DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Washington, D.C. 20201

NOV 12 2003

TO: Wynethea Walker
Acting Director, Audit Liaison Staff
Centers for Medicare & Medicaid Services

FROM: Dennis J. Duquette
Deputy Inspector General for Audit Services

SUBJECT: Review of Medicare Termination and Severance Costs Claimed by United HealthCare Insurance Company (A-01-02-00508)

We are alerting you to the issuance of the subject report within 5 business days from the date of this memorandum. A copy of the report is attached. This audit was performed at the request of the Centers for Medicare & Medicaid Services (CMS).

We suggest that you share this report with those CMS components involved with monitoring the Medicare contractors' financial operations, particularly the Office of Financial Management, the Center for Medicare Management, and the Office of the Actuary.

United HealthCare Insurance Company informed CMS on February 10, 2000, that it did not intend to renew its Medicare contracts. Both parties agreed to a 7-month transition period through September 30, 2000, the effective contract termination date. The objective of our review was to determine whether the termination and severance costs related to Medicare contract termination and claimed by United HealthCare were allowable, allocable, and reasonable in accordance with Medicare contract provisions and instructions, Federal regulations, and company policies.

Through June 2002, United HealthCare claimed total contract termination costs of $10,806,497 ($8,554,948 for termination costs and $2,251,549 for severance costs). We determined that $2,527,776 in termination costs and $366,234 in severance costs were unallowable. Claims for additional termination and severance costs will continue to be made as the remaining Medicare operations are closed down. For the most part, these additional costs will include the future salary and severance costs for the five United HealthCare Medicare employees staying on to close out the contracts.

The intermediary agreements and carrier contracts provide that if the Medicare contract between CMS and United HealthCare is terminated or not renewed, then subcontracts between United HealthCare and its subcontractors will be terminated unless CMS and United HealthCare agree to the contrary. In the absence of such agreement, costs incurred after the effective date of the nonrenewal or termination are not allowable. Contrary to these provisions, United HealthCare did not get CMS approval, but still claimed subcontract lease costs related to periods after the contract termination date. In addition, certain termination costs were not reasonable and therefore not allowable for reimbursement per the Federal Acquisition Regulations.

United HealthCare claims included the following termination costs, which we believe are not allowable for Medicare reimbursement:

- $1,026,858 for rental and lease termination costs related to certain Medicare field offices for periods after the September 30, 2000, termination date;

- $931,250 for data processing subcontract costs related to the period after September 30, 2000;

- $337,826 for rental and lease termination costs related to equipment leases at the Utica, NY, printing facility that were inappropriately allocated to Medicare; and

- $231,842 for rental costs that were inappropriately allocated to Medicare.

We also found that severance costs claimed by United HealthCare were not allowable for reimbursement because they were contrary to company severance policies as follows:

- $276,012 in excess severance payments to Medicare senior executives without regard to the compensation offset provision of the company's severance policy;

- $60,551 for severance payments and unused vacation hours which exceeded amounts allowed per the company's policies;

- $14,543 in severance benefits paid to temporary employees who were not eligible for such benefits; and

- $15,128 in severance costs erroneously duplicated on two vouchers.

We recommend disallowances of $2,527,776 in termination costs and $366,234 in severance costs.

In its May 21, 2003, response to our draft report, United HealthCare agreed with $196,684 of the recommended disallowances ($121,005 related to termination costs and $75,679 related to severance costs). However, with respect to the remaining recommended disallowances of $2,697,326 ($2,406,771 related to termination costs and $290,555 related to severance costs), United HealthCare did not agree with our interpretations of applicable regulations and criteria. As a result, United HealthCare officials believe that these recommended disallowances should be withdrawn and resolution of these issues should be negotiated with CMS. We believe that our recommended disallowances accurately reflect the extent of United HealthCare's failure to comply with applicable Federal regulations and Medicare program criteria. We continue to believe that these financial adjustments are warranted.

We summarized United HealthCare's comments and responded to those comments at the conclusion of the "Findings and Recommendations" section of the report and included the comments in their entirety as appendix D to the report.

If you have any questions or comments about this report, please address them to George M. Reeb, Assistant Inspector General for the Centers for Medicare & Medicaid Audits, at (410) 786-7104 or Michael J. Armstrong, Regional Inspector General for Audit Services, Region I, at (617) 565-2689. To facilitate identification, please refer to report number A-01-02-00508 in all correspondence.

Attachment

DEPARTMENT OF HEALTH & HUMAN SERVICES — OFFICE OF INSPECTOR GENERAL

Office of Audit Services
Region I
John F. Kennedy Federal
Building
Room 2425
Boston, MA 02203
(617) 565-2684

NOV 18 2003

Report Number: A-01-02-00508

Ms. Patricia Murawski
Director, Government Operations
United HealthCare Insurance Company
450 Columbus Boulevard
Hartford, Connecticut 06115-0450

Dear Ms. Murawski:

Enclosed are two copies of the Department of Health and Human Services (HHS), Office of Inspector General's (OIG) report entitled "Review of Medicare Termination and Severance Costs Claimed by United HealthCare Insurance Company." A copy of this report will be forwarded to the action official named below for review and any action deemed necessary.

Final determinations as to actions to be taken on all matters reported will be made by the HHS action official named below. We request that you respond to the HHS action official within 30 days from the date of this letter. Your response should present any comments or additional information that you believe may have a bearing on the final determination.

In accordance with the principles of the Freedom of Information Act, 5 U.S.C. 552, as amended by Public Law 104-231, OIG reports are made available to the press and general public to the extent information contained therein is not subject to exemptions in the act which the Department chooses to exercise. (See 45 CFR part 5.)

To facilitate identification, please refer to report number A-01-02-00508 in all correspondence relating to this report.

Sincerely yours,

Michael J. Armstrong

Michael J. Armstrong
Regional Inspector General
for Audit Services

Enclosures - as stated

Direct Reply to HHS Action Official:

Charlotte Yeh, M.D.
Regional Administrator
Centers for Medicare & Medicaid Services – Region I
Department of Health and Human Services
Room 2325, JFK Federal Building
Boston, Massachusetts 02203

Department of Health and Human Services

OFFICE OF
INSPECTOR GENERAL

REVIEW OF MEDICARE TERMINATION AND SEVERANCE COSTS CLAIMED BY UNITED HEALTHCARE INSURANCE COMPANY

NOVEMBER 2003
A-01-02-00508

EXECUTIVE SUMMARY

Background

The Centers for Medicare & Medicaid Services (CMS) contracted with United HealthCare Insurance Company to process Part A, Part B, durable medical equipment, and Railroad Retirement Board claims submitted by hospitals, physicians, and other medical suppliers in various States throughout the country. In accordance with the Medicare contract, United HealthCare informed CMS on February 10, 2000, that it did not intend to renew its Medicare contracts. As part of the company's termination from the program, United HealthCare and CMS agreed to a 7-month transition period through September 30, 2000, to allow for a smooth and orderly transfer of responsibilities to new contractors. CMS agreed to reimburse United HealthCare for allowable, allocable, and reasonable termination and severance costs incurred in closing out the Medicare contracts.

Objective

The objective of our review was to determine whether the termination and severance costs related to Medicare contract termination and claimed by United HealthCare were allowable, allocable, and reasonable in accordance with Medicare contract provisions and instructions, Federal regulations, and company policies.

Summary of Findings

Through June 2002, United HealthCare claimed total contract termination costs of $10,806,497 ($8,554,948 for termination costs and $2,251,549 for severance costs). We determined that $2,527,776 in termination costs and $366,234 in severance costs were unallowable. Claims for additional termination and severance costs will continue to be made as the remaining Medicare operations are closed down. For the most part, these additional costs will include the future salary and severance costs for five United HealthCare Medicare employees staying on to close out the contracts.

The intermediary agreements and carrier contracts provide that if the Medicare contract between CMS and United HealthCare is terminated or not renewed, then subcontracts between United HealthCare and its subcontractors will be terminated unless CMS and United HealthCare agree to the contrary. In the absence of such agreement, costs incurred after the effective date of the nonrenewal or termination are not allowable. Contrary to these provisions, United HealthCare did not get CMS approval, but still claimed subcontract lease costs that did not benefit the Medicare program. In addition, certain termination costs were not reasonable and therefore not allowable for reimbursement per the Federal Acquisition Regulations.

United HealthCare claims included the following termination costs, which we believe are not allowable for Medicare reimbursement:

- $1,026,858 for rental and lease termination costs related to certain Medicare field offices for periods after the September 30, 2000, termination date;

- $931,250 for data processing subcontract costs related to the period after September 30, 2000;

- $337,826 for rental and lease termination costs related to equipment leases at the Utica, NY, printing facility that were inappropriately allocated to Medicare; and

- $231,842 for rental costs that were inappropriately allocated to Medicare.

We also found that severance costs claimed by United HealthCare were not allowable for reimbursement because they were contrary to company severance policies as follows:

- $276,012 in excess severance payments to senior executives without regard to the compensation offset provision of the company's severance policy;

- $60,551 for severance payments and unused vacation hours which exceeded amounts allowed per the company's policies;

- $14,543 in benefits paid to temporary employees who were not eligible for such benefits; and

- $15,128 in severance costs erroneously duplicated on two vouchers.

Recommendation

We recommend disallowances of $2,527,776 in termination costs and $366,234 in severance costs.

In its May 21, 2003, response to our draft report (see appendix D), United HealthCare agreed with $196,684 of the recommended disallowances ($121,005 related to termination costs and $75,679 related to severance costs). However, with respect to the remaining recommended disallowances of $2,697,326 ($2,406,771 related to termination costs and $290,555 related to severance costs), United HealthCare did not agree with our interpretations of applicable regulations and criteria. As a result, United HealthCare officials believe that these recommended disallowances should be withdrawn and resolution of these issues should be negotiated with CMS. We believe that our recommended disallowances accurately reflect the extent of United HealthCare's failure to comply with applicable Federal regulations and Medicare program criteria. We continue to believe that these financial adjustments are warranted.

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INTRODUCTION

BACKGROUND

Title XVIII of the Social Security Act established the Health Insurance for the Aged and Disabled (Medicare) program. This program has two distinct parts. Part A is the hospital insurance program, which provides coverage of inpatient hospital care, posthospital extended care, and posthospital home health care. Part B is an optional medical insurance program that covers physician services, hospital outpatient services, home health care, and other health services. Part B coverage includes the cost of durable medical equipment, prostheses, orthotics, and related supplies required by Medicare beneficiaries. Part B services are also provided to eligible railroad retirement beneficiaries under separate provisions of the act.

CMS administers Parts A and B of the Medicare program by contracting with private organizations to process and pay claims for services provided to eligible beneficiaries. Contractors administering Part A are known as intermediaries, and those administering Part B are known as carriers. The Railroad Retirement Board administers the railroad retirement provisions of the act.

CMS and the Railroad Retirement Board contracted with United HealthCare Insurance Company to process Part A, Part B, and railroad retirement claims in various States throughout the country. United HealthCare was also contracted to be a durable medical equipment regional contractor. As a Medicare contractor, United HealthCare was responsible for receipt, review, and payment of (1) Medicare Part A claims in Connecticut, Michigan, and New York; (2) Medicare Part B claims in Connecticut, Minnesota, Mississippi, and Virginia; (3) claims for railroad retirement beneficiaries nationwide; and (4) durable medical equipment claims in Connecticut, Delaware, Maine, Vermont, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, and Rhode Island.

In accordance with provisions in the Medicare contracts, United HealthCare informed CMS on February 10, 2000, that it did not intend to renew its Medicare contracts. United HealthCare and CMS agreed to a 7-month transition period from February 10 to September 30, 2000, during which United HealthCare continued as a Medicare contractor to allow for a smooth and orderly transfer of responsibilities to new contractors. Under the termination agreement, CMS agreed to reimburse United HealthCare for reasonable, allowable, and allocable termination costs which the company incurred in transferring its responsibilities to other contractors in accordance with Federal Acquisition Regulations (FAR) 31.205-42 and provisions of the contracts and for allowable severance costs in accordance with FAR 31.205-6 (g) and United HealthCare's established severance benefits plan.

United HealthCare is being reimbursed for termination and severance costs by submitting periodic vouchers to CMS as costs are incurred. The company claimed $10,806,497 in termination and severance costs for reimbursement through June 30, 2002. Claims for additional termination and severance costs will continue to be made as the remaining Medicare operations are closed down. For the most part, these additional costs will include the future salary and severance costs related to five United HealthCare Medicare employees staying on to close out the contracts.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of our review was to determine whether the termination and severance costs related to Medicare contract termination and claimed by United HealthCare were allowable, allocable, and reasonable in accordance with Medicare contract provisions and instructions, Federal regulations, and company policies.

We examined the nine termination vouchers and the four severance vouchers totaling $10,806,497 in costs claimed for reimbursement by United HealthCare for the period October 1, 2000, through June 30, 2002. These costs included $8,554,948 for termination costs and $2,251,549 for severance costs. We limited our review to United HealthCare's claims through June 2002.

This audit was performed in conjunction with an ongoing Office of Inspector General (OIG) audit of the Medicare Final Administrative Cost Proposals submitted by United HealthCare for the period October 1, 1998, through September 30, 2000. Certain information obtained and reviewed during that audit was also used in performing this review.

We examined applicable Medicare contract provisions and instructions, Federal regulations, and United HealthCare company policies to determine if the amounts claimed met reimbursement requirements. In examining the termination and severance vouchers, we obtained supporting expense reports, payroll reports, and personnel records to (1) perform detailed audit tests of various cost categories, (2) determine the eligibility of terminated employees for severance benefits, and (3) determine the accuracy of United HealthCare's calculations of termination and severance costs. In this regard, we interviewed United HealthCare officials to determine the methods used in calculating some claimed costs that, according to our analysis, did not meet reimbursement requirements.

We also discussed the objectives of our review with CMS headquarters and regional office officials to identify requirements CMS placed on carriers and intermediaries to ensure that costs claimed by United HealthCare were allowable, allocable, and reasonable in accordance with Medicare contract provisions and instructions.

Our fieldwork was performed at the United HealthCare Medicare home office in Meriden, CT, from February through July 2002. In addition, we met with CMS officials in their regional office in Boston, MA. The audit was conducted in accordance with generally accepted government auditing standards.

FINDINGS AND RECOMMENDATIONS

Through June 2002, United HealthCare claimed total contract termination costs of $10,806,497 ($8,554,948 for termination costs and $2,251,549 for severance costs). We determined that $2,527,776 in termination costs and $366,234 in severance costs were unallowable.

TERMINATION COSTS

Article III of appendix A of the intermediary agreements and carrier contracts states that an Automatic Termination of Subcontract Clause must be included in all subcontracts (except for the purchase of supplies and equipment), including leases of real property. The clause states that:

> In the event that the Medicare contract . . . is terminated or nonrenewed, the contract between [United HealthCare] and (subcontractor) will be terminated unless the Health Care Financing Administration [predecessor to CMS] and [United HealthCare] agree to the contrary . . . .

Article III further states that:

> Failure of the Contractor to include the clause in such subcontract without the written agreement of the Secretary to its omission, shall make the related costs incurred after the effective date of the nonrenewal or termination, unallowable . . .

In addition, FAR indicates that in order to be allowable for Medicare reimbursement, costs must be reasonable and allocable. Specifically, part 31.201-3 states that "A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business . . . ."

FAR 31.201-4 states that "A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship . . . ."

We found that United HealthCare claimed termination costs totaling $2,527,776 that did not comply with the above requirements. Specifically, United HealthCare claimed:

- $1,026,858 for rental and lease termination costs related to certain Medicare field offices for periods after the September 30, 2000, termination date;
- $931,250 for data processing subcontract costs related to the period after September 30, 2000;
- $337,826 for rental and lease termination costs related to equipment leases at the Utica, NY, printing facility that were inappropriately allocated to Medicare; and

- $231,842 for rental costs that were inappropriately allocated to Medicare.

The following sections detail the results of our review of these unallowable termination costs.

Unexpired Rental Property Leases

The $1,026,858 in unallowable rental and lease termination costs, which related to certain Medicare field offices, applied to periods after September 30, 2000--the Medicare contract termination date. In addition, certain costs were not allowable for reimbursement because they were not claimed in accordance with the FAR.

United HealthCare claimed these costs despite the fact that it had not included the Automatic Termination of Subcontract Clause in the lease agreements for these field offices and did not request approval from CMS to waive the clause. Therefore, we believe the costs claimed for termination of these leases are not allowable for Medicare reimbursement.

Specifically, United HealthCare claimed reimbursement for rental costs and lease termination buyouts for two Medicare offices:

- $963,576 related to the termination of the Utica printing facility's 5-year lease, which had 4 years remaining, and

- $63,282 related to the Southfield, MI, Medicare office and represented net costs after subleasing part of an ongoing lease.

United HealthCare officials indicated that these offices had lease agreements that terminated after the Medicare contract termination date. The Utica landlord assessed additional buyout costs for terminating the lease early, and the Southfield landlord would not allow early termination of the lease.

Details on these lease termination costs follow.

Utica Printing Facility

With the December 1999 expiration of the old printing facility lease, United HealthCare entered into a contract for the construction and lease of a new printing facility in Utica, NY. The company signed a 5-year lease on August 23, 1999. However, internal correspondence dated July 29, 1999, and November 5, 1999, indicated that during this time frame, the company was also considering various corporate restructuring alternatives, one of which was to transfer its Medicare contracts to another corporation. Despite uncertainties about the future of its Government Operations Division, the company moved into the new printing facility in February 2000 and subsequently, in the same month, notified CMS that it would not renew its Medicare contracts.

United HealthCare did not include the Automatic Termination of Subcontract Clause in the Utica lease, nor did it obtain CMS's approval to waive the clause before entering into the lease agreement. As part of the termination process, the company negotiated a buyout of the 5-year lease. Medicare's share of the buyout costs totaled $963,576, which included $667,713 in rent and nonrent lease costs, as well as $295,863 in leasehold improvements. This amount was well over 90 percent of the rental liability remaining on the lease, even though the building was returned to the landlord with more than 4 years remaining on the 5-year lease.

We believe that United HealthCare's decision to sign a 5-year lease for a newly constructed building while, at the same time, considering leaving the Medicare program was not prudent, nor was it in the best interest of the Medicare program. In addition, we believe that it was not an appropriate business decision to incur significant costs for leasehold improvements when the building was specifically constructed to house United HealthCare's printing operation.

It is our opinion, therefore, that the Medicare program should not be held liable for these lease termination costs because United HealthCare (1) did not include the Automatic Termination of Subcontract Clause in the field office lease agreements, (2) did not obtain CMS's agreement to waive the clause and request approval for reimbursement of lease costs after termination, and (3) made questionable business decisions regarding the construction and leasing of the facility at a time when it was also considering corporate changes for the Medicare Government Operations Division.

Southfield, MI

United HealthCare charged Medicare $63,282 for net lease costs from the Southfield field office's closing on July 1, 2000, through March 31, 2002. Unable to terminate the lease, the company reduced the remaining lease payments to the above amount by subletting some of the space on a lease that did not expire until May 31, 2003.

We believe that the $63,282 is not allowable for Medicare reimbursement because United HealthCare did not include the Automatic Termination of Subcontract Clause in the lease, nor did it obtain CMS's approval to waive the clause and request approval for reimbursement of the costs after it vacated the building.

<u>Data Processing Subcontract Costs</u>

United HealthCare claimed costs for idle data processing capacity that are not allowable for Medicare reimbursement. The company subcontracted with IBM Global Services for a data center to provide a corporate-wide data processing capacity for its Medicare and commercial business. United HealthCare indicated that as a result of terminating its Medicare contracts, its remaining commercial business had to absorb that portion of the data processing costs that were formerly charged to the Medicare line of business. United HealthCare officials indicated that they expected CMS to pay for the portion of data processing costs formerly absorbed by Medicare until they were able to reallocate these costs to new business lines. Accordingly, United HealthCare requested Medicare reimbursement of $931,250 for the costs of underused data processing services from September 30 through December 31, 2000, when new business lines absorbed these costs.

As previously noted, the Medicare agreements provide that if the Medicare contract between CMS and United HealthCare is terminated or not renewed, then subcontracts between the company and its subcontractors will be terminated unless CMS and United HealthCare agree to the contrary. Any costs incurred after the effective date of the nonrenewal or termination are not allowable for reimbursement. Article III also provides that:

> . . . if the Contractor wishes to continue the subcontract relative to its own business after the contract between the Secretary and the Contractor has been terminated or nonrenewed, it may do so provided it assures the Secretary in writing that the Secretary's obligations will terminate at the time the Medicare contract terminates . . . .

Based on the above, we believe that United HealthCare's decision to terminate from the Medicare program and continue the data processing subcontract ended Medicare's obligation to participate in such costs. In addition, because the program is no longer benefiting from United HealthCare's continuation of its data processing contract, such costs are not allowable under FAR 31.201-4. Finally, we do not believe that Medicare should be required to reimburse United HealthCare for costs resulting from business decisions that affect only its private business lines.

As a result, we believe that United HealthCare's claim of $931,250 for these data processing subcontract costs is not allowable for Medicare reimbursement.

<u>Equipment Lease Termination Costs</u>

United HealthCare claimed $337,826 in equipment lease termination costs that were not allowable for Medicare reimbursement. These costs represent rental and lease termination costs related to equipment at the Utica printing facility. According to FAR 31.201-4, allowable costs charged to Medicare are allocable based on the relative benefits received.

United HealthCare established the Utica printing shop to conduct printing and mailing services for both Medicare and private business lines. Total costs of the printing shop, including prior depreciation on equipment, were allocated 67 percent to Medicare and 33 percent to private business lines. With United HealthCare's termination of its Medicare contract, the printing facility was closed and equipment leases that extended beyond the termination date had to be resolved. Our review disclosed that, in terminating equipment leases, United HealthCare claimed costs of $337,826 that did not benefit Medicare:

- $176,775 for costs of Scitex printers improperly allocated to Medicare;

- $133,314 for costs of leases related to Xerox printers that United HealthCare chose to continue to use for its private business lines; and

- $27,737 for costs of leases for mail presorter equipment that United HealthCare chose to continue to use for its private business lines.

Following are details on these costs.

Scitex Printers

United HealthCare charged Medicare for 100 percent of the $535,683 in lease buyout costs charged for equipment returned to the vendor; the company claimed that this equipment was used solely for Medicare purposes. This was contrary to United HealthCare's established cost allocation basis for the printing shop noted above. Consequently, we believe that $176,775, or 33 percent of the lease buyout amount, should be allocated to private business lines and is not allocable to Medicare.

Xerox Printers

United HealthCare chose to continue leasing four printers from the Utica facility to replace older printers at a non-Medicare printing facility in Duncan, SC. However, as a mitigating cost, United HealthCare billed Medicare 100 percent of the cost to ship those printers to the Duncan facility. Further, the company billed Medicare 100 percent of the costs to buy out the leases of the non-Medicare printers that were being replaced at the Duncan facility. In total, United HealthCare charged Medicare $133,314 as termination costs related to these printers.

Because United HealthCare chose to continue the lease for the Utica equipment for its private business lines and had exclusive use of the equipment, we believe there were, in fact, no lease termination costs. In addition, we believe that Medicare should not be required to pay for United HealthCare's corporate decision to update equipment used for its private business lines. Accordingly, we believe that the $133,314 is not allowable for Medicare reimbursement.

Mail Presorter Equipment

United HealthCare charged Medicare for costs incurred for certain postal equipment after the Medicare contract termination date. These included the costs to disassemble two mail presorter machines, ship them from the Utica facility to the Duncan facility, and reassemble and test them, as well as the costs related to periods when the mail sorters were idle. One of these machines had been placed into operation at the Duncan facility, and United HealthCare officials subsequently agreed that $27,737 should not have been charged to Medicare.

In summary, United HealthCare claimed $337,826 for equipment costs that we believe are not allowable for Medicare reimbursement.

<u>Medicare Home Office Rental Costs</u>

United HealthCare charged Medicare $278,352 in rent expense for the Medicare home office in Hartford, CT (the Gold Building), from October 1, 2000, to January 31, 2002. This building housed staff involved in closing down all Medicare operations after the contract termination. These employees were subsequently moved to a new location in Meriden, CT, and are continuing the Medicare closedown work.

United HealthCare calculated rent for the Gold Building based on employee head count by function for all of its Hartford rental properties. However, the company used outdated census estimates that did not accurately reflect the reduced number of employees working in Medicare functions after termination. The latest census count showed that the number of Medicare-related employees ranged from 6 to19 during this period, whereas United HealthCare's estimate for the Medicare rent calculation used 132 employees throughout the period.

We recalculated the rental for this location based on actual Medicare headcount data and determined that United HealthCare overcharged Medicare $231,842. Based on the FAR 31.201-4, we believe that these costs are not allowable for Medicare reimbursement.

<u>Recommendation</u>

We recommend that $2,527,776 in property lease, subcontract, equipment lease termination, and rental costs be disallowed for Medicare reimbursement.

SEVERANCE COSTS

Through June 2002, United HealthCare requested reimbursement of employee severance costs amounting to $2,251,549. Based on the company's severance policies, we determined that these costs were overstated by $366,234:

- $276,012 in excess severance payments to senior executives without regard to the compensation offset provision of the company's severance policy;

- $60,551 for benefits claimed that exceeded amounts allowed per company policies;

- $14,543 in benefits paid to temporary employees who were not eligible for such benefits; and

- $15,128 in severance costs erroneously duplicated on two vouchers.

Severance Benefits to Senior Executives

United HealthCare claimed Medicare reimbursement for all severance payments made to 8 United HealthCare employees classified as grade 29 and above without regard to the compensation offset provision of company severance policy. We found that excessive severance payments of $276,012 were made to these employees.

The United HealthCare "Employee Handbook" states that for employees in pay grades 29 and above, severance payments in excess of 12 weeks will be reduced by any cash compensation or other earnings received from other employment or as an independent contractor. United HealthCare's severance policy requires that such employees actively seek work after termination and inform the company of any compensation received elsewhere. The policy further provides that the company has the right to examine employee tax and other compensation records to verify the offset due United HealthCare.

United HealthCare officials stated that they relied on employees to report income earned to offset against severance payments in excess of 12 weeks. They did not attempt to identify other compensation or earnings. Further, United HealthCare officials stated that they did not intend to pursue recovery and recently revised their policies to eliminate this requirement.

Based on the policy in effect at the time, we believe that the entire $276,012 in excess severance payments made without regard to the offset provision should be disallowed unless United HealthCare pursues this matter to determine the correct amount.

Severance Benefits Claimed in Excess of Company Policy

United HealthCare claimed reimbursement for severance payments and unused vacation hours that exceeded amounts due employees according to its policies. The company incorrectly applied partial-year credits, rounded benefits due to the next full week, and made other calculation errors in determining severance due part-time employees. The company also incorrectly calculated the amounts paid to employees for unused vacation hours.

According to United HealthCare's Severance Pay Plan, section XIII (page 208), severance is calculated using the following factors: base pay, years of regular service with the company, grade level, and the effective date of layoff or position elimination. For employees with more than 5 years of regular service, the plan provides additional partial credits for each additional completed quarter of service based on anniversary date. The maximum plan benefits are 26 weeks for grade 32 and below and 52 weeks for grade 33 and above.

United HealthCare policies prohibit the conversion of unused vacation time to cash payments upon termination of employment. However, to ensure a smooth transition, CMS agreed to reimburse unused vacation time for employees who went to work for the two successor contractors that would not accept responsibility for unused employee vacation time.

United HealthCare made errors in calculating the severance payments due 37 employees. Most of the errors involved applying partial-year credits to employees who were not eligible because they had less than 5 years of service or were already at the maximum benefit level for their pay grade. Many employees' service time at the Utica printing facility was rounded up to the next full week. Company officials explained that this practice was in accordance with an unwritten internal policy at Utica. Also, in two instances, United HealthCare did not calculate the amounts paid to employees for unused vacation hours in accordance with its vacation policies.

The net effect was that United HealthCare claimed Medicare reimbursement of $60,551 in excess of amounts allowed by the company's severance policies.

Severance Benefits Paid to Temporary Employees

United HealthCare claimed Medicare reimbursement for vacation and severance payments to temporary employees who were not eligible for such benefits according to company policy. On February 10, 2000, United HealthCare notified CMS of its decision to terminate from the Medicare program as of September 30, 2000. United HealthCare hired 18 employees after February 10, and these employees worked for periods ranging from 11 days to 8 months. The average employment period amounted to 3 months.

According to United HealthCare's employment policies, temporary employees are not eligible for vacation pay or severance benefits. Company policy on classification of employees defines a temporary employee as a person hired to work a regular full-time or part-time schedule for a limited period of time. United HealthCare did not classify these employees as temporary and, accordingly, paid them vacation and severance benefits and claimed Medicare reimbursement.

Based on United HealthCare's policy, we believe that these employees should have been classified as temporary and, thus, ineligible for vacation and severance benefits. As a result, we believe that the company inappropriately claimed Medicare reimbursement of $14,543 for severance and vacation benefits for these temporary employees.

Other Costs

United HealthCare erroneously duplicated retention and enhanced severance payments on two consecutive termination vouchers. As a result, its claim for these severance costs was overstated by $15,128.

Recommendation

We recommend that $366,234 in severance costs be disallowed.

UNITED HEALTHCARE'S COMMENTS AND OIG'S RESPONSES

In its May 21, 2003, written response to the draft report, United HealthCare agreed with $196,684 of the recommended disallowances ($121,005 related to termination costs and $75,679 related to severance costs). With respect to the remaining recommended disallowances of $2,697,326 ($2,406,771 related to termination costs and $290,555 related to severance costs), United HealthCare stated that:

> The draft audit report is based upon facts that appear to be erroneous, incomplete or misstated; and, that several of the conclusions and recommendations are based upon incorrect interpretations of applicable regulations and criteria . . . .

As a result, United HealthCare officials believe that these recommended disallowances should be withdrawn and resolution of these issues should be negotiated with CMS.

United HealthCare's comments included lengthy, detailed interpretations of Federal regulations and criteria related to the various audit issues. The complete comments are included as appendix D. For this section of the report, we have summarized those comments that address the specific findings and recommendations and have included OIG's response.

<u>Unexpired Rental Property Leases</u>

United HealthCare's Comments

United HealthCare concurred with the $63,282 recommended disallowance related to the Southfield, MI, Medicare field office but disagreed with the $963,576 recommended disallowance related to the Utica printing facility.

The company provided a detailed explanation of its rationale for disagreeing with the recommended disallowance for the Utica printing facility:

- The Automatic Termination of Subcontract Clause requirements apply only to subcontracts expected to exceed the term of the Medicare contracts, which United HealthCare considers to be indefinite.

- Language in the Medicare carriers manual makes it doubtful that the Automatic Termination of Subcontract Clause applies to leases of real property.

- The lessor required a 5-year contract and would not accept an agreement containing the Automatic Termination of Subcontract Clause.

- United HealthCare achieved a reasonable termination settlement.

- United HealthCare believes that a CMS waiver of the Automatic Termination of Subcontract Clause requirement would have been justified for this situation.

United HealthCare's response provided a detailed discussion of the reasons the company believes its decision to enter into the Utica lease was reasonable. Briefly, United HealthCare's position is that, at the time of executing the lease, the company was only in the early stages of discussions regarding corporate reorganization and assumed that it would continue as a Medicare contractor. Therefore, United HealthCare believes that entering into the 5-year lease in August 1999 was reasonable. In addition, the response indicated that CMS opted for termination after finding reorganization alternatives unacceptable.

United HealthCare also stated that the Automatic Termination of Subcontract Clause should be waived if the commercial lessor does not agree to its inclusion. Further, United HealthCare asserted that CMS's reimbursement of termination vouchers containing Utica lease costs after CMS was aware of the Automatic Termination of Subcontract Clause omission in the Utica lease constituted a waiver of such requirement and estoppel from recovery of related costs. United HealthCare's response concluded that it obtained a very reasonable buyout of the lease and that the Government suffered no prejudice due to the absence of the Automatic Termination of Subcontract Clause.

OIG's Response

There should be no confusion on whether the Automatic Termination of Subcontract Clause applies to leases of real property. Article III of appendix A of the intermediary agreements and carrier contracts specifically states that this clause must be included in all subcontracts that exceed the term of the Medicare contracts, including leases of real property. In this regard, contrary to United HealthCare's contention that the Medicare contract was of indefinite duration, the Medicare contracts are, in fact, 1-year agreements renewed annually at the discretion of the Government and the contractor. Thus, the Automatic Termination of Subcontract Clause provides the means to limit the Government's liability should the contractor enter into long-term subcontracts and subsequently terminate from the program before the end of the subcontracts.

Based on its experience, United HealthCare should have been fully aware of the need to insert the Automatic Termination of Subcontract Clause in its subcontracts. In November 1998, United HealthCare negotiated a lease for the Richmond, VA, Medicare Part B field office. The landlord refused to accept the Automatic Termination of Subcontract Clause in the Richmond lease. The CMS Boston regional office indicated that it would not approve this lease without the inclusion of the clause. United HealthCare ultimately decided to execute the lease but acknowledged that it would accept full financial liability for early termination of the lease. We believe that this precedent validates our recommended disallowances based on the failure to include the Automatic Termination of Subcontract Clause in the Utica lease.

In our opinion, United HealthCare's business decision regarding the Utica lease was not prudent and the termination settlement was not reasonable for the following reasons:

- In August 1999, when United HealthCare signed the 5-year Utica lease, it was considering leaving the Medicare program as one of several reorganization options aimed at limiting company liability. We believe that United HealthCare's actions demonstrate that the company had decided not to continue with the Medicare program without CMS's approval of one of these options. In this regard, when CMS refused to approve any of the options in February 2000, United HealthCare immediately announced it was terminating its Medicare contracts.

- United HealthCare stated that a newly constructed facility was required because there was no existing space suitable for its needs in Utica. Yet, 1 year later, United HealthCare was unable to find a subleaser due to an overabundance of available lease space in the area. Further, for 3 additional months, United HealthCare continued to pay rent, maintenance, and utilities on an unoccupied building before arranging a buyout.

- With respect to United HealthCare's claim that a reasonable buyout was achieved, we noted that about 42 percent of the total Government liability due the landlord as of September 30, 2000, represented nonrent cost assessments to cover estimated taxes, maintenance, and utility expenses to be incurred over the next 4 years. Actual maintenance and utility expenses of an unoccupied building should be negligible. More important is the fact that the building was returned to the landlord, allowing him the opportunity to re-lease the building during this period.

Based on the above, we maintain that our recommended disallowance of $963,576 related to the Utica printing facility is valid.

Data Processing Subcontract Costs

United HealthCare's Comments

United HealthCare stated that our $931,250 disallowance of IBM Global Services data processing subcontract costs was based solely upon omission of the Automatic Termination of Subcontract Clause. However, United HealthCare officials asserted that this clause was incorporated by reference, in that the subcontract states that IBM Global Services shall comply with all provisions applicable to subcontractors under the Medicare contracts.

United HealthCare contended that upon the nonrenewal, it attempted to achieve the maximum mitigation of costs to itself and the Government. Further, United HealthCare issued a notice of partial termination on or about June 13, 2000, requesting that IBM

Global Services promptly enter into discussions regarding termination of the Medicare portion of the subcontract. United HealthCare noted that IBM Global Services refused to provide any termination proposal in response to this request. In lieu of the $9.7 million that United HealthCare estimates a termination settlement would have cost the Government, United HealthCare informed CMS in early January 2001 that it would continue the IBM Global Services subcontract and reallocate its commercial data processing volume to replace the data processing capacity idled by the nonrenewal of the Medicare contracts. United HealthCare stated that, during discussions held in early 2001, CMS appeared to agree with this approach and considered the $931,250 as fair and reasonable.

In addition, United HealthCare stated that our disallowance, based on selective reading of the Automatic Termination of Subcontract Clause, is flawed because proper reading of the full text clearly provides for the allowability of the IBM Global Services costs. United HealthCare stated that it had notified CMS in writing on numerous occasions that it wished to continue the IBM Global Services subcontract but that CMS's "obligations will terminate" upon nonrenewal of the Medicare contracts, subject to CMS's obligation to reimburse United HealthCare its IBM Global Services costs under the "termination cost provisions" of the Medicare contracts. In this regard, United HealthCare stated that these IBM Global Services costs are allowable according to FAR 31.205-42 and that costs continuing after termination are allowable unless due to negligent or willful failure to discontinue such costs.

If not allowed per the above, United HealthCare stated that it was entitled to claim these costs as idle capacity costs. United HealthCare asserted that since the IBM Global Services data center was a corporate capability set up to process both commercial and Medicare workload, a reduction in the workload caused by nonrenewal of the Medicare contracts idled a portion of the data center's total capacity. United HealthCare concluded that it was fair and reasonable to request reimbursement for only the 3 months immediately following the nonrenewal date, which represents the brief time necessary to replace the lost Medicare-related data processing workload.

OIG's Response

As stated in our report, our disallowance of the IBM Global Services subcontract costs was based not only on the Automatic Termination of Subcontract Clause but also on FAR 31.201-4, which allows costs to be charged to Government contracts based on the relative benefits received by those contracts. Because the subcontract no longer provided any benefit to the Government after the termination date of the Medicare contract, we believe that Medicare should not be charged for costs related to the subcontract.

We believe that United HealthCare's attempts to mitigate the IBM Global Services subcontract costs to the Government were not timely or prudent in reducing costs after termination. United HealthCare contends that the $931,250 claimed is actually a savings to the Government compared with the estimated $9.7 million settlement to terminate the subcontract. This argument ignores United HealthCare's own commercial obligation, as the IBM Global Services subcontract was 85 percent commercial and only 15 percent Medicare. As such, it was in United HealthCare's best interest to continue the subcontract.

Although United HealthCare announced its decision to terminate from the Medicare program on February 10, 2000, it did not request that IBM Global Services enter into discussions regarding termination of the Medicare portion of the subcontract until June 13, 2000. From the time IBM Global Services would not agree to terminate the Medicare portion of the subcontract, another 6 months elapsed (until January 2001) before United HealthCare replaced the Medicare data processing workload with other United HealthCare work. Had this been addressed in February 2000, it is reasonable to assume that United HealthCare would have finished replacing the Medicare data processing workload before the termination date.

Contrary to United HealthCare's response, CMS did not agree that $931,250 in IBM Global Services data processing costs was fair and reasonable. As of this date, CMS has denied payment of these costs on termination vouchers submitted by United HealthCare. In CMS's October 26, 2001, response to United HealthCare regarding the $931,250 in idle capacity costs, CMS explained that the volume of the commercial operations alone achieved the lowest possible discounted variable rates. As such, any increase in the actual allocation rates after loss of the Medicare workload reflects the impact associated with fixed charges spread over the lower volume of operations. The fixed charges are allocated to all users of the IBM Global Services data center based on utilization. It is normal to assume that the fixed charges agreed to by United HealthCare were predicated on the baseline volume. As the loss of Medicare business did not reduce the total volume below this baseline, the fixed charges could not be characterized as costs for excess capacity.

We maintain that our recommended disallowance of the $931,250 claimed for the IBM Global Services subcontract is valid.

Equipment Lease Termination Costs

United HealthCare's Comments

United HealthCare concurred with the $27,737 recommended disallowances for the mail presorter equipment but disagreed with the $176,775 related to Scitex printers and $133,314 related to Xerox printers.

United HealthCare stated that the disallowances were based on erroneous facts or analysis. The response noted that the underlying error was our statement that the total costs of the printing shop, including prior depreciation on this equipment, were allocated 67 percent to Medicare and 33 percent to commercial business. Further, United HealthCare asserted that these percentages were developed only to allocate termination costs for the Utica printing equipment and resources and were not used to allocate any ongoing expenses, including prior depreciation.

Specifically, United HealthCare stated that the Scitex printers were used only for Medicare; therefore, United HealthCare's commercial side should not be allocated any portion of the buyout costs. Regarding the Xerox printers, United HealthCare stated that its decision to replace older equipment at another location with the Utica printers actually benefited Medicare. Although CMS was charged 100 percent of the shipping and buyout costs of the older leases, United HealthCare asserted that the $133,314 should be allowed as it is less than the $360,812 Medicare share of termination costs if original Utica leases had been terminated.

OIG's Response

During our review, we noted that costs of the Utica printing facility were allocated to Medicare and to United HealthCare's commercial business indirectly through the use of print rates. Rates for the various printing functions were applied equally to all Medicare and commercial printing jobs, based on total printing costs and printing volumes. The costs allocated to Medicare or commercial lines of business for each print job were determined by the volume of the print job times the applicable print rates. Accordingly, the total costs of respective print jobs represented that line of business's allocation of the total Utica printing facility costs, including depreciation.

We noted for calendar year 1999, total corporate-wide print charges were $6,970,619. Of this amount, $4,678,008 (or 67 percent) was charged to Medicare programs and $2,292,611 (or 33 percent) was charged to United HealthCare's commercial lines of business. This was the basis the company used to determine the Medicare-commercial split, which United HealthCare claimed was developed only to allocate termination costs for the Utica printing facility equipment and resources. Contrary to United HealthCare's contention, and as noted above, the split used for the termination costs was based on the actual usage and costs charged to the various lines of business during the normal operation of the Utica printing facility. Therefore, allocating all costs, including the Scitex printers, in accordance with these percentages is proper.

Regarding the Xerox printers, United HealthCare's response focused solely on Medicare's share of the liability and how Medicare saved $227,498 as a result of the company's actions. However, we noted that by not terminating the original leases, United HealthCare avoided paying $174,714 for its corporate share of this liability and also did not pay its share of the termination costs. We believe that Medicare should not be required to pay for United HealthCare's corporate decision to update equipment used for its private business lines. Because United HealthCare chose to continue the original leases for its commercial business and had exclusive use of the equipment, we believe that there were no lease termination costs.

We maintain that the balance of our recommended disallowance of $310,089 related to printing equipment is valid.

<u>Medicare Home Office Rental Costs</u>

United HealthCare's Comments

United HealthCare agreed that it used outdated census estimates for home office rental calculations, rather than actual headcount. However, United HealthCare stated that the overcharge is only $29,986, not $231,842 as noted in our report. United HealthCare further agreed that the total rental costs for the Hartford campus were allocated to each United HealthCare entity (using the ratio of that entity's headcount to the total headcount of all United HealthCare entities in Hartford). Disagreeing with our calculation, the company contended that:

- we used budgeted rather than actual headcount for the Hartford campus total,

- the actual decreasing Medicare headcount from 19 to 6 employees from October 2000 to June 2001 should be increased to 105 employees based on full occupancy of the fifth floor due to contractual limitations placed on subletting idle space on that floor, and

- the actual Medicare headcount of five employees from July 2001 to January 2002 should be increased to nine employees to account for space set aside to accommodate four auditors.

OIG's Response

We recognize the seeming inequities of allocating rental costs based on headcount, rather than the more universally accepted basis of square footage. Situations like those listed above, where rent based on headcount seems inequitable to the cost of the space used, illustrates why square footage is the more acceptable basis for rental costs. However, United HealthCare should be consistent in its allocation of Hartford rental costs to Medicare. In this regard, we believe that by artificially inflating the headcount, United HealthCare is attempting to account for the unused space that resulted from phasing out the Medicare operations, which has the effect of switching to a square footage basis. It should be noted that before termination, United HealthCare's methodology of allocating total Hartford rental costs based on headcounts resulted in charging Medicare higher rental costs than the lease costs of the space occupied. To switch from an allocation methodology that had been advantageous to United HealthCare when it became disadvantageous is not fair or reasonable to Medicare.

Further, by artificially inflating the Medicare headcount as United HealthCare suggests, Medicare would be assessed not only a larger share of the rental costs of the fifth floor of the Gold Building, but a larger share of the rental costs of all properties on the Hartford campus. As a result, we believe that our calculation of the excess rental charges for the Hartford space is valid and that these costs should not be charged to Medicare.

Severance Benefits to Senior Executives

United HealthCare's Comments

United HealthCare agreed that the severance policy in effect included a compensation offset provision for senior executives. This offset provision mandated that severance pay over 12 weeks be reduced by cash compensation or other earnings received from other employment. United HealthCare also noted that the policy indicated that senior executives must actively seek work and that the company had the right to examine employee tax returns and other records to verify whether an offset was due United HealthCare. However, company officials disagreed that all severance pay to senior executives should be disallowed because United HealthCare relied solely on employee self-reporting and did not actively seek access to former executives' tax and personal business records. The response noted United HealthCare's reasons as follows:

- Severance pay is an allowable cost to the extent that it is required by law, an employer-employee agreement, or an established policy that constitutes implied agreement.

- United HealthCare has traditionally relied on self-reporting, and coercing tax or other compensation records would be difficult and require legal actions, thus increasing Medicare costs.

- By not enforcing the offset provision, United HealthCare has established an implied agreement that the offset provision is not legally valid.

- United HealthCare amended its severance plan effective January 21, 2002, to eliminate the offset provision.

OIG's Response

Although United HealthCare has since eliminated the offset provision, it was in effect at the time the severance payments were made to the Medicare senior executives. United HealthCare's severance policy clearly intended that severance pay in excess of 12 weeks for senior executives be reduced by cash compensation or other earnings received from other employment. As the company would take no action to determine what the correct amount of offset should be for the eight Medicare senior executives, we believe that our recommendation to disallow the entire $276,012 in excess severance payments is valid.

Severance Benefits Claimed in Excess of Company Policy

United HealthCare's Comments

United HealthCare concurred with the recommended disallowance of $60,551.

Severance Benefits Paid to Temporary Employees

United HealthCare's Comments

United HealthCare disagreed with the audit disallowance of $14,543 in severance benefits claimed for 18 employees whom we deemed as temporary. The response noted that to avoid workload disruptions, United HealthCare continued to hire staff during the transition, including the 18 employees in question. To ensure a smooth transition, CMS offered to reimburse United HealthCare for payment made for unused vacation time of employees transitioning to two successor contractors that would not accept the unpaid vacation balances as of the transition date. According to United HealthCare, 15 of the 18 employees went to work for these two successor contractors; 2 others were on short-term disability as of the termination date and, according to company policy, would be entitled to receive their severance benefits; and the remaining employee was hired to work in Utica before the decision to close this facility was made in June.

United HealthCare contended that CMS's instruction to allow payment for unused vacation time as well as severance benefits for the short-term disability employees applied to all employees, including the temporary employees.

OIG's Response

We believe that United HealthCare has taken the CMS instruction out of context. In this regard, CMS's communication with United HealthCare indicated that CMS would reimburse the company for unused vacation days of employees eligible for such payments who were transitioning to the two successor contractors that would not accept unused vacation balances. However, CMS did not offer to reimburse payments made to employees who were not eligible for such benefits.

As cited in the report, United HealthCare hired 18 employees after notifying CMS that it would terminate from the Medicare program September 30, 2000. The average employment period was 3 months. According to company policy, employees hired for a limited period (whether full time or part time) are classified as temporary. The policy stipulates that temporary employees, including those on short-term disability, are not eligible for vacation benefits.

Based on the above, we believe that our recommended disallowance for these costs is valid.

Other Costs

United HealthCare's Comments

United HealthCare concurred with the recommended disallowance of $15,128.

APPENDICES

UNITED HEALTHCARE INSURANCE COMPANY
MEDICARE TERMINATION COSTS CLAIMED AND OIG RECOMMENDATIONS

Cost Category	Amount Claimed	Recommended for Disallowance
Personnel Services		
Salaries	$918,403	$0
Fringe Benefits	182,452	0
Total Personnel Services	**$1,100,855**	**$0**
Other Costs		
Rental Property Leases	$1,026,858	$1,026,858
Data Processing Lease	931,250	931,250
Equipment Leases	782,170	337,826
Home Office Rental Costs	278,352	231,842
AT&T Amortization	1,434,521	0
Leasehold Improvements	989,428	0
IBM Global Services Fixed/Variable Expense	669,904	0
Assets	137,427	0
Legal Expenses	335,919	0
Other Expenses	868,264	0
Total Other Costs	**$7,454,093**	**$2,527,776**
Total Termination Costs	**$8,554,948**	**$2,527,776**

UNITED HEALTHCARE INSURANCE COMPANY
MEDICARE SEVERANCE COSTS CLAIMED AND OIG RECOMMENDATIONS

Cost Category	Amount Claimed	Recommended For Disallowance
Salaries	$2,122,326	$348,766
Fringe Benefits	129,223	17,468
Total Costs	**$2,251,549**	**$366,234**

Appendix C

UNITED HEALTHCARE INSURANCE COMPANY
SUMMARY OF OIG RECOMMENDED DISALLOWANCES

		Allocation of Recommended Disallowances			
Description of Findings	**Recommended Disallowances**	**Part A**	**Part B**	**Railroad Retirement Board**	**Durable Medical Equipment**
Rental Property Leases	$1,026,858	$117,724	$505,878	$197,629	$205,627
Data Processing Lease	931,250	52,616	488,906	190,999	198,729
Equipment Leases	337,826	19,087	177,359	69,288	72,092
Home Office Rental Costs	231,842	13,099	121,717	47,551	49,475
Severance Benefits Claimed in Excess of Policy	60,551	3,421	31,789	12,419	12,922
Severance Benefits to Temporary Employees	14,543	821	7,636	2,983	3,103
Other Costs	15,128	855	7,942	3,103	3,228
Severance Benefits to Senior Executives	276,012	15,595	144,906	56,610	58,901
Total Recommended Financial Adjustment	**$2,894,010**	**$223,218**	**$1,486,133**	**$580,582**	**$604,077**

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PAT MURAWSKI
Director
Government Operations

May 21, 2003

Mr. Robert M. Champagne
Suite 274 – William R Cotter Building
135 High Street
Hartford, CT 06103

Re: UHC Comments on Draft Audit Report by OIG
Common Identification No. A-01-02-00508

Dear Mr. Champagne:

As requested in the letter dated April 7, 2003, United HealthCare Insurance Company ("UHC") hereby provides its comments to the draft report entitled "Review of Medicare Termination and Severance Costs Claimed by United HealthCare Insurance Company," prepared by the Office of Audit Services, Office of Inspector General of the U.S. Department of Health and Human Services.

Our review reveals that there are several instances in which the draft audit report is based upon facts that appear to be erroneous, incomplete or misstated; and, that several of the conclusions and recommendations are based upon incorrect interpretations of applicable regulations or criteria. Of particular concern is the apparent confusion by the audit team regarding the joint termination decision, the timing of UHC's knowledge of the need to terminate, the recommended use of a clause requirement to justify an unfair forfeiture, and the inappropriate requirement for "benefit to the government," even after the effective termination date. Therefore, we will begin our comments with an Overview that addresses several of the overarching concepts that touch more than one of the specific types of costs claimed. Next, we will proceed to address each of the specific types of costs that the draft report indicates are not allowable.

We respectfully request that the authors of the audit report, as well as the CMS contracting team, review the additional facts, explanations, and authorities we have provided regarding the proposed disallowance of various costs. We are confident that our detailed response and additional rationale will justify withdrawing the recommended disallowance of costs, and ultimately lead to a negotiated resolution of these termination cost issues. In order to accelerate that process, we invite CMS to schedule a meeting promptly to discuss any outstanding issues not resolved by our detailed comments.

Yours very truly,

mP murawski

Pat Murawski
Director, Government Operations

cc: Armstrong, OIG
Aceto
McGowan

COMMENTS BY UHC
ON
DRAFT AUDIT REPORT BY OIG

I.

OVERVIEW

A. Joint Decision to Terminate for Convenience

In the Background portion of the draft report, the Office of Audit Services states: "UHC informed CMS on February 10, 2000 that it did not intend to renew the Medicare Contracts," thus leaving the false impression that UHC made a unilateral decision to terminate. In fact, the determination to terminate the Medicare Contracts for convenience was a joint decision by CMS and UHC that followed months of discussions. Since some of the recommendations to disallow costs are based upon "when" UHC reasonably knew that the Medicare Contracts would be terminated, we will summarize the time-line of the internal UHC actions and the discussions between CMS and UHC that eventually led to the joint determination to terminate:

February 1999 - UHC Management was given a white paper addressing the legal risks and benefits of the existing Medicare Contracts.

June 1999 - a working group was formed within Government Operations of UHC to prepare a full review of business options associated with the legal risks/benefits discussed in the white paper.

July 29, 1999 - a Business unit Strategic Planning document was released to UHC Management with six (6) business options regarding the Medicare Contracts - only one of those options was "termination". Others included reorganization of UHC business unit performing the contracts, including formation of a limited liability company ("LLC") to perform the contracts.

September 27, 1999 - a Government Operations Business Proposal Document was prepared and included a high level LLC implementation plan.

October 21, 1999 - UHC external legal counsel sent letter to CMS to set up a meeting on this topic with UHC executives.

November 5, 1999 - UHC external legal counsel sent follow-up letter to CMS re meeting

December 19, 1999 - first face-to-face meeting between UHC and CMS executives to confer re CMS receptivity to LLC option.

Early February 2000 - follow-up meeting between UHC and CMS executives, wherein the parties failed to reach agreement on the LLC or other business options for continuing UHC performance of the Medicare Contracts; and, the parties jointly agreed that a termination process was the best solution; whereupon, CMS advised UHC to terminate the Medicare Contracts under the relevant terms of each such contract.

February 10, 2000 - UHC Management sends formal notification of its withdrawal as Administrator and that Medicare Contracts will be terminated for convenience.

In summary, it is important to note that for a significant period of time, both UHC and CMS pursued good faith discussions examining various business options for the continued performance of the Medicare Contracts by UHC. When the parties could not agree on a going-forward approach, they mutually agreed to a termination scenario in which both agreed to work diligently on a smooth transition during a phased termination period exceeding seven (7) months.

The parties agreed and understood that UHC would be reimbursed its reasonable costs of insuring such smooth transition.

B. Failure to Use Correct Standards and Criteria for Allowability

A feature of the draft audit report that affects virtually all of the recommendations to disallow certain costs is a basic misperception regarding the criteria for allowability of costs incurred by UHC under the unique scenario outlined above. The draft audit report clearly ignores, or misapplies, four critical factors that justify the allowability of virtually all of the costs claimed by UHC:

1. Ignored Period of Transition. The audit report basically treats February 10, 2000 as the "effective" termination date, and uses that assumption to argue that certain costs are not allowable. That assumption flies in the face of reality in this unusual termination scenario, in which UHC and CMS agreed that the date of February 10, 2000 would merely begin a termination process -- a process lasting over seven months during which UHC would continue to perform its contractual duties and smoothly transition its duties to successor contractors selected by CMS. This unique "phased termination" process was agreed by the parties strictly for the benefit of the government. The legal and moral "quid pro quo" for this unusual "phased termination" process was that UHC would be reimbursed for all of its reasonable costs incurred during or caused by that extended process. This stands in sharp contrast to the standard termination for convenience scenario wherein the terminated contractor is given a dated termination notice and directed to cease operations immediately, with a minimum period of "winding down". Here there was an agreed period of extended performance by UHC (some of which is still ongoing), with an agreed purpose of benefiting the CMS mission and goal of a smooth transition to follow-on contractors. During this agreed transition period, UHC had the obligation to support the CMS goal by taking all reasonable and necessary

actions to insure the smooth transition. Thus, the legitimate effective date of termination was not February 10, 2000, but the end of the transition period -- September 30, 2000, and, under that unique agreement for a transition period (as well as pursuant to the terms of the Medicare Contracts and Federal Acquisition Regulation ("FAR") Part 31), UHC has the right to recover all reasonable, allocable and allowable costs of: a) continued performance and administration of the scope of effort required by the Medicare Contracts throughout the phased termination process; b) the costs arising from the transition of the effort of to the successor carriers; and c) costs caused by or arising from that phased termination process, including such costs that reasonably continue beyond the phased transition period. (per FAR § 31.205-42(b)). Any effort to deny UHC reimbursement of reasonable costs expended in this unique effort would in effect "punish" or penalize UHC for its "good deed" in agreeing to benefit the government by the phased termination process.

2. Ignored Specific Key Terms of the Medicare Contracts. The draft audit report also ignored a basic and critical concept engrained in each of the affected Medicare Contracts - - the principle that in performing the government's work, including termination-related work, the contractor shall not suffer any pecuniary loss. All of the Medicare Contracts state:

> It is the intent of this contract that the Carrier, in performing its functions under this contract, shall be paid its cost of administration under the principle of neither profit nor loss to the Carrier . . .

See, e.g., Contract No. CMS 87-301-2, as amended (Medicare Part B, Carrier Contract for Services in Connecticut, Minnesota, Mississippi, and Virginia), Article XV, p. 12, para. A.

It is clear that the net result of the recommendations of the draft audit report would result in UHC suffering a pecuniary loss by not recovering certain costs directly related to the Medicare Contracts and the agreed phased termination thereof. In short, if the draft audit report recommendations are implemented, UHC will not recover significant costs that it would not have incurred "but for" its performance of the Medicare Contracts, including their phased termination.

3. Ignored Guiding Principle Regarding Fairness & Business Judgment. The authors of the draft audit report also failed to apply key termination concepts required by the FAR, as well as established case precedent, by making recommendations based exclusively on a strict application of their interpretation of FAR cost principles. In so doing, they overlooked the primary FAR guidance regarding termination costs as set forth in FAR Part 49. Specifically, FAR § 49.113, Cost Principles (which applies to termination of all government contracts) states:

> The cost principles and procedures in the applicable subpart of Part 31 shall, *subject to the general principles in 49.201* --
>
> (a) Be used in asserting, negotiating, or determining costs relevant to termination statements under contracts with other than educational institutions....(Emphasis Added)

And, FAR § 49.201, General, sets forth those general principles, as follows:

> (a) *A settlement should compensate the contractor fairly* for the work done and the preparations made for the terminated portions of the contract, including a reasonable allowance for profit. Fair compensation is a matter of judgment and cannot be measured exactly. In a given case, various methods may be appropriate for arriving at fair compensation. *The use of business judgment, as distinguished from strict accounting principles, is the heart of a settlement.*
>
> (b) *The primary objective is to negotiate a settlement by agreement.* The parties may agree upon a total amount to be paid the contractor without agreeing on or segregating the particular elements of costs or profit comprising this amount.
>
> (c) *Cost and accounting data may provide guides, but are not rigid measures, for ascertaining fair compensation. In appropriate cases,* Costs may be estimated, differences compromised, and doubtful questions settled by agreement...(Emphasis Added).

The paramount principle of making a terminated contractor "whole" through "fair compensation" is not of recent origin, but has been enforced and emphasized by court and board decisions for over twenty years. In *Richardson Construction, Inc. v. General Services Administration,* GSBCA Nos. 1161, 11263, 93-1 B.C.A. ¶ 25,239 at 125, 704, *recons. granted,* 93-3 B.C.A. ¶ 26,206, the GSBCA found that "the cost standards of the FAR in Part 31 are applied in accordance with principles of business judgment and fairness, with the ultimate objective of making the contractor 'whole.'" (Emphasis Added). Also see *Codex Corp. v. United States,* 226 Ct. Cl. 693 (1981). And, the approach described in *Industrial Refrigeration Service Corp.,* VABCA No. 2532, 91-3 B.C.A. ¶ 24,093 (1991), as follows: "It is just such situations as this that the Board must be guided by the "fairness concept" set forth in FAR at Part 49 and endorsed by the Court of Claims in *Codex Corporation v. United States,* supra. We will not require the Appellant to document each and every cost item or to prove that it obtained the best deals on its subcontracts. Where it is clear that costs have been incurred, but the Appellant's supporting data is inadequate, the Board will resort to a "jury verdict" in order to arrive at a fair reimbursement which meets the spirit of the above-quoted provisions of the FAR." (Emphasis Added)

And, perhaps even more importantly in light of the subcontractor termination settlements at issue here, *see: General Electric Co.*, ASBCA No. 24111, 82-1 BCA 15,725, *recons. denied,* 83-1 BCA 16,207, which allowed recovery of a subcontractor settlement cost despite the possibility of a different result based upon a strict interpretation of the cost principles, and described the appropriate approach as follows: "To dispose of this appeal, we turn now to the fatal flaw in the Government's position: its reliance exclusively on strict accounting principles and the standards of ASPR Section XV . . . . As stated above, the only question to be decided is the 'reasonableness' of the amount agreed upon in the termination settlement between GE and Solar. 'Reasonableness' is defined by ASPR 15-201.3 in terms of costs not exceeding, in nature or amount, 'that which would be incurred by an ordinarily prudent person in the conduct of competitive business'....We have found that the settlement amount was arrived at after arm's length bargaining, without collusion, and reflected a sound exercise of prudent business judgment by GE. Nothing more is needed to support the settlement agreement in this case..." (Emphasis Added). These principles have recently been upheld in *General Dynamics Land Systems, Inc.*, ASBCA No. 52,283, 02-1 BCA 31,659 (2001), a case in which the government tried to avoid paying the prime contractor for the settlement of a subcontractor claim compromise that included certain costs the government considered meritless. The board reiterated the holding and logic of the case of *General Electric Co.*, supra, and explained: "The primary standards for ascertaining the allowability of a contractor's costs in settling a subcontractor's claims are the reasonableness and prudence of the settlement, including the competence and good faith with which the negotiations were conducted and the adequacy of the information upon which the settlement was based. What is reasonable can depend upon a variety of considerations and circumstances, including arm's length bargaining." (Emphasis Added)

4. Flawed Requirement for Benefit to the Government. In several instances, the draft audit report concludes that certain costs (both transition costs and continuing costs after effective date of termination) are unallowable because such costs no longer "benefit Medicare." This is a serious misapplication of the benefit concept, which directly conflicts with the FAR termination provisions and cost allowability principles, especially FAR § 31.205-42(b). That FAR provision states that: "Despite all reasonable efforts by the contractor, costs which cannot be discontinued immediately after the effective date of termination are generally allowable." The FAR states no prerequisite of "continuing benefit to the government" after the effective date of termination. The only stated basis for declaring any such continuing costs as unallowable is "due to the negligent or willful failure of the contractor to discontinue the costs." As far back as 1978, the U.S. Court of Federal Claims confirmed that "allocability" of costs to a specific contract can be achieved by either a causal or a beneficial relationship to that contract.

See *American Diversified Corporation and Jon-Dell, Inc. v. The United States,* 1978 WL 14855 (Ct. Cl. Trial Div.), especially Footnote 19, which states:

> "Cf. standards promulgated by the Cost Accounting Standards Board (CASB), which require each allocable cost or revenue item to be assigned to that operation which was intended to benefit from the resource represented by the cost, or, alternatively, which caused incurrence of the cost. See, CCH, Cost Accounting Standards Guide, ….."

An even clearer denial of the government's ability to base a disallowance merely upon "lack of benefit" is the recent case of *Boeing North American, Inc. v. James G. Roche, Secretary of the Air Force*, 298 F.3d 1274 (Fed. Cir. 2002), which explains:

> Thus, we agree with Boeing that allocability is an accounting concept and that **CAS does not require that a cost directly benefit the government's interests for the cost to be allocable**. The word "benefit" is used in the allocability provisions to describe the nexus required for accounting purposes between the cost and the contract to which it is allocated. **The requirement of a "benefit" to a government contract is not designed to permit contracting officers, the Board, or this court to embark on an amorphous inquiry into whether a particular cost sufficiently "benefits" the government so that the cost should be recoverable from the government.** The question whether a cost should be recoverable as a matter of policy is to be undertaken by applying the specific allowability regulations, which embody the government's view, as a matter of "policy," as to whether the contractor may permissibly charge particular costs to the government (if they are otherwise allocable). (Emphasis Added)

This recent and forceful statement by the Federal Circuit Court of Appeals directly invalidates the mistaken "benefit" concept which the audit report attempted to employ; and redirects this issue back to the "specific allowability regulations". Those allowability regulations, particularly FAR § 31.205-42, clearly make the costs at issue specifically allowable.

By ignoring or misapplying the appropriate standards and principles described in the above four paragraphs, the authors of the draft audit report produced flawed recommendations which must be rejected.

C. Automatic Termination of Subcontractor Clause

The audit report relies heavily upon Article III, Appendix A of the Medicare Contracts, requiring, in some circumstances, the inclusion of the so-called "Automatic Termination of Subcontracts" clause (the "ATS clause") in subcontracts supporting the Medicare Contracts. The audit report strictly interprets the scope and intent of these ATS clause requirements. Indeed, the audit report adopts a position that essentially results in UHC's complete forfeiture of otherwise allowable costs it incurred in direct support of the Medicare Contracts, based upon the mere absence of a waiver authorizing the exclusion of certain language in UHC's subcontracts or leases. By virtue of its position, the audit report applies the ATS clause requirements contrary to the intent of the parties to the Medicare Contracts and, in total disregard of all fairness considerations, such as whether or not the government suffered any prejudice. The audit report's strict mechanical application of the ATS clause requirements, resulting in UHC's total forfeiture of otherwise reasonable, allocable and allowable termination costs is unfair and, in any case, erroneous.

1. Interpretation

The audit report broadly asserts that the Medicare Contracts and applicable law and regulation required UHC to insert the ATS clause in each and every UHC contract with a third-party for supplies, services or lease of real property that may conceivably relate to the Medicare Contracts. Additionally, the audit report claims that the intent of the Medicare Contracts is that any failure by UHC to insert the ATS clause in such "subcontracts" compels an automatic forfeiture of UHC's "related [subcontract] costs incurred after the effective date of the nonrenewal or termination," absent a waiver from the CMS. The audit report is wrong.

The Medicare Contracts, properly interpreted with reference to the relevant CMS' Medicare Carriers Manual, do not require the insertion of the ATS clause in every UHC contract with a third party that might tangentially relate to the Medicare Contracts.[1] For example, the ATS clause requirements of CMS's Medicare Carriers Manual and the Medicare Contracts do not require UHC's insertion of the prescribed ATS clause language in subcontracts not expected to exceed the term of the Medicare Contracts. In the context of the Medicare Contracts, which were entered into in 1966 for an indefinite duration, few of UHC's contracts or leases with third parties could be viewed, reasonably, as subcontracts expected to exceed the indefinitely long-term nature of the Medicare Contracts. Indeed, <u>none</u> of UHC's relevant subcontracts (or leases) from which

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1 The Medicare Carrier Manual represents CMS' controlling regulatory interpretation of the ATS clause requirements included in the Medicare Contracts. Indeed, CMS and UHC entered into each of the Medicare Contracts subject to the authority and guidance of the Medicare Carrier Manual.

UHC's termination costs arise and, are now subject to the audit report's disallowance, constitute subcontracts UHC, or any reasonable person, would expect to exceed the duration of the indefinite-term, 34-year old Medicare Contracts.

2. Conflict With Contract Terms and Pertinent Regulation

The ATS clause requirements contained in the Medicare Contracts conflict with numerous other terms of the Medicare Contracts as well as applicable law and regulation. For example, the Medicare Contracts provide that UHC shall be paid all of its allowable cost pursuant to the "cost principles" of the FAR as modified by Appendix B of the Medicare Contracts. Both the cost principles of the FAR and Appendix B provide that UHC's termination costs are allowable. Additionally, as noted above, a fundamental term of the Medicare Contracts provides that UHC shall not suffer a loss as a result of its performance. Forfeiture of otherwise allowable costs will undoubtedly cause UHC to suffer a significant loss.

Significantly, CMS' Medicare Carriers Manual limits the instances where a contractor must insert the ATS clause to *subcontracts* and makes no reference to a forfeiture of otherwise allowable costs. In contrast, the Medicare Contracts purport to require UHC's insertion of the ATS clause in *both* subcontracts *and* leases of real property. Moreover, the Medicare Contracts purport further, without explanation, that UHC shall forfeit otherwise allowable costs under certain circumstances. Consequently, there are express conflicts between the ATS clause requirements stated in the Medicare Contracts, various other terms of the Medicare Contracts, and the controlling regulatory authority of the CMS' Medicare Carriers Manual and FAR Subpart 31.2. Given the directives of the CMS' Medicare Carriers Manual and FAR Subpart 31.2, it seems clear the CMS contracting officer lacked the authority to require UHC to insert the ATS clause in leases of real property or, to deem UHC's otherwise allowable termination costs forfeit.

3. Forfeiture Inappropriate Without Government Prejudice

The audit report relies upon the forfeiture terms of the ATS clause requirements to support the vast majority of its disallowance findings with respect to UHC's otherwise allowable termination costs. Such forfeiture terms, however, are unenforceable where any reasonable interpretation permits the avoidance of a UHC forfeiture or, where no prejudice to the government results from UHC's alleged failure to comply with the ATS requirements.

Indeed, it is well established that forfeiture of contract rights is highly disfavored. Restat. 2nd (Contracts) § 229; *United States v. One 1936 Model Ford V-8 De Luxe Coach*, 307 U.S. 219, 226 (1939); *Idaho v. Hodel*, 814 F.2d 1288, 1296-96 (9th Cir. 1987) cert. denied, 484 U.S. 854 (1987); *Bell Helicopter Textron*, ASBCA No. 21192, 85-3 B.C.A. ¶ 18,415 at 92,428-30 (1985). Contract provisions purporting to forfeit contract rights, therefore, are strictly construed. *Id.* Additionally, contractor forfeiture without any evidence of a concomitant prejudice to the government are routinely declared unenforceable as contrary to law. *See id.*

To the extent the audit report implies that the government suffered prejudice as a result of UHC's alleged non-compliance with the ATS clause requirements, it is erroneous. In fact, it is entirely unclear how the scant verbiage of the ATS clause could have reduced, in any manner, the termination costs UHC incurred under its various subcontract and lease arrangements. For example, the plain language of the ATS clause merely states that UHC may terminate a subcontract upon the termination or non-renewal of the Medicare Contracts. The ATS clause does not even purport to allow UHC to terminate its subcontract or lease arrangements on a "no-cost" basis with its subcontracts. Thus, even if the ATS clause were included in a subcontract, its language would not have precluded UHC's and CMS' obligation to pay reasonable termination costs in accord with applicable regulations and case precedent (especially for costs continuing after termination, rental under unexpired leases, and subcontractor claims, all of which are made specifically allowable by FAR § 31.205-42). The audit report's recommended disallowance of UHC's termination costs, therefore, is improper because it is not based upon any harm or prejudice suffered by the government, but would clearly permit the government to collect an unfair penalty or windfall from UHC.

4. Estoppel/Waiver

Pursuant to the Medicare Contracts, CMS must approve certain UHC subcontracts. Also, due to the nature of the Medicare Contracts' various requirements relating to subcontracts, the CMS must approve subcontracts UHC used for any of its Medicare-related operations. Accordingly, at all times relevant, the CMS knew or should have known of the terms upon which UHC entered into its various subcontracts that are the subject of the audit report.

Moreover, UHC formally became the CMS' carrier contractor under the terms of the Medicare Contracts (instead of a mere subcontractor to TIC under the Medicare Contracts) in 1999, pursuant to the novation agreement between CMS, TIC and UHC. At that time, the CMS accepted, in place, UHC's then existing infrastructure to perform the Medicare Contracts, including UHC's various subcontract and lease arrangements UHC had entered into as a subcontractor to TIC. Accordingly, CMS did not take exception to UHC's relevant subcontracts and lease arrangements, but regularly reimbursed UHC for its costs arising from such subcontracts and leases. In any case, prior to becoming the formal prime contractor under the Medicare Contracts in 1999, UHC was under no obligation to insert the ATS clause in its subcontracts and leases because UHC, itself, was a mere subcontractor to TIC under the Medicare Contracts.[2]

Additionally, as discussed above, the CMS' Medicare Carriers Manual is the definitive CMS interpretation of the Medicare Contracts. CMS provided its Medicare Carriers Manual to UHC and understood that UHC would rely upon the directives, interpretations and guidance provided therein. In fact, UHC actually relied upon the Medicare Carriers Manual, including the CMS' interpretation of the ATS clause requirements in the Medicare Contracts. The Medicare Carriers Manual, therefore, represents an express waiver of the ATS clause requirements, at least to the extent the Manual does not require UHC (1) to insert the ATS clause into leases of real property; or, (2) to forfeit otherwise allowable UHC termination costs.

Finally, UHC is aware that CMS is authorized to waive the ATS requirements upon request. With respect to UHC, the merits of whether a waiver was appropriate in this case were already discussed with CMS in conjunction with its vouchers for the termination costs. After requesting and considering UHC's comments regarding the omission of the ATS clause, CMS paid the vouchers requesting termination costs arising from the relevant subcontracts and leases. Accordingly, CMS has already reviewed the circumstances of UHC's termination costs for real estate and equipment and has impliedly waived the ATS clause requirement by paying these costs.

The audit report makes no attempt to argue UHC was not entitled to such a routine CMS waiver in any of the UHC's relevant subcontracts or leases. For years, in fact, CMS demonstrated complete indifference to the inclusion of the ATS clause in UHC's subcontracts or leases. Because the CMS knew or should have known of the absence of the ATS clause in UHC's subcontracts or leases, provided guidance in the Medicare Carriers Manual that UHC reasonably relied upon, and in any case, is authorized to waive the ATS clause requirements, the CMS is estopped, and should or has already waived its right to enforce a forfeiture of UHC's otherwise allowable termination costs.

5. <u>Fairness</u>

There can be little doubt the UHC termination costs, arising under UHC's relevant subcontracts and leases, were incurred for the benefit of the government. Indeed, the government enjoyed the benefit of such UHC termination costs wherein the government received the real property, equipment and data processing services acquired by UHC, and yet the government paid UHC only the reduced costs obtained on account of UHC's commercial bargaining power. Moreover, the government did not pay for the "right" to terminate the subcontracts. Further, except to the extent that the audit report alleges

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2 The Medicare Contracts' ATS clause requirements do not require flow-down of the ATS clause to 2nd tier subcontracts.

UHC's termination costs were unreasonably increased as a result of the absence of the ATS clause in the relevant UHC subcontracts and leases, the audit report is devoid of any demonstration that UHC's termination costs were not commercially prudent and reasonable under the circumstances of the Medicare Contracts. The audit report makes no such demonstration because it cannot; UHC's termination costs have consistently been incurred in good faith, and successful, efforts to obtain the best business deal possible for the benefit of the Medicare Contracts. Accordingly, the Medicare Contracts, applicable law and regulation as well as fairness dictate the government reimburse UHC for these claimed termination costs.

II.

UNEXPIRED RENTAL PROPERTY LEASES

A. Utica Print Facility

The draft audit report recommends disallowance of $963,576 in termination costs for Utica Print Facility (comprised of $667,713 for lease buyout, rent, and non-rent costs, and $295,863 for leasehold improvement costs). The report states the following rationale for disallowance: (1) UHC did not include the ATS clause in the field office lease agreements, (2) UHC did not obtain CMS agreement to waive the clause and request approval for reimbursement of lease costs after termination, and (3) UHC's questionable business decisions made regarding the construction and leasing of the facility at a time when it was also considering corporate changes for the Medicare Government Operations Division.

1. ATS Clause. UHC's general comments and response regarding the ATS clause are set forth in Section I.C. of the Overview above, because the ATS issue affects several items of cost. However, as the absence of an ATS clause specifically relates to the Utica Print Facility, UHC offers the following additional rationale why the ATS clause does not apply here, why CMS should waive such clause if it did apply, and why UHC acted reasonably in proceeding to obtain critical facilities via lease without such clause.

As noted in Section I.A. above, the audit report's allegation that UHC unilaterally decided not to renew the Medicare Contracts in February 2000 is just plain wrong. Likewise, the report's claim that UHC moved into the Utica facility in February 2000 (the same month as the termination determination), implying that UHC knew when it entered into the Utica Lease that it intended not to renew the Medicare Contracts, is entirely baseless. Compounding these misleading inferences, the audit report concludes that the omission of the ATS clause in the Utica Lease renders all of UHC's related termination costs unallowable, because such costs are unreasonable "penalty costs" incurred to wind-up the Utica Lease. This conclusion is unsupported and invalid, for the following reasons.

a. First, as discussed in detail in Section I.C., the Medicare Contracts' ATS clause requirements only relate to subcontracts that are expected to exceed the term of the Medicare Contracts. While the Utica Lease was for five years, such a lease term was minimal compared to the 34-year old, indefinite-term Medicare Contracts. So at the time UHC entered into the Utica Lease, UHC could not have expected that lease to exceed the long-running, indefinite duration of the Medicare Contracts. Indeed, nonrenewal or termination of the Medicare Contracts had not been seriously considered by UHC or CMS at the time UHC entered into the Utica Lease.

b. Second, the language of the Medicare Carriers Manual makes it doubtful that the Medicare Contracts' ATS clause requirements apply to leases of real property, such as the Utica Lease.

c. Third, the omission of the ATS clause from the Utica lease was reasonable because, among other reasons, the lessor required a firm long-term, five-year contract in the difficult economic conditions prevailing in Utica N.Y. at that time. In that tight rental market, the lessor, Center Green, was not motivated to accept a shorter term or any government-required clauses that could limit its right to a long-term lease agreement. In a written statement regarding the Center Green position, Mr. Michael S. Heurman, Managing Director, stated: "Center Green, Inc. would not lease such Demised Premises with a government-required clause - "Automatic Termination of Subcontracts" because we required a firm (5) five year lease term." Additionally, as has been discussed with CMS and OIG on several occasions, the lease arrangements in Utica N.Y. were the most efficient way available to ensure print facilities for Medicare Contract operations at reasonable cost, in light of: (1) the unavailability of facilities from MetLife; (2) the intact expertise and operations situated in Utica, N.Y.; (3) the absence of alternative facilities in Utica, N.Y.; and, (4) the CMS requirement that back-up or redundant print facilities be maintained.

d. Fourth, it must be noted that UHC has achieved a very reasonable termination settlement or "buy-out" of this lease, even without an ATS clause (as noted in Section I.C. above, the presence of the ATS clause would have had no impact on UHC's termination costs). Accordingly, the government suffered no prejudice due to the absence of the ATS clause in the Utica Lease. For these reasons, forfeiture of UHC's otherwise allowable costs of terminating the Utica Lease is unfair and improper.

e. Lastly, UHC is aware that CMS can waive the requirement with respect to the ATS clause when its inclusion is not acceptable to commercial lessors or it causes undue difficulty. The following facts support a waiver in these circumstances:

(1) As related above, UHC has documented the Lessor's position that it would not have accepted the ATS clause and required a 5-year lease

(2) UHC relied upon the CMS' Medicare Carrier Manual, which does not require the inclusion of the ATS clause into the Utica Lease under these circumstances.

(3) On June 14, 2001, CMS personnel asked UHC if the Utica Print Center Lease contained the ATS clause. UHC responded in writing that the ATS clause was not included and provided specific rationale for the omission. On August 24, 2001, UHC received funding from CMS for the termination costs associated with the buyout of the Utica lease totaling $667,713, as well as $295,863 for lease hold improvements for the Utica Print Center. UHC concluded from these events that CMS had indeed waived the application of the ATS clause for good cause. UHC still maintains that CMS, therefore, is estopped or has waived the requirement for inclusion of the ATS clause in the Utica Lease.

For all the reasons above, the proposed disallowance of UHC's Utica termination costs for omission of the ATS clause is based upon flawed rationale and should be withdrawn.

2. UHC's Reasonable Business Decision. The audit report recommendations appear to ignore the extensive background factual and legal rationale previously provided by UHC on this issue (OARS#5), which is attached hereto as Attachment A, leading to several erroneous conclusions, including that regarding allowability. The following factors strongly support the reasonableness of UHC's actions in a difficult economic environment:

a. The audit report states, without evidence, that UHC contracted for the construction and lease of a new print facility. As explained in earlier correspondence to CMS, UHC sought alternative space in the Utica area to relocate its print and mail operations after determining the earlier lease from MetLife could not be extended. As far back as July 1998, UHC sent out Requests for Proposal for a Utica Print/Mail Facility to six brokers/building owners - - with no success. So, after an exhaustive search during 1998 and 1999 for usable space, with the help of expert Trammel Crow, UHC determined that no suitable and cost-effective space in Utica was readily available. Therefore, in order to support the on-going Medicare Contracts, UHC entered into the 5-year lease with Center Green for its new building. The lease was signed August 23, 1999.

b. The audit report accuses UHC of making a poor business decision to enter into a 5-year lease when it was considering corporate restructuring alternatives. In reaching that conclusion, the authors of the report failed to consider several relevant facts:

(1) The Center Green lease was the best available and usable business deal in the Utica area in August 1999;

(2) Several of the corporate alternatives that were mentioned for UHC consideration included separate companies (such as an LLC) but still under the auspices of UHC. In August 1999, UHC was reasonable in assuming that it would retain corporate responsibility for the Medicare Contracts indefinitely, or perhaps transfer it to a subsidiary.

(3) UHC signed the lease on August 23, 1999, months before it even scheduled a meeting with CMS to confer regarding the possible reorganization issues. The lease was a matter requiring immediate attention in order to perform the Medicare Contracts.

(4) In October, November and December 1999, UHC pursued meetings with CMS to confer regarding a possible LLC (as set forth in the time line described in Section I.A. hereof). UHC prepared a plan to implement the LLC alternative and would have done so if CMS had agreed.

(5) UHC did not learn until its meeting with CMS in early February 2000 that CMS would not agree to the LLC option for going forward. At that meeting a joint termination decision was reached.

(6) Contrary to the inference in the audit report, UHC's action in entering into a 5-year lease demonstrates UHC's confidence that it would continue to perform the "indefinite" Medicare Contracts for an extended period into the future.

Under these circumstances, it was entirely reasonable for UHC to enter into the 5-year lease with Center Green in August 1999. Such lease was virtually the "only game in town" -- and UHC could not at that point consider consolidating print facility operations with its other facility in Duncan, S.C., because of the MCM requirement to maintain redundant disaster recovery capability. Also, as discussed in the OARS#5, UHC performed a detailed evaluation of the possibility of outsourcing the print and mail requirements to a third-party vendor, but concluded it would be more expensive than retaining internal capability. In summary, UHC made a reasonable, prudent, and business-like decision to enter the lease with Center Green.

c. CMS was well aware of corporate developments in 1994-1996 wherein The Travelers Insurance Company, the predecessor contractor to UHC, divested some of its business operations including those supporting the Medicare Contract. CMS actively participated with Travelers and UHC to ensure continued services under the contract. Indeed, CMS was party to a Novation Agreement under which the contractual obligations of Travelers to CMS were assigned to UHC. Through its active knowledge of and participation in this process, CMS acceded to the consequences of transfer and assignment, including the difficult situation in which UHC found itself with respect to the Utica facility.

d. The audit report infers it was unreasonable for UHC to move into the new leased print facility in February 2000 and, subsequently, "in the same month, notify CMS that it would not renew its Medicare Contracts." That assertion is disingenuous. As explained above, the lease decision was made and the lease signed in August 1999. UHC did not know until early February 2000 that CMS was opting for termination rather than permit UHC to continue the Medicare Contracts by forming a new LLC or other alternatives under which UHC could continue as Contractor. And, UHC has previously explained in OARS#5 that it had to delay moving into the new leased Center Green facility due to precautions dictated by "Y2K" computer concerns and special precautions that were prudent. In short, the fact that the move into the new facility and the termination determination and notice occurred in the same month was pure coincidence and did not reflect unreasonable business moves by UHC. Moreover, the net result was that CMS received the benefit of the Utica facility for an additional considerable period of time.

e. In attempting to support their assertion of unreasonable business decisions by UHC, the authors of the audit report state that the lease buyout amount totaling $963,576 "was well over 90 percent of the rental liability remaining on the lease even though the building was returned to the landlord with over 4 years remaining on the 5-year lease." This statement also is completely erroneous and misleading, as explained below:

(1) UHC negotiated a buyout of the remaining lease term for a total of $890,881. It then charged CMS with its proportionate share (67%) or $596,890 as termination costs. Adding rent and non-rent costs in the same proportion brought that figure to $667,713. In addition, UHC has claimed $295,863, which is CMS's proportionate share of leasehold improvements for Utica Print Facility - thus the total Medicare share of the Utica costs is $963,576. Obviously, the $295,863 must be treated independently, as explained in subparagraph 3 below.

(2) The auditor-asserted 90% is not valid as a percent of the rental liability remaining on the lease - - it is only valid as an approximate

percent of the buyout amount ($890,881) to the actual lease expense for the period (2/1/00 - 1/31/05). However, the more accurate way to view the reasonableness of UHC's very successful mitigation effort is to measure the total lease buyout amount ($890,881) to the total projected lease expenses remaining for the 4 year period if the buyout did not occur ($2,013,286 - which includes lease expense, taxes, CAM charges and electric expense). Under this more representative calculation, the buyout amount is only 44% of the total costs that CMS would have had to share if the buyout was not achieved - an extremely successful and reasonable achievement, especially in the unique and difficult economic environment existing at the time.

f. The buyout costs are also reasonable and allowable under specific provisions of the FAR and case precedent. The Buyout Agreement constitutes a settlement with one of UHC's subcontractors, and therefore is allowable pursuant to FAR § 31.205-42(h). See also: *General Dynamics Land Systems, Inc.*, ASBCA No. 52283, 02-1 BCA 31,659 (2001), which upholds the allowability of an arms-length settlement of a subcontractor's termination claim. Additionally, such costs would also be allowable as rental costs under unexpired leases pursuant to FAR § 31.205-42(e).

The above facts demonstrate that the recommended disallowance of the Utica Print Facility buyout costs was based upon erroneous factual assumptions, and a flawed rationale regarding the reasonableness of UHC's successful actions to mitigate the termination action.

3. Audit Report Confusion Regarding Leasehold Improvements. The audit report reaches two erroneous conclusions regarding the $295,863 in leasehold improvements for Utica Print Facility.

a. First, the report treats the $295,863 in leasehold improvements as part of the lease buyout settlement with Center Green. That is incorrect. The buyout settlement was for $890,881, of which, with proper adjustments for rent and non-rent costs, $667,713 was the appropriate Medicare share. In addition, the $295,863 in leasehold improvements were costs UHC incurred in the final preparation of the building for occupancy and were not related to the lease and other rental expense. UHC normally amortizes leasehold improvements for the same period as the lease. Since this was a five-year lease, the leasehold improvements were to be amortized over a five-year period also. After the termination of the Medicare Contracts, the remaining unamortized amount ($295, 683 - representing Medicare's 67% share) is an allowable termination cost.

b. Secondly, the audit report questions UHC's business decision to incur significant costs for leasehold improvements "when the building was specifically constructed to house UHC's printing operation." This is also an erroneous conclusion, because the leasehold improvement costs covered items unique to the printing operation, and items required by the move in any event. UHC remained a Medicare Contractor until September 2000, and until that time was obligated to print claim documents and meet the performance standards of the Medicare Contracts. Approximately 40% of the leasehold improvement costs were for an UPS (Uninterrupted Power Supply) that was installed to ensure that the computers and other equipment would not be impacted by power outages, which could impact UHC's ability to print claim documents - - another prudent business decision to ensure continuity of print operations. The remainder of the leasehold improvement costs were for items that normally occur as part of a move, such as furniture, moving expenses, telecommunications equipment (phones) change orders and design layout - all of which were not covered by the lease itself, or included in the buyout of the lease.

Significantly, for the reasons set forth above, UHC is independently entitled to this termination cost of $295,863 for leasehold improvements, regardless of the inclusion or exclusion of the ATS clause discussed elsewhere.

B. Southfield Medicare Office

The termination costs for the Southfield office were erroneously billed to CMS, and UHC hereby withdraws its claim for such termination costs.

III.

DATA PROCESSING SUBCONTRACT COSTS

The audit report disallows UHC's termination costs relating to data processing, in the amount of $931,250, arising from UHC's subcontract with IBM Global Services, Inc. ("IGS") (the "IGS Costs"). UHC's IGS Costs were incurred to reallocate its data processing requirements to permit UHC's replacement of the Medicare Contracts' volume with data processing requirements of its commercial business. UHC's IGS Costs, therefore, were incurred as a direct consequence of the Medicare Contracts' nonrenewal.

Because the IGS subcontract unquestionably incorporates the ATS clause by reference, the audit report does not question UHC's compliance with the requirement to insert the ATS clause in the subcontract. Instead the audit report relies on an entirely different portion of the ATS clause requirements to support its disallowance of the IGS Costs. That is, the audit report claims UHC's IGS Costs are unallowable because UHC failed to "assure the Secretary in writing that the Secretary's obligations will terminate [with respect to the IGS subcontract] at the time the Medicare [Contracts] terminate...," pursuant to the ATS clause requirements. The audit report adds, as further support for its disallowance, that the IGS subcontract no longer benefits the government and therefore, it is not fair for the government to reimburse UHC for any costs arising out of the IGS subcontract resulting from the nonrenewal of the Medicare Contracts. Each of these bases for disallowance are without merit under the terms of the Medicare Contracts and applicable law and regulation.

A. Background

The audit report findings suggest misunderstandings exist concerning the background leading to UHC's request for reimbursement of the IGS Costs in the amount of $931,250. UHC seeks to clear up these misunderstandings. Accordingly, UHC incorporates its response to OARS #7 concerning the IGS Costs and the IGS Subcontract. (See Attachment B). UHC provides additional pertinent background information concerning the IGS Costs and the IGS subcontract below.

On November 17, 1995, UHC entered into the IGS subcontract for data center support services, including the processing of computerized data and the storage of information concerning insurance claims. The IGS subcontract supported UHC's Medicare-related claims processing requirements under the Medicare Contracts as well as much of UHC's commercial business. The composition of UHC's claims processing business supported by the IGS subcontract was approximately 85% commercial and 15% Medicare-related.

Prior to 1995, the data processing facility supporting the Medicare Contracts was owned by the contractor responsible, at that time, for the performance and administration of the Medicare Contracts - The Travelers Insurance Company ("TIC"). In 1994, TIC announced its intention to form a jointly-owned but independently managed and operated venture with Metropolitan Life Insurance Company ("MetLife"), combining their respective group health insurance and related health benefits businesses. That venture, known as "MetraHealth," became operational on January 3, 1995. Among the business units that TIC contributed to MetraHealth was the operational unit that administered and performed the Medicare Contracts (Government Operations). With CMS's approval, MetraHealth continued to administer and perform the Medicare Contracts for TIC.

In 1995, TIC and MetLife announced their intention to sell their equity interests in MetraHealth to UHC. In conjunction with this purchase and sale, UHC was informed by TIC that MetraHealth could not continue to use TIC's data center without a substantial and costly restructuring of the arrangement. Thus, UHC was obliged to reevaluate and seek alternatives to TIC-owned data center facilities for its Medicare Contracts business.

UHC performed an extensive review of the business efficiency and cost effectiveness of TIC's data center arrangement. The review process demonstrated that the sale of MetraHealth to UHC made impractical, from both a business and cost perspective, the historical arrangement with TIC for data center support.

UHC embarked upon a competitive bidding process to identify contractors that could meet or exceed all of the performance specifications for data center support required for both the Medicare Contracts as well as for much of UHC's larger commercial business. While under no obligation to do so, UHC sought to enter into the most cost effective and efficient subcontracting arrangement possible by combining UHC's commercial and Medicare-related data center support requirements into one facility and services subcontract. That combination took advantage of the beneficial economies of scale and bargaining leverage that existed in the commercial marketplace from which CMS has subsequently benefited in the form of reduced charges with respect to the Medicare Contracts.

The competitive process resulted in the selection of IGS as the vendor which best met UHC's commercial and Medicare-related data center support requirements. On November 17, 1995, after extensive negotiations, UHC entered into the IGS subcontract. At that time, UHC also submitted the IGS subcontract to the CMS for its consent and approval under the Medicare Contracts. After detailed discussions with UHC, CMS subsequently provided its formal approval.

In any event, upon the nonrenewal of the Medicare Contracts, UHC attempted to achieve the maximum mitigation of costs to UHC and the government while providing, at the same time, an efficient transition of UHC's Medicare-related claims processing business to the successor Medicare carriers. UHC entered into discussions with IGS regarding a contemplated restructure of the IGS subcontract. Further, UHC issued a notice of partial termination to IGS on or about June 13, 2000 which requested that IGS promptly enter into discussions with UHC regarding the termination of the Medicare-related portion of the IGS Subcontract.

Importantly, the IGS contract incorporated the Medicare Contracts' ATS clause by reference. Specifically, the IGS subcontract's Section 23.03, Government Contract states that IGS shall "comply with all provisions applicable to subcontractors under the Medicare Contracts, which provisions are herein incorporated by reference," which included the ATS clause. Thus, UHC prepared its notice of partial termination and discussed partial termination with IGS in an attempt to enforce the ATS clause.

Not unexpectedly, IGS rejected UHC's attempt to enforce the ATS clause because IGS viewed the ATS clause as ineffective in eliminating UHC's liability to pay for the facility and services provided for under the IGS subcontract.[3] Thus, IGS refused to provide UHC with any termination proposal in response to UHC's request.

3 As discussed above, the ATS clause provides no effective relief from termination costs or other liability resulting from the termination of any subcontract.

Nevertheless, UHC entered into arms-length negotiations and attempted to achieve a termination settlement of the IGS subcontract for that portion of the subcontract related to the performance of Medicare-related requirements. UHC believes such settlement negotiations would have proved successful only if UHC were willing to pay to IGS and, pass onto CMS, termination costs in the amount of approximately $9.7 million. UHC ultimately determined such a termination settlement amount was too costly to UHC and the government, and thus no such settlement between UHC and IGS was possible.

UHC originally had requested CMS reimburse UHC's termination costs calculated in the amount of approximately $ 9.7 million (the termination costs UHC anticipated it would incur in any settlement with IGS pursuant to the ATS clause). At the meeting held January 17, 2001, UHC informed CMS that UHC would no longer pursue reimbursement of such IGS subcontract settlement costs in the amount of $9.7 million. At that meeting, UHC also advised CMS that, in lieu of the $9.7 million request, UHC intended to request reimbursement for increased costs to UHC resulting from the nonrenewal of the Medicare Contracts, but only to the extent UHC was unable to reallocate its remaining commercial data processing volume to satisfy the idled capacity resulting from the loss of the Medicare-related data processing volume. CMS representatives appeared to agree with UHC's alternative approach to settling the termination liability with respect to the IGS subcontract. Thus, in good faith, UHC submitted the IGS Costs for reimbursement, amounting to a 10-fold decrease in termination costs that would have resulted from any settlement with IGS under the ATS clause. The IGS Cost claimed was $931,250 due to UHC's successful reallocation of its data processing requirements under the IGS subcontract during the period September through December 2000.

B. <u>Discussion</u>

UHC is entitled under the Medicare Contracts and applicable law and regulation to charge the government its "fair share" of UHC's termination costs arising from the IGS subcontract. Indeed, UHC could have disputed IGS's position concerning UHC's partial termination of the IGS subcontract and rightfully charged the government its "fair share" of any resulting subcontractor dispute and/or settlement costs with IGS. (Such costs are estimated to be $9.7 million.) Instead, UHC informed CMS in early January 2001 that UHC would continue the IGS subcontract and reallocate its commercial data processing volume to replace the data processing capacity idled by the nonrenewal of the Medicare Contracts. In the best interests of both UHC and the government, therefore, UHC elected to continue the IGS subcontract, subject only to its request for reimbursement for the IGS Costs in the amount of $931,250 representing temporary idle capacity costs.

UHC deems its request for the $931,250 to be fair and reasonable, allocable and allowable under Medicare Contracts. UHC believes the CMS representatives also viewed this UHC approach and the resulting IGS Costs as fair and reasonable in the discussions held in early 2001. The audit report's contrary view, based upon the ATS clause requirements and its unsupported allegations that such UHC termination cost lack the requisite "benefits" and "fairness" to the government, represents a retrenchment of the government's position on this matter and, in any case, is incorrect under the Medicare Contracts and applicable law and regulation.

1. The Audit Reports' Reliance On the ATS Clause Requirements Is Fundamentally Flawed

The audit report disallows UHC's IGS Costs based upon a selective reading of the language contained within the ATS clause requirements of the Medicare Contracts. The audit report claims such selective language renders the IGS Costs unallowable because UHC failed to "assure [] the Secretary in writing that the Secretary's obligations will terminate [with respect to the IGS subcontract] at the time the Medicare [Contracts] terminates . . .". The audit report's disallowance of the IGS Costs, however, grossly distorts the meaning and intent of the Medicare Contracts' ATS clause requirements.

Indeed, the relevant ATS clause requirements read, *in full text*, as follows:

> Notwithstanding the following, if the Contractor wishes to continue the subcontract relative to its own business after the contract between the Secretary and the Contractor has been terminated or nonrenewed, it may do so provided it assures the Secretary in writing that the Secretary's obligations will terminate at the time the Medicare Contract terminates *subject to the termination cost provisions provided for in the contract between the Secretary and the contractor.* (Emphasis added.)

Rather than support any disallowance, the full text of the relevant ATS clause requirements confirms the government is obligated to pay UHC its requested IGS Costs in accordance with the "termination cost provisions provided for" in the Medicare Contracts.

Moreover, while the audit report seems to accept that the ATS clause was included in the IGS subcontract, it complains only that UHC did not: (1) notify the CMS it wished to continue the IGS subcontract with respect to UHC's commercial business; and, (2) assure the CMS its obligations under the IGS subcontract would cease. Assuming the audit report's allegations concerning UHC's failure to notify and assure the CMS are correct, which they are not, the audit report offers no logic as to why UHC's termination costs arising from the IGS subcontract are rendered unallowable.

In any case, UHC did notify and assure CMS it wished to continue the IGS subcontract and that CMS would be obligated only to pay the IGS Costs pursuant to the termination cost provisions of the Medicare Contracts. Indeed, UHC met with CMS in January 2001 to specifically discuss the IGS subcontract and has submitted numerous costs vouchers, a draft advance agreement and other statements to CMS relating to UHC's wish to continue the IGS subcontract and CMS' obligation only to pay the IGS Costs. Moreover, as early as 1996, when the CMS formally approved the IGS subcontract terms permitting the IGS data center to serve as a shared facility for UHC's commercial and Medicare-related data processing requirements, UHC informed CMS of its wishes and the nature of CMS's obligations under the IGS Subcontract. Importantly, even viewing this audit response apart from these numerous other UHC statements, CMS is now well-informed, in writing, that the CMS is under no further obligation for the IGS subcontract beyond the date of nonrenewal of the Medicare Contracts, except to the extent the Medicare Contracts contemplate the CMS' payment of UHC's IGS Costs under the relevant termination cost provisions.

In sum, the audit report's disallowance based upon its selective reading of the ATS clause requirements is fundamentally flawed because a proper reading of the full text of the requirements clearly provides for the allowability of the IGS Costs. In any event, UHC notified CMS, in writing, on numerous occasions that UHC wished to continue the IGS subcontract, but that the CMS' "obligations will terminate" at the time of the nonrenewal of the Medicare Contracts, subject to CMS' obligation to reimburse UHC its IGS Costs under the "termination cost provisions" of the Medicare Contracts.

2. The Audit Reports' Reliance On "Benefit" or "Fairness" To the Government To Support Its Disallowance Is Without Merit

With respect to the audit report's "benefit" and "fairness" allegations, UHC is entitled to payment of its IGS Costs to the extent such costs are allocable to the Medicare Contracts by virtue of a causal, beneficial or other equitable relationship to the Medicare Contracts. (Note our earlier discussion of the *Boeing* case in Section I.B.4, wherein the Federal Circuit clearly stated that **CAS does not require that a cost directly benefit the government's interests for the cost to be allocable**). UHC has clearly established the IGS Costs are allocable to the Medicare Contract based upon both a causal and/or beneficial relationship. Indeed, as discussed below, applicable law and regulation provide, among other things, that the IGS Costs are specifically allocable (and allowable) costs to the Medicare Contracts because such costs benefit and, in any case, were caused as a direct result of the nonrenewal of the Medicare Contracts.

a. "Costs Continuing After Termination"

The IGS Termination Costs are specifically allowable as costs which continue beyond the effective date of the Medicare Contracts' termination. FAR § 31.205-42 addresses "costs continuing after termination," describing the general nature and the criteria for a contractor's recovery of such costs, as follows:

> Despite all reasonable efforts by the contractor, *costs which cannot be discontinued immediately after the effective date of*

> *termination are generally allowable.* However, any costs continuing after the effective date of the termination due to the negligent or willful failure of the contractor to discontinue the costs shall be unallowable.

FAR § 31.205-42(b) (emphasis added). Absent evidence of negligence or serious misconduct, contractor costs which cannot be discontinued immediately upon termination are generally allowable where the contractor makes a reasonable effort to mitigate such costs. In accordance with FAR § 31.205-42(b), UHC made all reasonable efforts to mitigate its termination costs arising out of the IGS subcontract, nevertheless, UHC requests reimbursement of the IGS Costs that UHC incurred as a result of the nonrenewal of the Medicare Contracts, beyond the effective date of termination.

b. <u>"Idled Capacity Costs"</u>

UHC seeks only the IGS Costs which were incurred to permit UHC to reallocate its data processing workload to fill the idle processing capacity resulting from the loss of the Medicare Contracts requirements. As noted above, UHC subcontracted with IGS for the provision of a data center that would provide facilities and services to UHC amounting to a corporate-wide data processing capacity. Importantly, UHC treated the IGS subcontract data processing facilities and services as a corporate data processing capacity without regard to the pricing of the IGS subcontract.

Since IGS data center was a corporate capability to UHC, originally set up to process both Medicare-related and commercial workload, a reduction in Medicare-related data processing workload caused by the nonrenewal of the Medicare Contracts created an idling of a portion of the total capacity of the IGS data center. In fact, UHC's historical use of the IGS data center processing capacity was reduced in total volume by the loss of the Medicare-related data processing workload.

Clearly, the IGS costs constitute traditionally allowable "idle capacity" costs caused by a contract termination that temporarily idles a portion of a contractor's operating capacity. *See e.g. Baifield Industries, Division of A-T-O, Inc.,* ASBCA No. 20006, 76-2 BCA ¶ 12,096; *Fiesta Leasing and Sales, Inc.,* ASBCA No. 29311, 87-1 BCA ¶ 19,622, *modified on other grounds,* 88-1 BCA ¶ 20,499. Indeed, with UHC's request for the IGS Costs, UHC requests reimbursement only for the three (3) months immediately contiguous with the nonrenewal date of the Medicare Contracts (representing the brief time necessary for UHC to replace the lost Medicare-related data processing workload in the IGS data center). Thus, the IGS Costs are allowable "idle capacity" costs pursuant to the FAR. *See Id.;* FAR § 31.205-17(a) and (c); FAR § 31.205-42(b).

c. **<u>"Government Benefit and Fairness"</u>**

As noted above, the audit report appears to disallow the IGS Costs as not allocable to the Medicare Contract through the auditors' fashioning of an invalid "benefits and fairness test" that is not supported by the Medicare Contracts or applicable law and regulation. Indeed, in the context of a termination of a government contract, contractor costs that would not be incurred "but for" the termination are deemed allocable because such costs possess sufficient causal relationship to the terminated contract. (See the *Boeing* case, infra; FAR § 31.205-42, and Cost Accounting Standards).

Nevertheless, even if the audit report were correct that the UHC's IGS Costs must meet a "benefits test" to be allocable, the IGS Costs unquestionably "benefited" the government and constitute "fair" costs subject to government reimbursement. For example, from 1997 to 2000, the volume discounts associated with the IGS subcontract resulted in an estimated savings to the government's Medicare Contracts of approximately $2.5 million. This savings is due to increased volume contributed to the IGS subcontract from UHC's commercial operations ranging from 40 to 118 percent (%) in the various data processing work unit classifications (CPU, DASD and tape mounts). While the volumes increased at this rate, the costs increased at only a 20 percent increment for the same period. Importantly, the government extracted these and other "benefits" from UHC's IGS subcontract relationship during the performance of the Medicare Contracts.

Moreover, as discussed in detail above, the IGS Costs represent a 10-fold decrease in the costs that would be otherwise payable to UHC relating to the IGS subcontract upon the nonrenewal of the Medicare Contracts. This 10-fold decrease in termination costs relating to the IGS subcontract clearly benefited the government. UHC's alternative approach to terminating the IGS subcontract which resulted in the 10-fold decrease and UHC's subsequent request for reimbursement of the reduced IGS Costs was, at one point, well-received and appreciated by the government representatives present during termination settlement discussions in January 2001. If this 10-fold decrease in termination costs relating to the IGS subcontract is ultimately unacceptable to the government as indicated in the audit report, however, UHC is certainly willing to review the possibility of re-opening discussions with IGS concerning the termination of the Medicare-related portion of the IGS subcontract.

For the reasons set forth above, the audit report's claims that UHC's IGS Costs arising from the IGS subcontract are unallowable because UHC did not comply with the ATS clause, or because such costs do not benefit the government or are otherwise not "fair" costs for reimbursement, are erroneous.

IV.

EQUIPMENT LEASE TERMINATION COSTS

In this area of costs, the draft audit report recommends disallowance of a total $337,826 in equipment lease termination costs, purportedly because such costs "did not benefit Medicare." As we have explained earlier, there is ample authority in FAR § 31.205-42 and elsewhere supporting the allowability of the termination costs for unexpired leases, as well as costs continuing after termination. Also as we have explained earlier (see Section I.B.4) - - there simply is no requirement that reasonable termination costs continue to benefit the government after the effective date of termination. In addition, we will demonstrate below that the specific disallowances were also based on erroneous facts or analysis. However, a common error pervades this topic, beginning with the audit report statement under Equipment Lease Termination Costs (Page 6, para. 2): "Total costs of the print shop, including prior depreciation on this equipment, were allocated 67% to Medicare and 33% to UHC's commercial business." That statement is not correct, because the 67% Medicare and 33% commercial business line split was developed for use **only** as a method to allocate termination costs for Utica Print Center **shared** equipment and resources. Those percentages were not used at any other time to allocate any expenses, including prior equipment depreciation. Those percentages were developed as follows:

Government Operations management requested UHC Print Center staff to develop an estimate of anticipated termination costs for the Utica Print Center in the event that UHC management decided to close this facility as the result of the termination of the Medicare Contracts. Since this was a one-time event, UHC Print Center management had to develop a method to allocate the termination costs between all users of this facility. UHC used the Utica Print Center to support all of its Medicare related claims processing print and mail service requirements and the commercial side of UHC's business in the proportion of 67% Medicare related and 33% commercial. We reiterate that such percentages were not used at any other time.

A. Inserter Equipment

In recommending disallowance of $176,775 for costs of Inserter Equipment, the audit report states: "This was contrary to UHC's established allocation basis for costs related to this facility as noted above." -- another erroneous statement.

1. First, the title for this section, Inserter Equipment, is incorrect. The charge in the amount of $535,863 in lease buyout costs is not for inserters; it is for four (4) Scitex printers.

2. Second, as explained above, UHC did not have an established allocation basis (67% Medicare and 33% commercial business) for **all** costs related to the Utica

Print Center facility. The 67% Medicare and 33% commercial business line split was developed for use **solely** as a method to allocate termination costs for Utica Print Center **shared** equipment and resources.

3. Third, UHC was correct in charging 100% of the lease buyout costs for the Scitex printers for the following reasons:

a. Medicare (CMS) had a program requirement for all contractors to use non-windowed envelopes for all Medicare mailing of checks, explanation of benefits, etc. The Scitex printers were needed to spray both the mailing and return addresses on the envelopes. This Medicare requirement resulted in Government Operations not conforming to the specifications the Print Center required for all other users' printing needs. All other Print Center applications used windowed envelopes and required nothing to be printed on the envelopes.

b. Since the Scitex printers leased from Pitney Bowes were only needed for processing Medicare applications, UHC was correct in charging 100% of the lease buyout costs for those printers to Medicare, because they were only used for Medicare printing. No other user of the Utica Print facility used or shared the use of these printers.

c. The commercial side should not be allocated any expense for the lease buyout cost of printers that never provided any benefit to the commercial side business.

B. Printers

Here, the audit report seeks to disallow $133,314 for "printers UHC chose to continue to use for its commercial business lines." The audit report recommendation is based upon the following misstatement: "Because UHC chose to continue the lease for the Utica equipment for its commercial business lines and had exclusive use of the printers, we believe there were, in fact, no lease termination costs. In addition, we believe that Medicare should not be required to pay for UHC's corporate decision to update equipment used for its commercial business lines." The following will demonstrate not only the error in the statement above, but that the UHC decision regarding the relevant printers was not only a prudent business decision overall, but saved Medicare $227,948!

1. When the Medicare Contracts were terminated, UHC Print Center management was responsible for the disposal of the equipment that was used in this facility. In order to complete this task, a list of equipment in use at the Utica Print Center was compiled and reviewed to determine the cost impact to CMS. As a result of the equipment review, UHC Print Center management concluded that there were four Xerox printers in Utica that were the same type as printers used in the Duncan, South Carolina

Print Center. (NOTE: UHC's contract with CMS required that UHC maintain a backup print facility for Medicare printing which in this case was the Duncan facility.) After a review of all leases for this particular model printer, UHC Print Center management concluded that the four Utica printers could be shipped to Duncan to replace the four printers in use there. The leases on the four older printers in Duncan would be terminated, resulting in lower lease termination costs to CMS than if the leases on the new printers in Utica had been terminated.

2. The two scenarios below depict the cost impact on termination costs without and with the completion of the cost benefit analysis.

Scenario I — No Cost Benefit Analysis

- UHC terminates the leases on the four printers in Utica.
- Lease termination cost is $360,812 ($535,526 times 67 % Utica Print Center utilization factor for shared equipment).
- $360,812 is billed to CMS as a termination expense.

Scenario II— Cost Benefit Analysis Completed

- UHC ships four printers to Duncan from Utica and terminates the leases on the four older printers in Duncan.
- Lease termination cost is $119,126.
- Shipping expense for the printers is $14,188.
- $133,314 is billed to CMS as a termination expense.

The fact that UHC decided to implement Scenario #2 resulted in savings to CMS of $227,498 ($360,812—$133,314). UHC did bill CMS for 100% of the lease and shipping costs since UHC saved CMS allowable termination costs of almost twice as much as UHC would have been eligible to claim in Scenario #1.

3. UHC chose to continue the lease for the Utica equipment after completing the cost benefit analysis. UHC performed the cost benefit analysis in an effort to mitigate the applicable termination costs. As prudent business people, cost and the associated benefit are part of the consideration in making an informed business decision. In retrospect, if UHC had realized that completing a cost benefit analysis would result in the disallowance of this termination cost and the savings to the Medicare program, UHC would have considered billing for the lease buyout on the Utica printers in the amount of $360,812. Other Print Center equipment lease terminations handled in this manner have not been disallowed in this audit.

4. UHC believes that both the Medicare program and UHC benefited from UHC's decision to review equipment utilization and lease schedules to reduce the impact of the lease terminations. The Medicare program benefited because the costs billable to the program were reduced from $360,812 to $133,314 resulting in a net saving of $227,498 by shipping the printers to Duncan and buying out the leases on the older equipment. UHC benefited as they were able to replace older printers with newer models.

By implementing Scenario #2 as described above, CMS saved more ($227,498) than was claimed ($133,314) as a result of the appropriate and prudent business decision made by UHC which was clearly in the best interests of the Medicare program.

C. **Mail Pre-Sorter Equipment**

Upon further review, UHC has concluded that these costs should not be claimed. Therefore UHC withdraws its prior request for $27,737 related to Mail Pre-Sorter Equipment.

V.

MEDICARE HOME OFFICE RENTAL COSTS

The audit report asserts that UHC overcharged CMS $231,842, through the use of outdated census estimates for the Home Office Rental calculations, rather than actual headcounts. UHC agrees in part, but as explained below, states that the amount of the overcharge is only $29,986, not $231,842.

A. Our first comment is that it appears the reference to FAR § 31.210-4 is a typo; it should be FAR § 31.201-4.

B. Secondly, the total Medicare Home Office (HO) rent charged through termination Voucher 9 was $252,208, not $278,352. (See Attachment C for details)

C. Our third comment is that we agree UHC used outdated census estimates to arrive at the rent calculation for the Hartford Campus for the period October 2000 through January 2002, and these should be updated to reflect actual census counts and actual rent/non-rent expenses. However, we disagree with the calculation of the $231,842 overcharge.

1. The HO rent/non-rent calculation for the Hartford Campus for the period October 2000 through January 2002 should be $222,222 which is $29,986 less than the $252,208 that was charged. The basis for this calculation is as follows:

a. From October 2000 through June 2001 Medicare staff was located on the 5th floor of the Gold Building. UHC leased the entire 5ss floor. UHC staff shared this floor with Electronic Data Systems Corporation ("EDS") staff. EDS assumed responsibility for maintaining the Part B standard system from United HealthCare, offered positions to former UHC IS staff and took over the system and staff as a turnkey operation. There was concern by EDS and CMS that a move during the transition period would have a negative impact on the transition of the Medicare Contracts, as well as the transition of UHC's former IS staff to EDS. For this reason, EDS continued to occupy space on the 5th floor during the transition period and beyond. The agreement ran to the lease termination date (October 2000 through June 2001).

b. A Space and Service Agreement dated May 16, 2000 was completed between United HealthCare Services Inc. and EDS for EDS to lease space on the 5th floor of the Gold Building located at 755 Main Street. There were clauses in this agreement that are critical in explaining why United HealthCare Services Inc. continued to lease the whole 5th floor only for Medicare related business reasons.

(1) Part 1 of the Agreement: "If UHS determines that EDS is not fully utilizing all the spaces allocated to EDS in the Building, UHS has the right to assign use of unused spaces, with the consent of EDS, to other employees of the Government Operations Division of UHS." This clause allowed the remaining UHC Medicare staff located on the 5th floor to share space with EDS staff.

(2) Part 13 of the Agreement: "Post September 30, 2000 Occupancy. UHS hereby commits that, at no point during the Term of this Agreement will there exist commingling of EDS Users with non-Government Operations Division employees in the fifth floor of the Building for the duration of the Agreement."

2. This is the reason UHC continued leasing the entire 5th floor from October 2000 through June 2001, sharing it with EDS staff. UHC could not sublease any of the idle space on the 5th floor because EDS was contractually prohibited from sharing the same floor space with non-governmental agencies. The only way EDS could have shared space on the fifth floor was to be placed in a secured location separate from any other non-governmental contractors. This would have required major renovations to the existing floor and was cost prohibitive.

3. Therefore, the allowable rental expense for the 5th floor for the period October 2000 through June 2001 should be calculated assuming the whole fifth floor was occupied by Medicare staff. The monthly Medicare FTEs used for the 5th floor for the period October 2000 through June 2001 is 105. This is the actual Medicare census as of February 2000, the month that UHC announced the Medicare Contract was not being renewed. We chose to freeze the FTE count at 105 because immediately thereafter the FTEs started to decline as staff left for other positions within and outside UHC as well as

to EDS. The rent expense was reduced by the amount received from EDS for use of the space they occupied.

4. See Attachment D for detail on how the revised HO rent/non-rent calculation of $222,222 for the same period was calculated. It also details how the initial $46,510 HO rent/non-rent calculation in the "draft" audit report for the period October 2000 through January 2002 was determined.

5. The major reasons for the increase in allowable Home Office rent/non-rent expense from $46,510 in the "draft" audit report to the $222,222 are as follows:

a. The $46,511 recalculated HO rent reflected in the "Draft" audit report used a monthly ratio times the "budgeted" monthly campus rent and operating expense for the same period. The monthly ratio was developed using the "actual" Medicare FTEs at the end of each month, and dividing this by the "Budgeted" Hartford campus FTEs for the same period. Budgeted figures should not be used when calculating the revised HO rent/non-rent expense. Only actuals should be utilized.

b. For the period October 2000 though June 2001 the Medicare FTE count should be based upon full occupancy of the 5th floor due to the contractual limitations placed upon EDS to share space with non-governmental staff. UHC could not sublet space to any other non-government entity unless the space occupied by EDS staff was secured.

c. Medicare staff moved to the 6th floor of the Gold Building from July 2001 through January 2002. During this period we shared the floor with other UHC units. The actual Medicare FTE figure for this period on the 6th floor was 6. To the actual FTE figure reflected in the census, we added 4 FTEs for the work area set aside to accommodate 4 OIG auditors. The total Medicare FTEs was 10 through December, 2001. Effective January 2002, the FTEs reduced to 9 (5 UHC and 4 auditors).

6. In summary, the total home office rent/non-rent expense charged through Termination voucher #9 is $252,208 instead of the $278,352 reflected in the "draft" audit report.

D. The allowable home office rent/non-rent for the period October 2000 through January 2002 for the staff located in the Gold Building should be $222,222, not the $46,510 presented in this "draft" audit report. This increased rent charge is because UHC could not sublease any idle space on the 5th floor of the Gold Building for this period (10/00 through 6/01) and the actual Medicare headcount should be based upon 100% occupancy of the 5th floor and not limited to actual census. The amount due CMS is $29,986 , not $231,842 as represented in this report.

VI.

SEVERANCE COSTS

The audit report recommends disallowance of $366,234 due to overstated claims by UHC for various severance costs. In each case, we will explain below why all of the claimed severance costs are both reasonable and allowable.

A. Severance Benefits to Senior Executives

The audit report recommends that $276,012 be disallowed because, allegedly, UHC failed to enforce its severance policy, which includes a "compensation offset" provision that, for certain senior executives, mandates that any severance pay over 12 weeks will be reduced by any cash compensation or other earnings received from other employment. The UHC severance policy also stated that such executives must actively seek work after termination and inform UHC of any compensation received elsewhere. The plan further provided that UHC has the right to examine the employee's tax and other compensation records to verify whether any offset is due to UHC. The auditors claim that because UHC relied on severed former executives to self-report, and did not actively demand access to the former executives' tax and personal business records, that all severance pay over 12 weeks is excess and should be disallowed. The auditors' position is not valid, for the following reasons:

1. Severance pay is generally an allowable cost to the extent that it is required by law, by an employer-employee agreement, by a contractor's established policy that constitutes an implied agreement, or by the circumstances of a particular employment. FAR § 31.205-6(g)(2).

2. UHC has traditionally relied on executives to self report income earned after 12 weeks of severance, and the company has never gone to the next step of attempting to coerce tax records, etc. from its former executives, whether for Medicare reimbursable severance or UHC commercial severance. The company concluded that any attempts to access a former executive's tax or other compensation records would be challenging at best, and in any event, such investigative and legal costs would be prohibitive.

3. Therefore, UHC has consistently administered its ERISA Severance Plan such that the 12 week offset provision has not been enforced. While this administration does not match the specific language of the plan per say, it benefits the employees and has been consistently applied and thus is not in violation of ERISA. The above-described manner of administering its ERISA Severance Plan has been in effect for a considerable

period of time, to the extent that a court would surely find that such established practice has become "a contractor's established policy that constitutes an implied agreement". Confirming that the non-enforcement of the offset provision is and has been UHC's established policy, the company amended the Plan effective January 21, 2002 to eliminate completely the offset provision.

4. In view of UHC's established policy as described above, if UHC were now to take a small group of participants and demand different treatment, it would be in violation of its established practice, its plan and the law. Any such action by UHC would very likely lead to litigation, and significant legal defense costs that would be allowable costs pursuant to the termination of the Medicare Contracts.

5. In light of the facts above, UHC believes that an implied agreement exists with its executives, including former executives, not to enforce the now-rescinded offset provisions - - and, that the company does not have the legal right to pursue enforcement of such offset provision. For this reason, the actions of UHC have been both legal and reasonable, and there is no basis for the audit report assertion that $276,012 of UHC's severance costs have been overstated. Such audit recommendation should be withdrawn.

B. Severance Benefits Claimed In Excess of Company Policy

In this area, the audit report asserts that UHC made errors in calculating the amounts of severance payments due 37 employees, with most of the errors involving applying partial year credits to employees who were not eligible because they had less than 5 years of service. UHC concurs with this audit report finding.

C. Severance Benefits Paid to Temporary Employees

Here the audit report attempts to disallow $14,543 for 18 employees that the auditors deem to be temporary employees, and thus not eligible for vacation pay or severance benefits. That conclusion is in error, as explained below.

1. One of the primary objectives that CMS established early in transition planning was that the transition of UHC business to the multiple incoming contractors be smooth and seamless with little or no disruption to workloads. To that end, UHC continued to hire staff as regular employees with the understanding that if they met performance requirements these employees would transition to the new contractors and be eligible for all the benefits that current UHC employees were eligible for, including vacation and severance.

2. As part of transition planning, all successor contractors with the exception of two agreed to accept vacation balances as of the transition dates. To ensure a smooth transition, CMS requested UHC reimburse the employees that would transition to these two successor contractors even though it was contrary to UHC policy to pay terminating

employees for unused vacation. Vacation reimbursement for all employees that went to work for these two successor contractors was to be paid regardless of the employee's tenure.

3. Of the 18 employees included in this categorization, fifteen (15) went to work for the two successor contractors that were unwilling to accept the unused vacation. As requested by CMS, UHC reimbursed these employees for unused vacation. These payments are reimbursable for the following reason. Alabama BS - Cahaba (Mississippi Part B) and Florida BS - First Coast (Conn. Part B) were the successor contractors assigned by CMS to take over the noted Part B locations. They both did not want to accept the remaining unused granted vacation time for those UHC Medicare employees who were offered future employment with the successor contractors. CMS requested UHC to reimburse these employees for their unused accrued vacation days. A copy of the email from CMS documenting this request was provided under separate cover. UHC concurred with CMS's request and made the appropriate payments. These expenses totaling $8,563 should be considered allowable based upon the above.

As for the other three employees included in this temporary employee categorization:

- Two were on short-term disability (STD) as of contract termination and under UHC policy, employees on STD are terminated, but remain on STD for the applicable period as well as receive any severance benefits. If they had been at work, they would have transitioned to the successor contractors.

- The remaining employee was located at the Utica Print Center. Print Center employees were not notified of the decision to close the facility until early June due to discussions with several of the successor contractors regarding potential use of this facility. The employee was hired well before June. The need to continue Print Center operations through the contract transition was critical to CMS; hence, CMS' agreement that Utica Print Center employees would be treated the same as other UHC Medicare employees.

D. <u>Other Costs</u>

The audit report states that UHC erroneously duplicated retention and enhanced severance payments on two termination vouchers, overstating severance costs by $15,128. UHC concurs with this audit report finding.

VII.

OTHER COST ISSUES

UHC was disappointed that the auditors did not render an opinion on outplacement expenses totaling $48,323, as this was one of the two cost categories that CMS disallowed upon initial review of our termination related expenses submitted. The other cost category that totaled $931,250, IGS Idle Capacity, was in-fact covered within this audit. It is also critically important to note that although both of these cost categories were claimed by UHC in their termination vouchers; CMS disallowed them and did not reimburse UHC for these expenses. Appendix A through C of the concerned draft report should therefore be adjusted to reflect the fact UHC did not receive reimbursement for the $931,250 of IGS Idle Capacity expense.

Real Estate Costs (Utica Lease /OARS No. 5)

The OIG recommends the disallowance of UHC's termination costs for real estate leases, focusing primarily upon the costs relating to UHC's five-year lease for a print and mail facility in Utica, N.Y. (the "Utica Lease"). The OIG concludes that the absence of the ATS clause in the Utica Lease should render unallowable, all of UHC's costs in the amount of approximately $963,576 incurred to wind-up the Utica Lease. UHC believes that the OIG's audit findings contain several factual errors and that UHC's costs incurred relating to the Utica Lease are allowable.

In its findings, the OIG states that UHC unilaterally decided not to renew the Medicare Contracts in February 2000, providing for effective date of termination for the Medicare Contracts of September 30, 2000. The OIG further states that UHC entered into the Utica Lease in the same month as the termination determination (February 2000), thus implying that UHC knew when it entered into the Utica Lease that it intended not to renew the Medicare Contracts. Finally, the OIG appears to believe that UHC costs relating to the Utica Lease termination resulted from "penalties" assessed by the landlord. Each of these factual assertions or implications are incorrect.

1. Mutual Determination to Terminate Medicare Contracts.

UHC directs the OIG's attention to a detailed factual summary of circumstances surrounding UHC's costs relating to the Utica Lease that UHC has previously provided to the CMS in conjunction with its request for an advance agreement to cover the payment of such costs. See Attachment 1 for detail. As noted in the detailed factual summary, in late-1999, UHC entered into a dialogue with CMS to discuss alternative forms of business entities to assume the Medicare Contracts. Unfortunately, such discussions failed to identify an acceptable arrangement for UHC's continued performance of the Medicare Contracts. Thus, CMS advised UHC to terminate the Medicare Contracts under the relevant terms for non-renewal. On February 10, 2000, UHC provided the required formal notices to terminate the Medicare Contracts.

2. Determination to Terminate Had Not Been Made When Utica Lease Executed.

While it is correct that UHC did not complete its transition to occupy the print center in Utica N.Y. under the Utica Lease until February 2000, the Utica Lease was executed at least six months prior -- on August 23, 1999. At the time of the execution of the Utica Lease, therefore, CMS and UHC had not yet discussed UHC's non-renewal of the Medicare Contracts. UHC entered into the five-year lease for, among other reasons, to ensure the uninterrupted and long-term continued performance of the Medicare Contracts. UHC was initially compelled to seek the new print and mail facility in Utica, N.Y. because its then existing lease with MetLife for print and mail facilities was due to expire as of December 31, 1999. Thus, UHC had little choice but to seek a new arrangement for print center services upon the best possible terms in a tough business environment.

Utica Termination Costs Were Not a Penalty.

As has been discussed with CMS, on several occasions, the arrangements made in Utica N.Y. were the most efficient way to ensure print facilities for Medicare Contracts' operations at reasonable cost given: (1) the unavailability of facilities from MetLife; (2) the intact expertise and operations situated in Utica, N.Y.; (3) the absence of alternative facilities in Utica, N.Y.; and, (4) the CMS requirement that back-up print facilities be maintained. Despite a severe business environment still prevailing, UHC was able to negotiate a lease buy-out of the remaining lease term (not a "penalty") on very favorable terms, reducing a potential liability to Medicare of $1,461,300 down to $693,857, a savings of $767,443.

3. ATS Clause Would Not Have Been Accepted by Landlord.

At the time of execution of the Utica Lease, the ATS clause was not included because, among other reasons, the lessor required a firm long-term, five-year contract in the difficult economic conditions prevailing in Utica N.Y. at that time. UHC is aware that CMS waives the requirement with respect to the ATS clause when its inclusion is not acceptable to commercial lessors or it causes undue difficulty. UHC has further documented the Lessor's position regarding the unacceptability of the clause. Additionally, it must be noted that UHC has achieved a very reasonable termination settlement or "buy-out" of this lease even without the presence of such clause, moreover, as noted above the presence or absence of the ATS clause has no impact on UHC's obligation to pay termination costs. Under these circumstances, the UHC believes there is good cause to waive the requirement for inclusion of the ATS clause in the Utica Lease.

4. ATS Clause Was Not Required for Utica Lease.

Finally, the ATS clause is not required in subcontracts that are not expected to exceed the term of the Medicare Contracts. UHC, or The Travelers Insurance Company, its operational predecessor, had been performing the Medicare Contracts for over 33 years under automatically renewable contracts. Despite its five-year term, therefore, the Utica Lease would not have qualified as a subcontract expected to exceed the term of the Medicare Contracts. Thus, UHC requests the OIG withdraw its audit findings concerning the ATS clause and UHC's termination costs incurred under the Utica Lease set forth in OARS No. 5.

Attachment 1 referred to on Page 2 of Attachment A

Lease Termination – Utica

OARS #5

During late 1999 and early 2000, CMS (at that time known as HCFA) and UHC entered into a dialogue to examine alternative forms of business entities to assume the performance of the Medicare Contracts. The purpose of the dialogue was to explore the potential for reducing UHC's exposure to various types of business and legal risks inherent in the Medicare claims administration business. The dialogue failed to identify a form of business organization that was acceptable to HCFA in a way that would allow continuation of the Medicare Contracts by or through UHC with a level of risk acceptable to UHC.

HCFA advised UHC to terminate the Medicare Contracts under the relevant terms of each such contracts. On February 10, 2000, UHC provided formal notices under the relevant clauses of the Medicare Contracts to implement the agreement of the parties that the term of performance for the Medicare Contracts would terminate as of September 30, 2000.

Factual Background

The print and mail facility located at Utica, N.Y provided a 24-hour capability for printing, sorting and stuffing envelopes and distributing through the U.S. Mail system claims-related correspondence and negotiable checks for payment of benefit claims. In performing the Medicare Contracts, UHC employed the Utica Print Center to support all of its Medicare-related claims processing print and mail service requirements. The print and mail services provided by the Utica Print Center also supported other aspects of UHC's business in the approximate proportion of 67% Medicare-related and 33% commercial.

Prior to the current Utica Print Center arrangement, dated August 23, 1999, MetraHealth executed a 5-year lease with MetLife and occupied approximately 30,000 sq. ft. of space within MetLife's Utica, N.Y. area operations to perform print and mail services similar to those now provided by the Utica Print Center. The lease with MetLife was to expire on December 31, 1999. UHC approached MetLife to discuss an extension of the lease for the continued use of the leased space for print and mail support for the Medicare Contracts. In early 1999, however, it became clear that UHC's requests for a lease extension would be denied and that MetLife would affirmatively seek to recapture the space occupied by UHC upon the expiration of the lease.

In anticipation of the expiration of the lease with MetLife, UHC performed an evaluation of the Utica, N.Y. print and mail operations. UHC sought to determine whether outsourcing UHC's Medicare-related print and mail service requirements to a third-party commercial vendor would be an appropriate and cost efficient business strategy. UHC also considered the possibility of moving the current Utica, N.Y. print and mail operations to a similar internal UHC facility located in Duncan, S.C.

UHC completed the evaluation in early 1999. The evaluation rejected outsourcing the print and mail service requirements to a third-party vendor because it would be more expensive than continuing to provide the services internally. Moreover, an internal redistribution of the Utica, N.Y. print and mail operations to the facility in Duncan, S.C. was not feasible. Under the contingency planning requirements of the Medicare Carriers Manual, HCFA required carriers to maintain redundant disaster recovery capability. An internal redistribution would leave only one internal print and mail facility at Duncan, S.C., leaving UHC without a redundant, internal disaster recovery print and mail capability, thereby necessitating the procurement of the required disaster recovery capability from a third-party vendor. Such an arrangement was found to be prohibitively expensive. Thus, UHC determined in early 1999 that the Utica, N.Y. print and mail service operations must be preserved in a new site to support the Medicare Contracts with cost effective disaster recovery capability beyond the expiration of the lease with MetLife on December 31, 1999.

At the advice of Trammel Crow, UHC's outside real estate consultant, UHC sought alternative space in the Utica, N.Y. area to relocate its print and mail operations. After an exhaustive search, it was determined that no suitable and cost-effective space in the Utica, N.Y. area was readily available. Therefore, UHC entered into negotiations in late July 1999 with Center Green, Inc. for the lease of a newly constructed building suitable for use.

The negotiations resulted in a 5-year lease expiring on January 31, 2005 for approximately 25,900 sq. ft. of space suitable to relocate the print and mail operations for the present Utica Print Center. The lease was signed on August 23, 1999.

The physical relocation of the personnel and equipment for the print and mail operations to the Utica Print Center was completed in February 2000 (through the negotiation of a short "holdover" extension of the MetLife lease) in order to provide UHC with the opportunity to react and remedy any possible complications resulting from "Y2K" computer problems prior to relocating and assure that no interruption of print and mail support for the Medicare Contracts would occur.

The Utica Print Center lease required UHC to pay monthly rent and service charges (taxes, utilities, maintenance, and security) of approximately $46,000, which equated to approximately $552,000 per year of which the Medicare share was approximately $26,000 and $320,000, respectively. Additionally, UHC incurred approximately $470,000 of leasehold improvement costs to prepare the new space for the print and mail operations. The leasehold improvement costs are amortized over the 5-year lease (approximately $10,000 per month for the term of the lease).

Transition Background

After agreeing with HCFA that the Medicare Contracts would be terminated, UHC senior management performed an extensive review of its current corporate-wide print and mail service operations and requirements. In performing this review, UHC senior management analyzed all existing information regarding its ongoing and projected corporate-wide print and mail service needs. The review focused on identifying the most cost-effective business strategy to accommodate the termination of the Medicare Contracts. The review recognized the need to provide continued support of the Medicare-related requirements of the Medicare Contracts through the date of termination and for an efficient transition to Successor Carriers, as well as to allow UHC to mitigate, to the maximum extent practicable, the costs associated with the Utica Print Center.

UHC concluded that the most cost-effective and prudent business strategy was to close the Utica Print Center operations immediately upon the date of termination of the Medicare Contracts and to transfer any remaining commercial print and mail requirements previously performed by the Utica Print Center to the Duncan, S.C. facility. UHC's decision to close the Utica Print Center was based on business necessity resulting from the loss of the Medicare-related workload. Moreover, UHC identified significant benefits with the consolidation of the remaining Utica Print Center workload at the Duncan facility.

Of UHC's two print facilities, Duncan, S.C. was the larger operation. The decision to consolidate in Duncan rather than Utica was based on the following considerations:

1. Duncan was large enough to manage the remaining Utica Print Center workload (in contrast, Utica Print Center did not have the capacity to absorb the Duncan workload);
2. severance and related expenses were lower in closing the Utica Print Center because there were significantly fewer employees than at Duncan, S.C.; and
3. training costs were lower for new workers required for the consolidated workload at Duncan, S.C.

Termination Costs for the Utica Print Center

UHC is entitled to recover termination costs arising from the closure of the Utica Print Center, in an amount proportionate to the Medicare-related operations of the Utica Print Center, (approximately 67% of total costs). All of these termination costs are allowable under the Medicare Contracts and the Cost Principles as described below.

Costs of Unexpired Leases Are Specifically Allowable

The termination cost of $963,576 claimed arising from the closure of the Utica Print Center is the cost related to unexpired lease (rent & leasehold improvements) for the Utica print facility. The Cost Principles specifically provide for recovery of rental and alteration or restoration costs under unexpired leases, in pertinent part, as follows:

> *Rental under unexpired leases.* Rental costs under unexpired leases, less the residual value of such leases, are generally allowable when shown to have been reasonably necessary for the performance of the terminated contract, if-
>
> (1) The amount of rental claimed does not exceed the reasonable use value of the property leased for the period of the contract and such further period as may be reasonable; and
>
> (2) The contractor makes all reasonable efforts to terminate, assign, settle, or otherwise reduce the cost of such lease.

FAR § 31.205-42 (e). FAR § 31.205-42 (e) provides for the recovery of costs for *any* type of leased property which meets the criteria, since it addresses rental costs *generally* and is not limited to any particular type or category of leased property. Further, the boards and courts have interpreted FAR § 31.205-42 (e) to allow recovery of post-termination rental costs as direct charges to the terminated contract. *See e.g., American Electric, Inc.*, ASBCA No. 16635, 76-2 BCA ¶ 12,151; *Pamco Corp.*, ASBCA No. 3114, 57-2 BCA ¶ 1489.

The term of a lease is not determinative as to the allowability of post-termination costs, even if the term of the lease runs well beyond the date of termination. *See e.g., Qualex International*, ASBCA No. 41,962, 93-1 BCA ¶ 25,517 (finding that the appellant was reasonable in choosing an extraordinarily long lease term since the government received lower charges and greater benefits under the lease). Accordingly, the costs of unexpired leases are allowable for a reasonable period beyond the termination of the contract and may extend well beyond the scheduled contract completion date if a contractor acted reasonably and has taken all prudent steps to otherwise minimize its costs. *See e.g., International Space Corp.*, ASBCA No. 13883, 70-2 BCA ¶ 8519; *American Electric, Inc.*, ASBCA No. 16635, 76-2 BCA ¶ 12,151; *Sundstrand Turbo v. U. S.*, 389 F.2d 406 (Ct. Cl. 1968). Thus, the appropriate proportion of the costs (approximately 67%) relating to rent on real property, taxes, maintenance, security and other lease related costs for the idled Utica Print Center are allowable.

Costs of Leasehold Improvements Are Specifically Allowable

Within the lease-related costs arising from the closure of the Utica Print Center are costs relating to leasehold improvements made by UHC to prepare the facility for use. Such leasehold improvement costs are generally allowable in the context of a termination where the improvements benefited the performance of the terminated contracts. *See Baifield Indus., Div. of A-T-O, Inc.*, ASBCA No. 20006, 76-2 BCA ¶ 12,096; *American Elec., Inc.*, ASBCA No. 16635, 76-2 BCA ¶ 12,151. Moreover, the Cost Principles specifically provide that:

> The cost of alterations and reasonable restorations required by the lease may be allowed when the alterations were necessary for performing the contract.

FAR § 31.205-42(f). Thus, the appropriate share, proportionate to the amount of space dedicated to Medicare-related activities (approximately 67%), of the unrecovered leasehold improvement costs arising from the closure of the Utica Print Center are allowable under the Medicare Contracts and the Cost Principles.

IGS Data Processing Costs (OARS No. 7)

OIG recommends the disallowance UHC's costs for data processing capacity of $931,250, based solely upon UHC's alleged omission of the ATS clause. To the contrary, the ATS clause was indeed included in the IGS subcontract by incorporation. UHC believes the OIG may have overlooked the provision in UHC's contract with IBM Global Services ("IGS") contract at Section 23.03 Government Contract, stating that IGS shall "comply with all provisions applicable to subcontractors under the Medicare Contracts, which provisions are herein incorporated by reference." Accordingly, since the ATS clause was mandated by both the Medicare Contract and the Medicare Carriers Manual ("MCM") regulation, UHC fulfilled the requirements of Article III, Appendix A of the Medicare Contracts by incorporating all such applicable requirements (including the ATS clause) as required, into its subcontract with IGS. UHC also notes that it has asserted the ATS clause through Section 23.03 Government Contract of its contract with IGS upon termination of the Medicare Contracts on September 30, 2002. The use of such provisions to incorporate prime contract requirements is well established and valid practice in government contracts. UHC requests, therefore, that the OIG withdraw its draft audit findings concerning the ATS clause requirement relating to UHC's incurred costs for data processing capacity.

Attachment C

Medicare Home Office Rental Costs

This exhibit provides support for the total Medicare Home Office Rental Costs claimed through Termination Voucher #9.

Description	Amount	Voucher
Oct. 00 Rent (includes erroneous $12,652.95)	57,574.94	5
Nov. 00 Rent (includes erroneous $12,652.95)	57,574.94	5
EDS Credit for 10/00	(26,435.84)	5
Dec. 00 Rent (includes erroneous $12,652.95)	57,574.94	5
EDS Credit for 11/00 - 1/01	(79,307.52)	5
1/01 – 3/01 Rent	135,471.93	5
EDS Credit for 2/01	(26,435.84)	5
EDS Credit for 3/01	(26,435.84)	5
April 01 Rent	45,216.38	5
May 01 Rent	45,216.38	5
EDS Credit for 4/01and 5/01	(52,871.68)	5
June 01 Rent	45,216.38	5
EDS Credit for 6/01	(19,386.18)	5
Oct. 00 Non-Rent (includes erroneous $13,491.12)	22,945.45	5
Nov. 00 Non-Rent (includes erroneous $13,491.12)	22,945.45	5
Dec. 00 Non-Rent (includes erroneous $13,491.12)	22,945.45	5
1/01 – 3/01 Non-Rent	25,398.60	5
April 01 Non-Rent	8,466.20	5
May 01 Non-Rent	8,466.20	5
June 01 Non-Rent	8,466.20	5
Rent/Non-Rent - Termination Voucher #5	**332,606.54**	
10/00 Rent Correction	(12,652.95)	6
11/00 Rent Correction	(12,652.95)	6
10/00 Non-Rent Correction	(13,491.12)	6
11/00 Non-Rent Correction	(13,491.12)	6
Rent/Non-Rent - Termination Voucher #6	**(52,288.14)**	
July 01 Rent	3,454.00	7
Aug. 01 Rent	3,454.00	7
Sept. 01 Rent	3,454.00	7
Oct. 01 Rent	3,454.00	7
Nov. 01 Rent	3,454.00	7
Dec. 01 Rent	3,454.00	7
Oct. 00 Rent Correction (Apply to 12/00 Erroneous Charge)	($12,652.95)	7
Nov. 00 Rent Correction (Erroneous Duplication)	($12,652.95)	7
Oct. 00 Non-Rent Correction (Apply to 12/00 Erroneous Charge)	(13,491.12)	7
Nov. 00 Non-Rent Correction (Erroneous Duplication)	(13,491.12)	7
Rent/Non-Rent - Termination Voucher #7	**(31,564.14)**	
Jan. 02 Rent	3,454.00	8
Rent - Termination Voucher #8	**3,454.00**	
Total Rent/Non-Rent through Termination Voucher #9	**252,208.26**	

Attachment D

UHC Revised Calculation

	Oct-00	Nov-00	Dec-00	Jan-01	Feb-01	Mar-01	Apr-01	May-01	Jun-01	Jul-01	Aug-01	Sep-01	Oct-01	Nov-01	Dec-01	Jan-02	
Medicare FTEs (Actual)	105	105	105	105	105	105	105	105	105	10	10	10	10	10	10	9	
Campus FTEs (Actual)	1,841	1,852	1,865	1,885	1,905	1,923	1,953	1,981	2,030	1,948	1,946	1,944	1,925	1,881	1,871	1,851	
% Allocation	0.05703422	0.05669546	0.05630027	0.05570292	0.05511811	0.05460218	0.05376344	0.05300353	0.05172414	0.00513347	0.00513875	0.00514403	0.00519481	0.00531632	0.00534474	0.00486224	
Campus Monthly Rent (Actual)	$663,395.14	$663,395.14	$663,395.14	$617,473.15	$617,473.15	$617,473.15	$617,473.15	$617,473.15	$617,473.15	$759,277.15	$759,277.15	$578,357.27	$582,844.51	$669,939.02	$669,929.02	$667,704.43	
Campus Monthly Oper. Expense Actual)	$116,394.48	$218,315.21	$182,317.05	$264,164.93	$217,024.83	$321,886.83	$180,828.97	$299,695.59	$164,815.84	$385,104.21	$166,455.17	$182,028.01	$178,385.96	$181,592.39	$237,459.58	$309,363.67	
TOTAL (Actual)	$779,789.62	$881,710.35	$845,712.19	$881,638.08	$834,497.98	$939,359.98	$798,302.12	$917,168.74	$782,288.99	$1,144,381.36	$925,732.32	$760,385.28	$761,230.47	$851,531.41	$907,388.60	$977,068.10	
Medicare Campus Rent/Non-Rent Allocation	$44,474.69	$49,988.98	$47,613.82	$49,109.81	$45,995.95	$51,291.11	$42,919.47	$48,613.18	$40,463.22	$5,874.65	$4,757.10	$3,911.45	$3,954.44	$4,527.01	$4,849.75	$4,750.74	$453,095.39
EDS Credit	($26,435.84)	($26,435.84)	($26,435.84)	($26,435.84)	($26,435.84)	($26,435.84)	($26,435.84)	($26,435.84)	($19,386.18)	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	($230,872.90)
TOTAL	$18,038.85	$23,553.14	$21,177.98	$22,673.97	$19,560.11	$24,855.27	$16,483.63	$22,177.34	$21,077.04	$5,874.65	$4,757.10	$3,911.45	$3,954.44	$4,527.01	$4,849.75	$4,750.74	$222,222.49
Actual HO Rent Charge (in Term Vouchers Thru #9)																	$252,208.26
Difference Funds Due CMS																	($29,985.77)

Original Calculation

	Oct-00	Nov-00	Dec-00	Jan-01	Feb-01	Mar-01	Apr-01	May-01	Jun-01	Jul-01	Aug-01	Sep-01	Oct-01	Nov-01	Dec-01	Jan-02	
Medicare FTEs (Actual)	19	11	10	7	7	7	6	6	6	5	5	5	5	5	5	5	
Campus FTEs (Budgeted)	2,056	2,056	2,056	2,056	2,056	2,056	2,056	2,056	2,056	2,056	2,056	2,056	2,056	2,056	2,056	2,056	
% Allocation	0.00924125	0.00535019	0.00486381	0.00340467	0.00340467	0.00340467	0.00291829	0.00291829	0.00291829	0.002431907	0.00243191	0.00243191	0.00243191	0.00243191	0.00243191	0.00243191	
Campus Monthly Rent (Budgeted)	$705,504.33	$705,504.33	$705,504.33	$705,504.33	$705,504.33	$705,504.33	$705,504.33	$705,504.33	$705,504.33	$705,504.33	$705,504.33	$705,504.33	$705,504.33	$705,504.33	$705,504.33	$705,504.33	
Campus Monthly Oper. Expense (Budgeted)	$133,326.00	$133,326.00	$133,326.00	$133,326.00	$133,326.00	$133,326.00	$133,326.00	$133,326.00	$133,326.00	$133,326.00	$133,326.00	$133,326.00	$133,326.00	$133,326.00	$133,326.00	$133,326.00	
TOTAL (Actual)	$838,830.33	$838,830.33	$838,830.33	$838,830.33	$838,830.33	$838,830.33	$838,830.33	$838,830.33	$838,830.33	$838,830.33	$838,830.33	$838,830.33	$838,830.33	$838,830.33	$838,830.33	$838,830.33	
%	$7,751.84	$4,487.91	$4,079.91	$2,855.94	$2,855.94	$2,855.94	$2,447.95	$2,447.95	$2,447.95	$2,039.96	$2,039.96	$2,039.96	$2,039.96	$2,039.96	$2,039.96	$2,039.96	$46,511.02