004), "[t]he underlying theory of law asserted in a petition determines what statute of limitations should apply" (Opinion at 12). Absent a state statute prescribing otherwise, the five-year statute of limitations in KRS 413.120(2) applied to administrative actions such as this one (Opinion at 12-13).

Even if the Cabinet had promulgated no regulations to control its conduct, *Hollander v. Brezenoff*, 787 F.2d 834 (2d Cir. 1986) reveals the basic flaws in the Cabinet's fifteen-year argument. There, as here, the Court confronted a dispute

over whether New York's counterpart to KRS 413.020 for statutorily enacted rights applied or whether the longer New York period for contract claims governed a Medicaid reimbursement claim. As here, nursing homes entered into provider agreements with the state. The providers sought additional Medicaid reimbursement and argued that the claim was contractual in nature under the provider agreements. They unsuccessfully advanced the same rationale that the Cabinet presents, namely: while applicable statutes create the right to reimbursement, "whatever rights a provider acquires arise exclusively from the executed agreement .... [t]herefore without the execution of these agreements, appellant contends, no right to reimbursement would exist." *Id.* at 838. The District Court **rejected** those arguments and granted summary judgment to the state under the counterpart to KRS 413.020.

The Second Circuit affirmed, holding that "there is no basis" upon which to impose the contract limitations period. The Court recognized that the relationship between a Medicaid program participant and the state "may be effectuated by means of a provider contract," but "all rights to reimbursement arise under the applicable statutes." 787 F.2d at 839. **"Signing a provider agreement does not convert statutory mandates to a contract claim.**" *Id.* at 835 (emphasis added).

The reasoning of *Hollander* stands entirely consistent with Kentucky law. As the Cabinet itself concedes, the inquiry is not the relationship between the parties – whether contractual or otherwise – but the underlying theory of law (Cabinet Court of Appeals Brief at 20, citing *Million v. Raymer*, 139 S.W.3d 914,

918 (Ky. 2004); *see also* Brief at 5). The Cabinet's recoupment claims against EPI never have been based on breach of contract. Not a single one of the Cabinet's audit adjustments rely on the provider contracts as the basis for the adjustments. Likewise, the Cabinet's May 26, 2004 recoupment demand cites no contract as the grounds for withholding Medicaid payments.

In *Pennsylvania Dept. of Public Welfare v. River Street Associates*, 798 A.2d 260 (Pa. Cmwlth. 2002), the nursing facilities alleged that the state Medicaid agency had violated, misinterpreted or misapplied regulations that governed the computation of certain Medicaid reimbursements. The nursing facilities argued the dispute was contractual in nature giving the State Board of Claims jurisdiction over the matter. The Board of Claims agreed, determining that the claims were derived from the provider agreements signed by the nursing facilities, and were based on the contractual relationship between the parties, giving it jurisdiction over the matter. *Id.* at 263. The Court disagreed and reversed the Board of Claims. The state Supreme Court had said that a dispute was not contractual simply because a contract may be involved in an action. Rather the claimant had to rely upon the provisions of a contract in asserting the claim against the Commonwealth before the dispute would be considered contractual. *Id.* at 264, citing to *Keenheel v. Com., Pennsylvania Securities Commission*, 565 A.2d 1147 (Pa. 1989).

As here, in *River Street* the nursing facilities cited no provision of the provider agreement that the agency had allegedly breached. Instead, each of the alleged breaches involved disputes over the meaning of the regulations, their

proper application and their validity. *Id.* In *River Street*, as in this case, the dispute was "a complicated method of establishing payment rates and setting payment rates." *Id.* at 264. Just as the Court should hold, the court concluded:

> While [the agency's] obligation to pay [the nursing facilities] in accordance with law and regulation may be an implied term of the provider agreement a regulatory dispute cannot be converted into a contractual one through the device of implied terms.

Id. at 265, (brackets added). The fact that EPI signed provider agreements with the Cabinet does <u>not</u> convert this dispute into a contractual one. This dispute concerns a complicated methodology for setting payment rates and allowing or disallowing costs.

The sole basis for the Cabinet's audit and recoupment has always been its allegation that certain costs in EPI's cost reports are not reimbursable under Medicaid regulations. The adjustments in the audit reports cite Medicaid and Medicare regulations – not the provider agreements – as the justification for disallowing certain costs.[45] The provider agreements say nothing whatsoever

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[45] Included as Appendix 2 hereto, are samples of the Cabinet's auditors' Audit Adjustment Reports. As is reflected in the middle column labeled "Adjustment and Explanation of Adjustment," the adjustments are reportedly based on the Cabinet's manual, "KMAP Manual" ("Kentucky Medical Assistance Program Manual") and/or the Medicare Provider Reimbursement Manuals referred to variously as the "Health Insurance Manuals" e.g. "HIM-15", or the "Provider Reimbursement Manuals", e.g. "PRM-1". *See Brookline Manor v. Dept. of Public Welfare*, 823 A.2d 1069, 1071, text + n.9 (Pa. Cmwlth. 2003). The federal manuals are published on a yearly basis by the Department of Health and Human Services. They appear in a loose leaf service, with periodic replacement pages, making it difficult and tedious to go back ten or fifteen years to reconstruct the relevant provisions as they were constituted at the relevant time.

The dispute in *Brookline* over allowable interest expense and which manual provision controls is much like just one of the many substantive issues that (continued...)

about "disallowed" cost items. The allowance of those items turns on applicable statutes and regulations. Thus, even if the contract reflects an agreement to follow the "law," the theory of the Cabinet's recoupment remains statutory: "Where a duty undertaken by contract has already been imposed upon the parties by statute, the mere existence of the contract does not alter the parties' obligations to one another." *Hollander*, 787 F.2d at 838-39.

Contrary to the Cabinet's reasoning, a tort action does not become a contract action simply because the tortfeasor happens to have a contract with the plaintiff. In *Carr v. Texas Eastern Transmission Corporation*, 344 S.W.2d 619 (Ky. 1961), the plaintiff sued the holder of an easement for damages to his livestock covered by the defendant's construction work in the easement. The defendant argued that the suit was untimely because the plaintiff did not file within the one-year limitation on actions for injury to livestock. The plaintiff insisted that the fifteen-year contractual limitations period applied because the parties had a written contract for the easement. Just as EPI would not be a Medicaid participant without its provider agreement, the livestock would not have been injured if there had been no easement for construction work. The Court nevertheless saw the theory of the case for what it was – an action for injury to livestock, **not** a contract action. Though the claim may have derived indirectly from the contract, the object of the suit was to recover for injuries to livestock.

(...continued)

remain to be decided here, if the Court should determine the Cabinet is not time-barred from proceeding.

The fifteen-year statute did not apply.[46] Likewise, here, while EPI and the Cabinet have a contractual relationship, EPI's reimbursement rights and the Cabinet's recoupment rights depend on Medicaid statutes and regulations promulgated thereunder.

Since 1981, the law has been inescapably clear that reimbursements issues rest on statutes and regulations, not contract:

> The Boren Amendment to the Medicaid Act creates a right, enforceable in a private cause of action pursuant to §1983, to have the State adopt rates that it finds are reasonable and adequate rates to meet the costs of an efficient health care provider.[47]

Ignoring the Boren Amendment, the Cabinet relies primarily on *Spurlin v. Ranier*, 457 S.W.2d 491 (Ky. 1970), which does not even involve statutorily created liability. A dispute over the insured's right to recover premium overpayments, *Spurlin* considers whether a valid contract existed in the first

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[46] *See also Barnes v. Louisville & N.R. Co.*, 283 Ky. 261, 140 S.W.2d 1041, 1045 (1940) ("[t]he right of action ... is not for breach of the written contracts although it springs from those contracts").

[47] *Wilder v. Virginia Hospital Association*, 496 U.S. 498, 524, 110 S.Ct. 2510, 2525 (1990). The Boren Amendment, 42 U.S.C. §1396a(A)(13)(A) (1982 ed. Supp. F.), was repealed by the Balanced Budget Act of 1997, effective for services rendered after October 1997. It remains effective for all cost periods here. Notably most of the cases cited by the Cabinet in arguing this matter is contractual are pre-Boren Amendment cases. The few post-Boren Amendment cases cited by the Cabinet do not pick up any yardage for the Cabinet. For example, *Wayside Farm, Inc. v. U.S. Dept. of Health and Human Services*, 863 F.2d 447 (6th Cir. 1988) cited by the Cabinet has nothing to do with the applicable statute of limitations. It simply says that providers still enter provider agreements. Similarly, *Indiana State Dept. of Health v. Legacy Health Care, Inc.*, 72 N.E.2d 185 (Ind. App. 2001), is nothing more than a dispute over whether the state agency had authority to terminate a provider's Medicaid certification when the provider failed to give quality care. It is simply not germane to the issues here.

instance, namely whether the insured had a valid policy. The Court simply applied the long-settled rule that an insurance company cannot treat a policy contract as valid when collecting premiums and invalid when denying claims. Obviously, the whole case turned on the validity of the contract so the fifteen-year limitation applied. There is no dispute here over the existence or validity of EPI's provider agreements.

Similarly, in *Watkins v. Oldham*, 731 S.W.2d 829 (Ky. App. 1987), a teacher claimed benefits under his employment contract, which expressly provided for benefits. Here, the provider agreements say nothing about which costs are allowable and the Cabinet has never staked its alleged recoupment rights on any provider agreement. If the regulations did not give the Cabinet the ability to disallow certain costs, it would have no basis for doing so.

City of Louisville v. McNaughton, 114 Ky. 333, 70 S.W. 841 (1902), and other cases regarding a city's liability on a contract are no different.[48] In *McNaughton*, the Court applied the fifteen-year limitation period after holding specifically that no statute imposed an obligation on property owners. Here, EPI's alleged obligations are dependent solely on the reimbursement statutes and regulations. The "gist of the action" for recoupment is statutory. The Cabinet cannot point to anything in its contract with EPI that establishes reimbursement or recoupment rights to any amounts.

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[48] *See, e.g. Hunt v. City of Ashland,* 274 Ky. 567, 119 S.W.2d 640, 641 (1938) (city's liability rested on express contract).

When the Cabinet finds a modern case dealing with Medicaid reimbursements, it is not helpful. The Cabinet cites to *Robert F. Kennedy Medical Center v. Dept. of Health Services*, 72 Cal. Rptr.. 2d 180 (Cal. Ct. App. 1998), saying that (1) statutes of limitations have no bearing on administrative actions (Brief at 5, n. 20); and (2) the California court applied a contractual statute of limitations to a Medicaid recoupment claim (Brief at 10). On the first point, California law is clearly at odds with Kentucky law. In *Commonwealth, Natural Resources and Environmental Protection Cabinet v. Kentucky Insurance Guaranty Association*, 972 S.W.2d 276 (Ky. App. 1997), the Court of Appeals, giving thorough consideration to the issue, said that the "legislative preference for prompt resolution of claims which underlies all statutes of limitations is equally compelling whether the forum is a court or a quasi-judicial tribunal." *Id.* at 280. In *Natural Resources* the Court of Appeals applied by analogy, as it did here, the statute of limitations applicable to the common law predecessor to, or counterpart of the administrative action. *Id.* at 281.

On its second point, the Cabinet reads *Kennedy* too loosely. To the extent the claims there were described as contractual, it was because the state agency had entered into a letter agreement with the hospital to defer recoupment until a federal lawsuit was resolved. When the state finally got around to collecting on the letter agreement almost four years after the federal suit was resolved, the California court had to decide whether the defense of laches would apply. Since four years was the statute of limitations for a written contract, the California court determined that was not an unreasonable delay for purposes of laches in an

administrative proceeding acting on a letter agreement. 72 Cal. Rptr. 2d at 182-83.

More recently, in *Fountain Valley Regional Hospital & Medical Center v. Bonta*, 89 Cal. Rptr. 2d 139 (1999), where the state Medicaid agency was actually trying to revise final reimbursement settlements to a Medicaid provider, similar to the Cabinet's actions here, the court expanded on *Kennedy*. It explained that it borrowed an analogous statute of limitations for purposes of laches to shift the burden of proof to the Medicaid agency. In that case the court said, without deciding the issue, that three different statutes of limitations might apply: (1) the four-year limitations on a book account; (2) the three-year limitations for actions upon a liability created by statute; or (3) the three-year limitations for actions for relief on the ground of fraud or mistake. *Id.* at 144-45. In any event, the California courts, having wandered off into the murky area of laches for administrative proceedings, made it clear it was not giving the state Medicaid agency a free pass or a looser rein. Three to four years was more than adequate to resolve Medicaid reimbursement issues.[49] The Court of Appeals here correctly determined that the Cabinet had run out of time.

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[49] As the court noted in *Fountain Valley*, there has to be some finality to a Medicaid agency's reimbursement decisions.

> Otherwise, a hospital's financial planning and rational allocation of its resources will simply be impossible. Such a result is neither fair nor socially desirable.

89 Cal. Rptr. 2d at 145.

IV. RECOUPMENT FOR 1990, 1991 AND 1992 IS BARRED FOR FAILURE TO AUDIT WITHIN THREE YEARS.

In addition to the bar raised by its own regulations and the five-year limitations period, the Cabinet also confronts a disabling hurdle under federal law for at least three cost periods: 1990, 1991 and 1992. Throughout the relevant time, the Cabinet has relied on Medicare reimbursement principles when its Medicaid regulations are silent.[50] Under Medicare principles, the Cabinet has three years from a cost report to audit. *See* 42 C.F.R. §405.1885. "In other words, the Secretary can recoup excessive (or correct insufficient) reimbursement for a given year so long as the Secretary acts within the three-year reopening window."[51]

As the Medicare Provider Reimbursement Manual, Part 1, §2390, observes, "[i]t is in the interest of providers and the program that, at some point, intermediary determinations and the resulting amount of program payment due the provider or the program becomes no longer open to correction" [TR 302]. The Cabinet concedes that EPI's cost reports were timely filed by the end of each calendar year. The Cabinet failed to initiate its audits for cost periods 1990, 1991 and 1992 within three years. For this separate reason, its recoupment for those cost years is barred.

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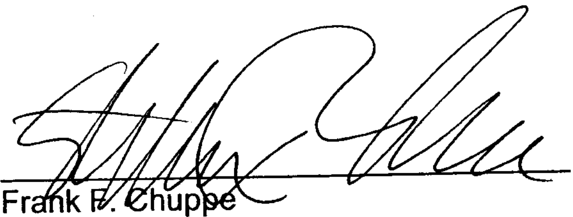
[50] *See, e.g.,* 907 KAR 1:025E, Section 4 (1990) ("the Cabinet's reimbursement system is supported by the Medicare Principles of Reimbursement, with the system utilizing such principles as guidelines in unaddressed policy areas).

[51] *Regions Hosp. v. Shalala*, 522 U.S. 448, 453, 118 S. Ct. 909, 913 (1998).

CONCLUSION

Under its own rules, the Cabinet had twenty-one months to accomplish recoupment from each of the cost periods 1988 through 1995. Its regulations during all cost periods did not permit a stay or tolling pending administrative appeal and the twenty-one month period expired years before the Cabinet's May 2004 recoupment demand. Even if the Cabinet's regulation were silent, which did not happen until 2002, KRS 413.120(2) bars the Cabinet's 2004 recoupment because its cause of action accrued at the time EPI submitted its cost reports to the Cabinet (Opinion at 15), all occurring before 1996, more than five years before the May 26, 2004 recoupment demand. The fifteen-year period governing contract claims can have no application because the Cabinet's recoupment rights hinge solely on its own regulations, which the contract incorporates. The contract would not even exist without the Cabinet's regulatory arguments. The Court of Appeals correctly and unanimously held that the Cabinet's recoupment was time-barred. This Court should affirm.



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