

Stark III: Physician Recruitment

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Practice Area: Health Law

As part of the long-awaited final Stark Phase III regulations, the Centers for Medicare and Medicaid Services ("CMS") has once again focused on recruiting arrangements between hospitals and physicians. CMS has made several significant revisions to the Stark physician recruitment exception, which protects payments made by a hospital to induce a physician to relocate his or her medical practice to the geographic area served by the hospital.

Recognizing the recruitment challenges in rural areas, CMS has provided greater flexibility in recruitment by rural hospitals. In addition, CMS now permits rural health clinics to utilize the recruitment exception subject to the same conditions that apply to hospitals. While many of Stark III's changes relax recruitment restrictions (such as by allowing practice groups to impose noncompetes on recruited physicians under certain circumstances), CMS tightens the rules in other areas (such as in connection with cross-town recruiting arrangements). Finally, in an attempt to close an "unintended loophole," CMS has narrowed its definition of an indirect compensation arrangement in a way that may impact a limited subset of physician recruitment arrangements.

Defining the Hospital's "Geographic Area"

One of the key concepts in Stark's recruitment exception involves the definition of the "geographic area served by the hospital." Under Stark II, a hospital's geographic area was defined as the lowest number of contiguous zip codes from which the hospital draws at least 75% of its inpatients. CMS has adopted several changes in Stark III that expand that definition, particularly for rural hospitals.

Many rural hospitals had complained that the existing definition made it difficult for them to recruit physicians into outlying parts of their service areas – areas that typically presented a greater need for recruitment support. CMS has responded by allowing rural hospitals to determine their geographic area using an alternative test that encompasses the lowest number of contiguous zip codes (and in some circumstances, noncontiguous zip codes) from which the hospital draws 90 percent of its inpatients. Stark III also permits rural hospitals to recruit physicians into an area outside of the hospital's geographic service area if it is determined through a CMS advisory opinion that the area has a demonstrated need for the recruited physician.

There may be circumstances where a hospital is unable to meet the 75% test because it draws more than 25% of its inpatients from outside of the zone of contiguous zip codes. This may arise in situations where, due to the regional or national reputation of the hospital, the hospital draws a significant number of patients from more distant communities. Stark III now allows the hospital to recruit a physician into the geographic area composed of all of the contiguous zip codes, even if the total percentage of inpatients coming from that area is less than 75%.

Stark III also makes it clear that “contiguous zip codes” means contiguous to one another, as opposed to contiguous to the hospital. CMS made minor wording changes to address situations where there might be a “hole” in the area of contiguous zip codes, so that the hospital could recruit into that “hole” even if it represented a zip code that was not itself part of the hospital’s “geographic area” as defined under the regulation. CMS also clarified that a hospital may use any configuration that satisfies the “lowest number” test, which could mean that a hospital could use different geographic areas for different recruitment arrangements. All of these changes should allow hospitals greater flexibility in structuring recruiting support.

Income Guarantees and Expense Allocations

CMS received several comments concerning the types of expenses that may be included in the calculation of income guarantees. Stark III confirms that these expenses may include headhunter fees, travel expenses and other costs associated with visits during the recruitment process, moving expenses, telephone calls, and tail malpractice insurance covering the physician’s prior practice.

On the other hand, CMS suggests that if a hospital pays a group for the time spent recruiting a physician, as opposed to actual out-of-pocket expenses, that compensation will not be covered under the recruitment exception. This is because the recruitment exception limits expenses in an income guarantee to the actual incremental costs associated with the recruited physician. This limitation is intended to prevent a physician practice from shifting its overhead costs to a hospital to which the practice refers. As a result, any such payments will need to be structured to meet a compensation exception other than the recruitment exception.

While Stark generally does not allow a practice to include overhead costs in the income guarantee calculation, Stark III relaxes that restriction when physicians are recruited into a rural area or Health Professional Shortage Area (“HPSA”) to replace a physician who retired, relocated or died within the previous 12 months. In those situations, the practice may allocate a per capita portion of the practice’s aggregate overhead and other expenses, not to exceed 20% of the practice’s aggregate costs, when calculating hospital support under an income guarantee.

Finally, CMS clarified that the recruitment exception does not permit the use of the income guarantee/incremental expense provisions in situations where physicians simply co-locate with an existing practice, but do not join the existing group (*e.g.*, in a side-by-side space and expense-sharing arrangement).

Cross-town Recruitment

One requirement under Stark’s recruitment exception is that the physician must be “relocating” his or her practice to the geographic area served by the hospital. Stark II stated that “relocation” involved either (1) relocating the physician’s office a minimum of 25 miles; or (2) establishing that at least 75% of the physician’s revenues are derived from services provided to new patients. This definition sparked an ongoing debate about whether a hospital could provide support when recruiting a physician who already maintained a practice within the hospital’s service area, so long as the revenue test was met. On the one hand, the definition of “relocation” contained no explicit requirement of an actual move so long as 75% of revenues came from new patients. On the other hand, a physical office move seemed implicit in the very notion of a “relocation.”

In Stark III, CMS confirms that the recruited physician must relocate his or her medical practice from outside the hospital's geographic area in addition to satisfying one of the two tests noted above. Stark III allows cross-town recruiting, however, for physicians who have been employed for at least two years by (a) a federal or state entity operating correctional facilities, to serve exclusively a prison population; (b) the Department of Defense or the Department of Veterans Affairs to serve active or veteran military personnel and their families; or (c) facilities of the Indian Health Service to serve patients who receive their medical care exclusively through that agency. Each of these exceptions is subject to the proviso that the physician did not also maintain a separate private practice. CMS acknowledged that the unique nature of these patient populations would effectively prevent them from continuing their care with the physician or the recruiting hospital following the relocation of the physician's practice.

These exceptions are in addition to the existing carve-out under Stark II for residents and physicians in their first year of practice, to whom the relocation requirement does not apply. In addition, a hospital may now apply for an advisory opinion that a physician does not have an established medical practice whose patients are or could become patients of the recruiting hospital. Absent one of these sets of circumstances, Stark III generally spells the end of cross-town recruitment support.

Non-competes and Other Practice Restrictions

Stark III changes the physician recruitment rules to permit a group to impose practice restrictions so long as they do not unreasonably restrict the ability of the recruited physician to practice in the geographic area served by the recruiting hospital. Specific examples recognized by CMS as permissible include the requirement that a recruited physician pay reasonable liquidated damages if the physician leaves the practice and remains in the community; restrictions on the physician's ability to moonlight; confidentiality requirements; and nonsolicitation provisions.

This change is significant insofar as it may now permit a hospital to offer recruitment support to a practice group even if the recruit is required to accept a covenant not to compete with the group as a condition of employment. In the preamble to Phase II of the Stark regulations, CMS had indicated that it considered such non-competes to be impermissible practice restrictions. Under the final Phase III rule, however, a group may impose a non-compete and still remain eligible for recruitment support so long as the non-compete does not unreasonably restrict the recruited physician's ability to practice in the hospital's geographic area. The preamble to Stark III suggests that compliance with state and local laws governing non-competes will satisfy that requirement.

While this change is likely to be welcomed by recruiting hospitals and practice groups alike, it injects an element of risk and uncertainty into the arrangement. CMS has stated that the Stark regulations are intended to provide bright-line guidance on acceptable and unacceptable behavior. In this situation, however, the question of whether a recruitment arrangement is compliant with Stark may not be resolved unless and until a recruited physician challenges the enforceability of the non-compete. An adverse determination could have financial consequences for the hospital that far outweigh the group's inability to enforce the non-compete.

Retention Payments Under Stark III

Stark contains an exception for physician retention payments by a hospital or federally qualified health center located in a HPSA. The Phase III rules relax the requirements that must be met in order to offer such payments by permitting (under specified conditions) retention payments even when the physician does not have a written offer to relocate the physician's practice; by adding flexibility for physicians in underserved areas; and by allowing rural health clinics to make retention payments. In order to waive the written offer requirement, the physician must make certain written certifications as to the terms of the competing employment opportunity. The hospital, rural health clinic, or FQHC must take reasonable steps to verify that information.

Stark III clarifies that the amount of the retention payment is not limited to what it would cost to recruit a new physician; rather, the amount may take into account the retained physician's experience, training and length of service in the area. CMS also confirmed that retention payments must be made directly to the physician, and not to the physician's group practice.

Non-Physician Practitioners

In the preamble to Stark III, CMS notes its concern regarding recruiting support payments made to non-physician practitioners. While such payments do not directly implicate Stark (since they involve payments to a non-physician), they may raise issues if the effect of the payment is to subsidize a physician's costs in recruiting and employing those non-physician practitioners. By relieving the physician of certain costs of the practice, the hospital is in effect creating a compensation arrangement with the physician for which no exception would apply. CMS stated that "these kinds of subsidy arrangements pose a substantial risk of fraud and abuse."

The End of the Indirect Approach?

As discussed in a companion Legal Update, Stark II treated payments by hospitals to physician practices as potential "indirect" rather than "direct" financial relationships between the hospitals and the physicians in the practice. Due to nuances in Stark II's definition of an indirect compensation arrangement, it was possible that a recruitment payment to a physician practice might not give rise to any financial relationship between the hospital and the individual physicians so long as the hospital could demonstrate that the payment did not, in the aggregate, vary with or otherwise reflect the volume or value of referrals between the physician and the hospital.

For example, if a physician practice was structured so that it did not have any physician owners who received profit distributions from the practice, and if the aggregate compensation received by the physician employees did not vary with or otherwise reflect referrals, no direct relationship with the physician, the arrangement would not trigger Stark's referral prohibitions. This opened a possible avenue for recruitment arrangements that would not otherwise qualify for the specific recruitment exception.

The use of the indirect compensation analysis to avoid the requirements of the recruitment exception was controversial, and its availability was limited. Stark III has now significantly changed the equation and further limited the ability to rely on the indirect approach, perhaps eliminating that route altogether. As discussed in our companion article, Stark III now treats compensation that flows from a hospital to a physician through an intervening physician organization as a direct compensation arrangement rather than a potential indirect arrangement. The physician in these situations is deemed to "stand in the shoes" of the physician organization, such that the arrangement must meet an exception applicable to direct compensation arrangements – in this case, the recruitment exception.

The question remains whether physician recruitment arrangements that involve an intervening entity other than a physician organization may still be analyzed as a potential indirect arrangement rather than under the new stand-in-the-shoes doctrine. Stark III defines a "physician organization" as a physician (including a professional corporation of which the physician is the sole owner), a physician practice or a group practice.

CMS apparently did not intend the term "physician organization" to be all-encompassing, but it remains unclear what types of entities might fall outside the scope of that term. For purposes of this article, the focus is on whether there are entities to which a hospital might provide recruitment support, but which do not qualify as a "physician organization" under Stark III. In such a situation, the employed physicians would not stand in the shoes of the entity – and any recruitment support paid by a hospital to the entity would not create a direct compensation arrangement between the employed physicians and the hospital. If that support does not vary with or otherwise reflect referrals by the employed physicians to the hospital, then the support payments also should not give rise to an indirect financial arrangement. Absent the existence of either a direct or indirect financial relationship, the hospital would not need to structure the payment to meet the strict criteria of Stark's recruitment exception.

Hospitals should tread carefully before offering recruitment support in any form that does not comply with Stark's recruitment exception. While support payments to an intervening entity that is neither a group practice nor a physician practice may avoid the stand-in-the-shoes analysis, hospitals should seek further guidance before relying on the indirect compensation approach when determining compliance under Stark III.

Effective Date

The Stark III changes go into effect as of December 4, 2007. Hospitals should review existing arrangements and, where necessary, take steps to unwind or restructure noncompliant arrangements prior to that date. Hospitals and rural health clinics wishing to take advantage of Stark III's more flexible provisions (for example, by offering recruitment support to practice groups that impose reasonable non-competes on recruited physicians) should time their new arrangements to go into effect after that date.

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